

**\$993,450,000**  
**Puerto Rico Electric Power Authority**  
**\$509,520,000 Power Revenue Bonds, Series RR**  
**\$483,930,000 Power Revenue Refunding Bonds, Series SS**

The Power Revenue Bonds, Series RR (the “Series RR Bonds”) and the Power Revenue Refunding Bonds, Series SS (the “Series SS Bonds”) and, together with the Series RR Bonds, the “Bonds”) of Puerto Rico Electric Power Authority (the “Authority”) are being issued pursuant to a Trust Agreement, dated as of January 1, 1974, as amended, between the Authority and U.S. Bank Trust National Association, New York, New York, successor trustee (the “1974 Agreement”).

The Bonds, the outstanding bonds previously issued under the 1974 Agreement and any additional bonds that the Authority may from time to time issue under the 1974 Agreement are payable solely from the net revenues of the Authority’s electric generating, transmission and distribution system. The Bonds will have the following characteristics:

- The Bonds will be dated their date of delivery.
- The Bonds will be registered under the book-entry only system of The Depository Trust Company (“DTC”). Purchasers of the Bonds will not receive certificates evidencing the Bonds.
- Interest on the Bonds will be payable on January 1, 2006 and on each January 1 and July 1 thereafter.
- The Bonds will be subject to redemption, commencing on July 1, 2015, as described herein.
- The inside cover page contains information concerning the maturity schedule, interest rates and yields of the Bonds.
- The scheduled payment of principal of and interest on some of the Bonds will be insured by CDC IXIS Financial Guaranty North America, Inc., Financial Guaranty Insurance Company, Financial Security Assurance Inc., MBIA Insurance Corporation, or XL Capital Assurance Inc., as indicated on the inside cover page of this Official Statement.
- In the opinion of Squire, Sanders & Dempsey L.L.P., Bond Counsel, under existing law (i) assuming continuing compliance with certain covenants and the accuracy of certain representations, interest on the Bonds is excluded from gross income for federal income tax purposes and is not an item of tax preference for purposes of the federal alternative minimum tax imposed on individuals and corporations, and (ii) the Bonds and the interest thereon are exempt from state, Commonwealth of Puerto Rico and local income taxation. Interest on the Bonds may be subject to certain federal taxes imposed only on certain corporations, including the corporate alternative minimum tax on a portion of that interest. For a more complete discussion of the tax aspects of the Bonds, see *Tax Matters* herein.
- The Authority expects that the Bonds will be available for delivery to DTC on or about April 4, 2005.
- The issuance of the Bonds and the purchase of the Bonds by the Underwriters are subject to the approval of legality by Squire, Sanders & Dempsey L.L.P., Bond Counsel, and certain other conditions. O’Neill & Borges, San Juan, Puerto Rico, will pass upon certain legal matters for the Underwriters.

**The Bonds are not a debt or obligation of the Commonwealth of Puerto Rico or any of its municipalities or other political subdivisions, other than the Authority, and neither the Commonwealth of Puerto Rico nor any such municipalities or other political subdivisions, other than the Authority, shall be liable for the payment of the principal of or interest on the Bonds.**

**JPMorgan**

**Merrill Lynch & Co.**

**Morgan Stanley**

**Banc of America Securities LLC**

**Citigroup**

**Goldman, Sachs & Co**

**Lehman Brothers**

**Raymond James & Associates, Inc. Samuel Ramírez & Co.**

**UBS Financial Services Inc.**

**Wachovia Bank, National Association**

March 24, 2005

**\$993,450,000**  
**Puerto Rico Electric Power Authority**

**\$509,520,000 Power Revenue Bonds, Series RR**

**\$483,930,000 Power Revenue Refunding Bonds, Series SS**

<u>Maturity (July 1)</u>	<u>Principal Amount</u>	<u>Interest Rate</u>	<u>Yield</u>
2020**	\$ 21,310,000	5.00%	4.15%*
2021*	22,410,000	5.00	4.21*
2022*	23,560,000	5.00	4.26*
2023*	24,765,000	5.00	4.30*
2024*	26,035,000	5.00	4.33*
2025++	27,370,000	5.00	4.44*
2026++	28,770,000	5.00	4.45*
2027++	30,245,000	5.00	4.47*
2028**	31,800,000	5.00	4.52*
2029**	33,430,000	5.00	4.55*
2030++	35,145,000	5.00	4.54*
\$204,680,000 5.00% Series RR Term Bonds due July 1, 2035* - Yield 4.48 %*			

<u>Maturity (July 1)</u>	<u>Principal Amount</u>	<u>Interest Rate</u>	<u>Yield</u>
2007	\$ 8,115,000	3.00%	2.86 %
2008	3,490,000	4.00	3.04
2008	5,030,000	3.00	3.04
2009	5,285,000	5.00	3.22
2009	3,545,000	3.125	3.22
2010	4,815,000	5.00	3.39
2010	4,375,000	3.30	3.39
2011+	1,310,000	5.00	3.32
2011+	8,230,000	3.30	3.32
2012**	13,320,000	3.55	3.51
2013+	4,565,000	3.60	3.63
2013+	22,640,000	5.00	3.63
2014+	2,105,000	3.625	3.74
2014+	9,515,000	4.00	3.74
2014+	20,020,000	5.00	3.74
2015+	2,865,000	3.75	3.84
2015+	14,395,000	5.00	3.84
2016+	18,105,000	5.00	3.93 *
2017+	170,000	3.875	4.00
2017+	1,380,000	4.25	4.00 *
2017+	17,665,000	5.00	4.00 *
2018+	20,140,000	5.00	4.05 *
2019**	23,040,000	5.00	4.11 *
2019+	2,950,000	4.00	4.11
2019+	37,055,000	5.00	4.11 *
2020+	3,720,000	4.00	4.15
2020+	38,245,000	5.00	4.15 *
2021+	44,030,000	5.00	4.21 *
2022+	985,000	4.125	4.26
2022+	22,945,000	5.00	4.26 *
2023+	25,120,000	5.00	4.30 *
2024+	1,085,000	4.25	4.33
2024+	25,310,000	5.00	4.33 *
2025+	1,525,000	4.30	4.36
2025+	26,180,000	5.00	4.36 *
2030**	5,000,000	4.375	4.58
2030	2,760,000	4.625	4.68

- \* Yield to July 1, 2015 call date
- \*\* Insured by CIFGNA
- \* Insured by FGIC
- \*\* Insured by FSA
- + Insured by MBIA
- ++ Insured by XLCA

\$32,900,000 5.00% Series SS Term Bonds  
due July 1, 2030\*\* - Yield 4.46%\*

No dealer, broker, sales representative or other person has been authorized by the Authority or the Underwriters to give any information or to make any representations, other than those contained herein, and, if given or made, such other information or representations must not be relied upon as having been authorized by the Authority or any Underwriters. This Official Statement does not constitute an offer to sell, or the solicitation of an offer to buy, nor shall there be any sale of the Bonds offered hereby by any person in any jurisdiction in which it is unlawful for such person to make such offer, solicitation or sale. The information set forth herein has been obtained from the Authority, the Commonwealth of Puerto Rico, and other official sources that are believed to be reliable, but it is not guaranteed as to accuracy or completeness and is not to be construed as a representation by any Underwriter. The information and expressions of opinion herein are subject to change without notice, and neither the delivery of this Official Statement nor any sale made hereunder shall, under any circumstances, create any implication that there has been no change in the affairs of the Authority or the Commonwealth of Puerto Rico since the date hereof.

The Underwriters have provided the following sentence, as well as the following paragraph, for inclusion in this Official Statement: The Underwriters have reviewed the information in this Official Statement in accordance with, and as part of their respective responsibilities to investors under, the federal securities laws as applied to the facts and circumstances of this transaction, but the Underwriters do not guarantee the accuracy or completeness of such information.

IN CONNECTION WITH THIS OFFERING, THE UNDERWRITERS MAY OVERALLOT OR EFFECT TRANSACTIONS WHICH STABILIZE OR MAINTAIN THE MARKET PRICES OF THE BONDS OFFERED HEREBY AND OF THE AUTHORITY'S OUTSTANDING POWER REVENUE BONDS AT LEVELS ABOVE THOSE WHICH MIGHT OTHERWISE PREVAIL IN THE OPEN MARKET. SUCH STABILIZING, IF COMMENCED, MAY BE DISCONTINUED AT ANY TIME.

CERTAIN STATEMENTS CONTAINED IN THIS OFFICIAL STATEMENT REFLECT NOT HISTORICAL FACTS BUT FORECASTS AND "FORWARD-LOOKING STATEMENTS." THESE STATEMENTS ARE BASED UPON A NUMBER OF ASSUMPTIONS AND ESTIMATES THAT ARE SUBJECT TO SIGNIFICANT UNCERTAINTIES, MANY OF WHICH ARE BEYOND THE CONTROL OF THE AUTHORITY. IN THIS RESPECT, THE WORDS "ESTIMATES," "PROJECTS," "ANTICIPATES," "EXPECTS," "INTENDS," "BELIEVES" AND SIMILAR EXPRESSIONS ARE INTENDED TO IDENTIFY FORWARD-LOOKING STATEMENTS. ALL PROJECTIONS, FORECASTS, ASSUMPTIONS, EXPRESSIONS OF OPINIONS, ESTIMATES AND OTHER FORWARD-LOOKING STATEMENTS ARE EXPRESSLY QUALIFIED IN THEIR ENTIRETY BY THIS CAUTIONARY STATEMENT: ACTUAL RESULTS MAY DIFFER MATERIALLY FROM THOSE EXPRESSED OR IMPLIED BY FORWARD-LOOKING STATEMENTS.

Other than with respect to the information concerning CDC IXIS Financial Guaranty North America, Inc. ("CIFGNA"), Financial Guaranty Insurance Company ("FGIC"), Financial Security Assurance Inc. ("FSA"), MBIA Insurance Corporation ("MBIA") and XL Capital Assurance Inc. ("XLCA") contained under the heading "Bond Insurance" of this Official Statement, none of the information in this Official Statement has been supplied or verified by CIFGNA, FGIC, FSA, MBIA or XLCA. CIFGNA, FGIC, FSA, MBIA and XLCA make no representation or warranty, express or implied, as to (i) the accuracy or completeness of such information, (ii) the validity of the Bonds, or (iii) the tax exempt status of the interest on the Bonds.

**TABLE OF CONTENTS**

	<u>Page</u>		<u>Page</u>
INTRODUCTORY STATEMENT.....	1	Notes.....	43
RECENT DEVELOPMENTS.....	2	Government Development Bank Lines of Credit.....	43
OVERVIEW.....	2	Principal and Interest Requirements.....	43
Operating Results.....	3	<b>NET REVENUES AND COVERAGE.....</b>	<b>44</b>
System Improvements and Additional Capacity.....	4	Management’s Discussion and Analysis of Operating Results.....	46
<b>PLAN OF FINANCING.....</b>	<b>5</b>	Factors Affecting the Utility Industry.....	47
Series RR Bonds.....	5	Projected Net Revenues.....	48
Series SS Bonds.....	5	<b>ENVIRONMENTAL MATTERS.....</b>	<b>51</b>
Estimated Sources and Uses of Funds.....	7	Environmental Litigation and Administrative Proceedings.....	51
<b>SECURITY.....</b>	<b>8</b>	Compliance Programs.....	52
Source of Payment.....	8	<b>INSURANCE.....</b>	<b>54</b>
Flow of Funds under 1974 Agreement.....	8	Coverage.....	54
Rate Covenant.....	10	Self-insurance Fund.....	55
Reserve Account.....	10	<b>LABOR RELATIONS.....</b>	<b>56</b>
Reserve Maintenance Fund, Self-insurance Fund and Capital Improvement Fund.....	10	<b>PENSION PLAN.....</b>	<b>56</b>
Additional Bonds.....	11	<b>LITIGATION.....</b>	<b>57</b>
Subordinate Obligations.....	11	<b>TAX MATTERS.....</b>	<b>58</b>
<b>BOND INSURANCE.....</b>	<b>12</b>	Original Issue Discount and Original Issue Premium.....	58
The CIFGNA Bond Insurance Policy.....	12	<b>VERIFICATION OF MATHEMATICAL COMPUTATIONS.....</b>	<b>59</b>
The FGIC Bond Insurance Policy.....	13	<b>UNDERWRITING.....</b>	<b>60</b>
The FSA Bond Insurance Policy.....	16	<b>MATERIAL RELATIONSHIPS.....</b>	<b>60</b>
The MBIA Bond Insurance Policy.....	17	<b>LEGAL MATTERS.....</b>	<b>60</b>
The XLCA Bond Insurance Policy.....	19	<b>LEGAL INVESTMENT.....</b>	<b>60</b>
Certain Rights of the Bond Insurers.....	21	<b>GOVERNMENT DEVELOPMENT BANK FOR PUERTO RICO.....</b>	<b>61</b>
<b>PROPOSED SUPPLEMENTAL AGREEMENT.....</b>	<b>21</b>	<b>INDEPENDENT ACCOUNTANTS.....</b>	<b>61</b>
<b>DESCRIPTION OF THE BONDS.....</b>	<b>22</b>	<b>RATINGS.....</b>	<b>61</b>
General.....	22	<b>CONTINUING DISCLOSURE.....</b>	<b>61</b>
Book-Entry Only System.....	22	<b>MISCELLANEOUS.....</b>	<b>63</b>
Discontinuance of the Book-Entry Only System.....	24	<b>APPENDIX I - Definitions of Certain Terms.....</b>	<b>I-1</b>
Mandatory Redemption.....	24	Summary of Certain Provisions of the 1974 Agreement Excluding Proposed Supplemental Agreement.....	I-8
Optional Redemption.....	25	Summary of Certain Provisions of Proposed Supplemental Agreement.....	I-21
<b>THE AUTHORITY.....</b>	<b>26</b>	<b>APPENDIX II - Audited Financial Statements.....</b>	<b>II-1</b>
Powers.....	26	<b>APPENDIX III - Letter of the Consulting Engineers.....</b>	<b>III-1</b>
Management.....	26	<b>APPENDIX IV - Proposed Form of Bond Counsel Opinion.....</b>	<b>IV-1</b>
<b>THE SYSTEM.....</b>	<b>28</b>	<b>APPENDIX V - Specimen of CIFGNA Insurance Policy.....</b>	<b>V-1</b>
Generating Facilities.....	28	<b>APPENDIX VI - Specimen of FGIC Insurance Policy.....</b>	<b>VI-1</b>
Transmission and Distribution Facilities.....	30	<b>APPENDIX VII - Specimen of FSA Insurance Policy.....</b>	<b>VII-1</b>
Adequacy of Capacity.....	32	<b>APPENDIX VIII - Specimen of MBIA Insurance Policy.....</b>	<b>VIII-1</b>
Statistical Information.....	34	<b>APPENDIX IX - Specimen of XLCA Insurance Policy.....</b>	<b>IX-1</b>
Historical Capital Improvement and Financing Program.....	36		
Projected Five-Year Capital Improvement and Financing Program.....	36		
Rates.....	37		
Major Clients.....	39		
Fuel.....	39		
Subsidies, Contributions in Lieu of Taxes and Set Aside.....	40		
<b>DEBT.....</b>	<b>42</b>		
Rural Electrification Bonds.....	43		

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**INTRODUCTORY STATEMENT**

The purpose of this Official Statement of Puerto Rico Electric Power Authority (the “Authority”), which includes the cover page, the Appendices hereto and the information incorporated by reference as set forth below, is to furnish information in connection with the issuance and sale by the Authority of its Power Revenue Bonds, Series RR (the “Series RR Bonds”), and its Power Revenue Refunding Bonds, Series SS (the “Series SS Bonds” and, together with the Series RR Bonds, the “Bonds”).

The Bonds will be issued under and secured by a Trust Agreement, dated as of January 1, 1974, as amended (the “1974 Agreement”), between the Authority and U.S. Bank Trust National Association, successor trustee (the “1974 Trustee”). The Bonds, the other Puerto Rico Electric Power Authority Power Revenue Bonds and Power Revenue Refunding Bonds to be outstanding after the issuance of the Bonds, and such additional bonds as may be issued from time to time under the 1974 Agreement, are hereinafter collectively referred to as the “Power Revenue Bonds.”

Payment of the principal of and interest on the Series RR Bonds maturing July 1, 2028 and July 1, 2029, the Series SS Bonds maturing July 1, 2012, and the \$5,000,000 principal amount of the 4.375% Series SS Bonds maturing July 1, 2030, as indicated on the inside cover page of this Official Statement (the “CIFGNA Insured Bonds”), when due, will be insured by a financial guaranty insurance policy to be issued by CDC IXIS Financial Guaranty North America, Inc. (“CIFGNA”) simultaneously with the delivery of the CIFGNA Insured Bonds.

Payment of the principal of and interest on the Series RR Bonds maturing July 1, 2021 through July 1, 2024, inclusive, and the Series RR Term Bonds maturing July 1, 2035, as indicated on the inside cover page of this Official Statement (the “FGIC Insured Bonds”), when due, will be insured by a financial guaranty insurance policy to be issued by Financial Guaranty Insurance Company (“FGIC”) simultaneously with the delivery of the FGIC Insured Bonds.

Payment of the principal of and interest on the Series RR Bonds maturing July 1, 2020, the \$23,040,000 principal amount of 5% Series SS Bonds maturing July 1, 2019, and the 5% Series SS Term Bonds maturing July 1, 2030, as indicated on the inside cover page of this Official Statement (the “FSA Insured Bonds”), when due, will be insured by a financial guaranty insurance policy to be issued by Financial Security Assurance Inc. (“FSA”) simultaneously with the delivery of the FSA Insured Bonds.

Payment of the principal of and interest on the Series SS Bonds maturing July 1, 2011, the Series SS Bonds maturing July 1, 2013 through July 1, 2018, inclusive, the \$2,950,000 principal amount of the 4% Series SS Bonds maturing July 19, 2019, the \$37,055,000 principal amount of the 5% Series SS Bonds maturing July 19, 2019, and the Series SS Bonds maturing July 1, 2020 through July 1, 2025, inclusive, as indicated on the inside cover page of this Official Statement (the “MBIA Insured Bonds”), when due, will be insured by a financial guaranty insurance policy to be issued by MBIA Insurance Corporation (“MBIA”) simultaneously with the delivery of the MBIA Insured Bonds.

Payment of the principal of and interest on the Series RR Bonds maturing July 1, 2025 through July 1, 2027, inclusive, and the Series RR Bonds maturing July 1, 2030, as shown on the inside cover page of this Official Statement (the “XLCA Insured Bonds”), when due, will be insured by a municipal bond insurance policy to be issued by XL Capital Assurance Inc. (“XLCA”) simultaneously with the delivery of the XLCA Insured Bonds.

Capitalized terms used in this Official Statement and not defined shall have the meanings given to them in Appendix I, *Definitions of Certain Terms*.

In order to give potential purchasers of the Bonds general information on the Commonwealth of Puerto Rico (the “Commonwealth” or “Puerto Rico”), this Official Statement incorporates by reference the sections under the headings “Introduction” and “The Economy” of the Commonwealth of Puerto Rico Financial Information and Operating Data Report, dated August 1, 2004, which is attached as Appendix I to the Official Statement of the Commonwealth, dated September 24, 2004, relating to the issuance by the Commonwealth of its \$440,460,000 Public Improvement Bonds, Series 2005 A (General Obligation Bonds), and its \$93,790,000 Public Improvement Bonds, Series 2005 B (General Obligation Bonds), and under the heading “Recent Developments” in such Official Statement, which has been filed with each nationally recognized municipal securities information repository (“NRMSIR”). The Financial Information and Operating Data Report and the Official Statement for the Commonwealth’s General Obligation Bonds were not prepared by the Authority, and the Authority does not assume any responsibility for their accuracy or completeness. The Commonwealth does not guarantee the Bonds and is not otherwise responsible for their payment.

Any appendix of an Official Statement of the Commonwealth or any appendix of an Official Statement of any instrumentality of the Commonwealth containing the same information as the Financial Information and Operating Data Report that is filed with each NRMSIR and the Municipal Securities Rulemaking Board (“MSRB”) after the date hereof and prior to the termination of any offering of the Bonds shall be deemed to be incorporated by reference into this Official Statement to the extent set forth in the preceding paragraph and to be part of this Official Statement from the date of filing of such document. Any statement contained herein or in any of the above described documents or portions thereof incorporated herein by reference shall be deemed to be modified or superseded for purposes of this Official Statement to the extent that a statement contained herein or in any other subsequently filed document modifies or supersedes such statement. Any such statement so modified or superseded shall not be deemed, except as so modified or superseded, to constitute a part of this Official Statement.

## **RECENT DEVELOPMENTS**

On March 17, 2005, the President of the Governing Board of the Authority announced that Héctor M. Alejandro Narváez, until then the Vice Executive Director of the Authority, had been named Acting Executive Director of the Authority. Mr. Alejandro Narváez replaced Mr. Héctor Rosario, who was relieved of his duties by the Board as a result of differences between Mr. Rosario and the Board that could not be resolved. Mr. Alejandro Narváez is a chemical engineer and a lawyer with more than 30 years of experience at the Authority. For a brief summary of Mr. Alejandro Narváez’s work experience, see “Management” under *The Authority* below. The President of the Governing Board, himself a former Executive Director of the Authority, and the other members of the Authority’s Governing Board do not anticipate any changes in the Authority’s business strategy as a result of this management change, nor do they anticipate any other changes in the Authority’s senior management at this time.

## **OVERVIEW**

The Authority supplies virtually all of the electric power consumed in the Commonwealth and is one of the largest municipal utilities in the United States. The Authority was created in 1941 as a public corporation and governmental instrumentality of the Commonwealth. As of December 31, 2004, it served approximately 1.4 million clients and had utility plant totaling approximately \$8.3 billion, including \$2.4 billion of production plant in service and \$3.2 billion of transmission and distribution plant in service, all based on original cost. The Authority’s production facilities, together with two private co-generation facilities with long-term power purchase contracts with the Authority, have a dependable generating capacity of 5,365 megawatts (“MW”). As of December 31, 2004, the Authority had 2,338 circuit miles of

transmission lines and 30,248 circuit miles of distribution lines. In August 2004, the Authority realized a historical peak load of 3,560 MW.

For the twelve months ended December 31, 2004, the average percentage of the Authority's generating capacity available for service ("equivalent availability"), which includes the two co-generation facilities mentioned above, was 85%, up from 72% for fiscal year 1995. Improved availability, together with the Authority's progress in implementing its capacity expansion plan and improving its transmission and distribution system, have led to gains in the reliability of the Authority's electrical service to its clients.

## **Operating Results**

During the period from fiscal year 2000 through fiscal year 2004, the number of clients served by the Authority increased at a compound annual rate of 1.4%, and electric energy sales in kilowatt hours ("kWh") increased at a compound annual rate of 2.8%. During this period, Revenues and Current Expenses increased at a compound annual rate of 6.6% and 7.8%, respectively. Excluding the cost of fuel oil and purchased power, both of which costs are passed on to clients through a separate charge included in electric service rates, Revenues and Current Expenses increased during such period at a compound annual rate of 0.55% and 3.1% respectively, primarily due to higher energy demand.

During the first six months of fiscal year 2005, Revenues and Current Expenses increased by 9.0% and 13.0%, respectively, compared to the same period for the prior fiscal year. The increase in Revenues and Current Expenses was mainly due to an increase of \$4.85 per barrel (or 16.8%) in the price of fuel oil and an increase of \$0.012 per kWh (or 18.4%) in the average price of purchased power by the Authority. Excluding the cost of fuel oil and purchased power, Revenues and Current Expenses increased by 0.7% and 8.2%, respectively, compared to the same period of the prior fiscal year. Revenues during this period were adversely affected by Tropical Storm Jeanne, which struck Puerto Rico in September of 2004 and caused power interruptions throughout the Island.

Net Revenues increased at a compound annual rate of 3.2% during the period from fiscal year 2000 to fiscal year 2004. For the first six months of fiscal year 2005, Net Revenues decreased by 2.7% compared to the same period in fiscal year 2004.

Demand for energy is related to the level of economic and business activity in the Commonwealth, energy costs and climatological factors. The Commonwealth Planning Board's preliminary reports of the performance of the Puerto Rico economy during fiscal year 2004 indicate that the economy registered an increase of 2.8% in real gross product. The Planning Board reports indicate that real gross product increased by 2.0% in fiscal year 2003, decreased by 0.3% in fiscal year 2002, increased by 1.5% in fiscal year 2001, and increased by 3.0% in fiscal year 2000. For fiscal year 2005, the Planning Board is forecasting an increase in real gross product of 2.7%. Projections of future peak energy demand for the five fiscal year period ending June 30, 2009, prepared by the Authority, show an average annual increase of 2.3%.

The following table summarizes the operating results of the Authority for the five fiscal years ended June 30, 2004 and for the six-month periods ended December 31, 2004 and 2005. This table presents Net Revenues of the Authority under the provisions of the 1974 Agreement. These calculations of Net Revenues differ in several important respects from the Authority's calculations of changes in net assets prepared in accordance with generally accepted accounting principles. See Schedule II to the Financial Statements for the fiscal years ended June 30, 2003 and 2004 in Appendix II for a reconciliation of the Authority's change in net assets under generally accepted accounting principles with its Net Revenues under the 1974 Agreement.

**Operating Results**  
(dollars in thousands)

	Fiscal Years Ended June 30,					Six Months Ended December 31,	
	2000	2001	2002	2003	2004	2003	2004
Electric energy sales (in millions of kWh).....	18,145	18,723	19,130	19,887	20,260	10,524	10,441
Percentage change from year before .....	6.8%	3.2%	2.2%	3.9%	1.9%	2.7%	(0.8)%
Peak load (in MW).....	3,133	3,202	3,297	3,376	3,499	3,499	3,560
Percentage change from year before .....	2.4%	2.2%	3.0%	2.4%	3.6%	3.6%	1.7%
Total Revenues .....	\$2,025,284	\$2,373,077	\$2,193,681	\$ 2,536,250	\$2,613,006	\$1,317,288	\$1,438,687
Less: Current Expenses.....	\$1,466,823	\$1,722,689	\$1,566,595	\$ 1,871,476	\$1,979,756	\$ 979,877	\$1,110,311
Net Revenues.....	<u>\$ 558,461</u>	<u>\$ 650,388</u>	<u>\$ 627,086</u>	<u>\$ 664,774</u>	<u>\$ 633,250</u>	<u>\$ 337,411</u>	<u>\$ 328,376</u>
Principal and Interest Requirements.....	\$ 346,417	\$ 367,796	\$ 392,043	\$ 381,178	\$ 427,088	-	-
Ratio of Net Revenues to Principal and Interest Requirements.....	1.61	1.77	1.60	1.74 <sup>(1)</sup>	1.48	-	-

(1) Takes into consideration the reduction in debt service caused by refunding transactions. Excluding the effect of refunding transactions, the ratio would have been 1.6 in 2003.

### System Improvements and Additional Capacity

In order to meet the expected growth in demand, diversify its fuel sources to reduce its historic reliance on oil-fired generating units, and continue to improve the reliability of its service, the Authority has been investing in the improvement, rehabilitation and life extension of its generating, transmission and distribution facilities and has acquired additional capacity pursuant to long-term power purchase agreements with the operators of two privately owned cogeneration facilities.

The Authority entered into a long-term contract with EcoEléctrica, L.P. (“EcoEléctrica”) to purchase 507 MW of dependable generating capacity from a natural gas-fired cogeneration plant built by EcoEléctrica and located in Peñuelas, Puerto Rico, which commenced commercial operation in March of 2000. The Authority also entered into a long-term contract with AES Puerto Rico, L.P. (“AES-PR”) to purchase 454 MW of dependable generating capacity from a coal-fired cogeneration facility built by AES-PR and located in Guayama, Puerto Rico, which commenced commercial operation in November of 2002. These contracts allow the Authority to reduce its dependency on fuel oil while passing on to EcoEléctrica and AES-PR the risks of operating the cogeneration facilities. The contracts include these companies’ agreement to provide a fixed capacity at a higher availability level than the Authority currently achieves.

The Authority recently obtained the permits required for replacing two 44 MW steam units in San Juan, removed from service in fiscal year 1997, with new generating units that are projected to provide a net total of 464 MW of combined cycle capacity. Construction started during the summer of 2004, and the units are expected to be operational during fiscal year 2007.

The Authority is also expanding its 230 kilovolt (“kV”) transmission lines, which add to the stability of the electric system, improve reliability of service to clients, and reduce transmission losses. The Authority is constructing new 230 kV transmission lines to complete the transmission loop on the eastern part of the island. Construction is expected to be completed during August of 2005. In addition, the Authority is constructing a new 230 kV transmission line between the South Coast Steam Plant and the transmission center in Aguas Buenas. The new transmission line is expected to be in service during fiscal year 2008.



Set forth below is a summary of the Authority’s historical total capital improvement program and financing sources for the five fiscal years ended June 30, 2004 and the projected capital improvement program and financing sources for the five fiscal years ending June 30, 2009. See “Historical Capital Improvement and Financing Program” and “Projected Five-Year Capital Improvement and Financing Program” under *The System*.

**Capital Improvements  
(dollars in thousands)**

<u>Capital Improvements</u>	<u>Fiscal Years</u>			
	<u>2000-2004</u>	<u>% of Total</u>	<u>2005-2009</u>	<u>% of Total</u>
Production Plant .....	\$ 651,724	31.8%	\$ 803,630	37.8%
Transmission facilities.....	432,479	21.1	505,159	23.7
Distribution facilities.....	623,033	30.4	468,061	22.0
Other <sup>(1)</sup> .....	342,259	16.7	350,486	16.5
	<u>\$2,049,495</u>	<u>100.0%</u>	<u>\$2,127,336</u>	<u>100.0%</u>
 <u>Financing Sources</u> 				
Internally generated funds.....	\$ 439,675	21.5%	\$ 414,562	19.5%
Borrowed funds.....	1,609,820	78.5	1,712,744	80.5
	<u>\$2,049,495</u>	<u>100.0%</u>	<u>\$2,127,336</u>	<u>100.0%</u>

(1) Includes land and buildings, general equipment, preliminary surveys and investigations.

**PLAN OF FINANCING**

**Series RR Bonds**

The Authority is issuing the Series RR Bonds pursuant to Section 208 of the 1974 Agreement to finance a portion of the cost of various projects under its capital improvement program for fiscal years 2005 and 2006, to repay notes held by the Government Development Bank for Puerto Rico issued by the Authority for such purpose, and to pay capitalized interest on Series RR Bonds through January 1, 2006.

**Series SS Bonds**

The Authority is issuing the Series SS Bonds pursuant to Section 210 of the 1974 Agreement to refund the following Power Revenue Bonds (the “Refunded Bonds”) on the redemption dates and at the redemption prices set forth below plus accrued interest to the redemption dates:

Refunded Bonds	Maturity Date	Principal Amount to be Refunded	Interest Rate	Redemption Date	Redemption Price
Series Z	7/1/2006	\$ 1,530,000	5.100%	7/1/2005	102.0%
	7/1/2007	7,405,000	5.250	7/1/2005	102.0
	7/1/2008	7,795,000	5.000	7/1/2005	102.0
	7/1/2009	8,185,000	5.400	7/1/2005	102.0
	7/1/2010	8,625,000	5.500	7/1/2005	102.0
	7/1/2011	9,100,000	5.500	7/1/2005	102.0
	7/1/2012	13,220,000	5.500	7/1/2005	102.0
	7/1/2021 <sup>(1)</sup>	60,490,000	5.250	7/1/2005	100.0
Series AA	7/1/2005	4,000,000 <sup>(2)</sup>	4.900	At maturity	N/A
	7/1/2006	1,500,000 <sup>(3)</sup>	6.000	At maturity	N/A
	7/1/2013	13,090,000 <sup>(4)</sup>	5.400	7/1/2007	101.5
	7/1/2014	15,380,000	5.375	7/1/2007	101.5
	7/1/2015	16,205,000	5.250	7/1/2007	101.5
	7/1/2016	17,055,000	5.250	7/1/2007	101.5
	7/1/2017	17,950,000	5.250	7/1/2007	101.5
	7/1/2022 <sup>(5)</sup>	105,710,000	5.625	7/1/2007	101.5
	7/1/2023	24,840,000	5.625	7/1/2007	101.5
7/1/2027 <sup>(6)</sup>	53,885,000	5.375	7/1/2007	101.5	
Series BB	7/1/2013	14,690,000	5.400	7/1/2007	101.5
	7/1/2014	15,595,000	5.375	7/1/2007	101.5
Series EE	7/1/2005	2,740,000 <sup>(7)</sup>	5.000	At maturity	N/A
Series GG	7/1/2005	5,875,000	3.800	At maturity	N/A
Series HH	7/1/2019	22,880,000	5.625	7/1/2010	101.0
	7/1/2030	40,330,000	5.375	7/1/2005	101.0
Series KK	7/1/2005	7,765,000	4.000	At maturity	N/A
Series MM	7/1/2005	11,000,000 <sup>(8)</sup>	4.000	At maturity	N/A

- (1) Represents the Amortization Requirements due July 1 of the years 2019, 2020 and 2021.  
(2) Represents a portion of the \$9,450,000 aggregate principal amount maturing on July 1, 2005.  
(3) Represents a portion of the \$9,915,000 aggregate principal amount maturing on July 1, 2006.  
(4) Represents a portion of the \$14,590,000 aggregate principal amount maturing on July 1, 2013.  
(5) Represents the Amortization Requirements due July 1 of the years 2018, 2019, 2020, 2021 and 2022.  
(6) Represents the Amortization Requirements due July 1 of the years 2024 and 2025.  
(7) Represents a portion of the \$7,575,000 aggregate principal amount maturing on July 1, 2005.  
(8) Represents a portion of the \$12,270,000 aggregate principal amount maturing on July 1, 2005.

The refunding will permit the Authority to realize savings on its debt service requirements on Power Revenue Bonds outstanding under the 1974 Agreement. The Authority will deposit the net proceeds of the Series SS Bonds with the 1974 Trustee, as escrow agent, under the terms of an escrow deposit agreement. The net proceeds of the Series SS Bonds will be invested in Government Obligations, the principal of and interest on which when due will provide moneys sufficient to pay the principal of or the redemption price of the Refunded Bonds and the interest coming due on the Refunded Bonds through their date of redemption.

Upon the deposit with the 1974 Trustee referred to above, the Refunded Bonds will, in the opinion of Bond Counsel, no longer be outstanding under the provisions of the 1974 Agreement and the Refunded Bonds will thereupon be defeased. In rendering the foregoing opinion, Bond Counsel will rely on the report of The Arbitrage Group, Inc., as verification agent, dated the date of delivery of the Bonds, relating to the verification of certain mathematical computations with respect to the moneys and Government Obligations deposited with the escrow agent under the terms of the escrow deposit agreement.

### Estimated Sources and Uses of Funds

#### *Series RR Bonds*

Sources:

Principal amount of the Series RR Bonds.....	\$ 509,520,000.00
Original issue premium.....	<u>23,496,510.60</u>
Total Sources .....	<u>\$ 533,016,510.60</u>

Uses:

Deposit to 1974 Construction Fund.....	\$ 332,067,172.17
Repayment of Government Development Bank Line of Credit <sup>(1)</sup> .....	167,932,827.83
Capitalized interest on Series RR Bonds through January 1, 2006 .....	18,481,477.27
Underwriting discount, municipal bond insurance premiums, and estimated legal, printing and other financing expenses.....	<u>14,535,033.33</u>
Total Uses .....	<u>\$ 533,016,510.60</u>

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(1) Includes \$12,900,000 expected to be drawn under a Government Development Bank line of credit between the date of this Official Statement and the expected date of delivery of the Bonds.

#### *Series SS Bonds*

Sources:

Principal amount of the Series SS Bonds.....	\$ 483,930,000.00
Net original issue premium.....	28,084,075.15
Other available moneys <sup>(1)</sup> .....	<u>30,315,281.82</u>
Total Sources .....	<u>\$ 542,329,356.97</u>

Uses:

Deposit to Escrow Fund for the Refunded Bonds.....	\$ 533,090,846.40
Underwriting discount, municipal bond insurance premiums, and estimated legal, printing and other financing expenses.....	<u>9,238,510.57</u>
Total Uses .....	<u>\$ 542,329,356.97</u>

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(1) Derived from moneys on deposit in the Bond Service Account and Redemption Account of the 1974 Sinking Fund to pay debt service on the Refunded Bonds.

## SECURITY

The Bonds are not a debt or obligation of the Commonwealth or any of its municipalities or other political subdivisions, other than the Authority, and neither the Commonwealth nor any such municipalities or other political subdivisions, other than the Authority, are liable thereon, nor shall the Bonds be payable out of any funds other than those of the Authority as further described herein.

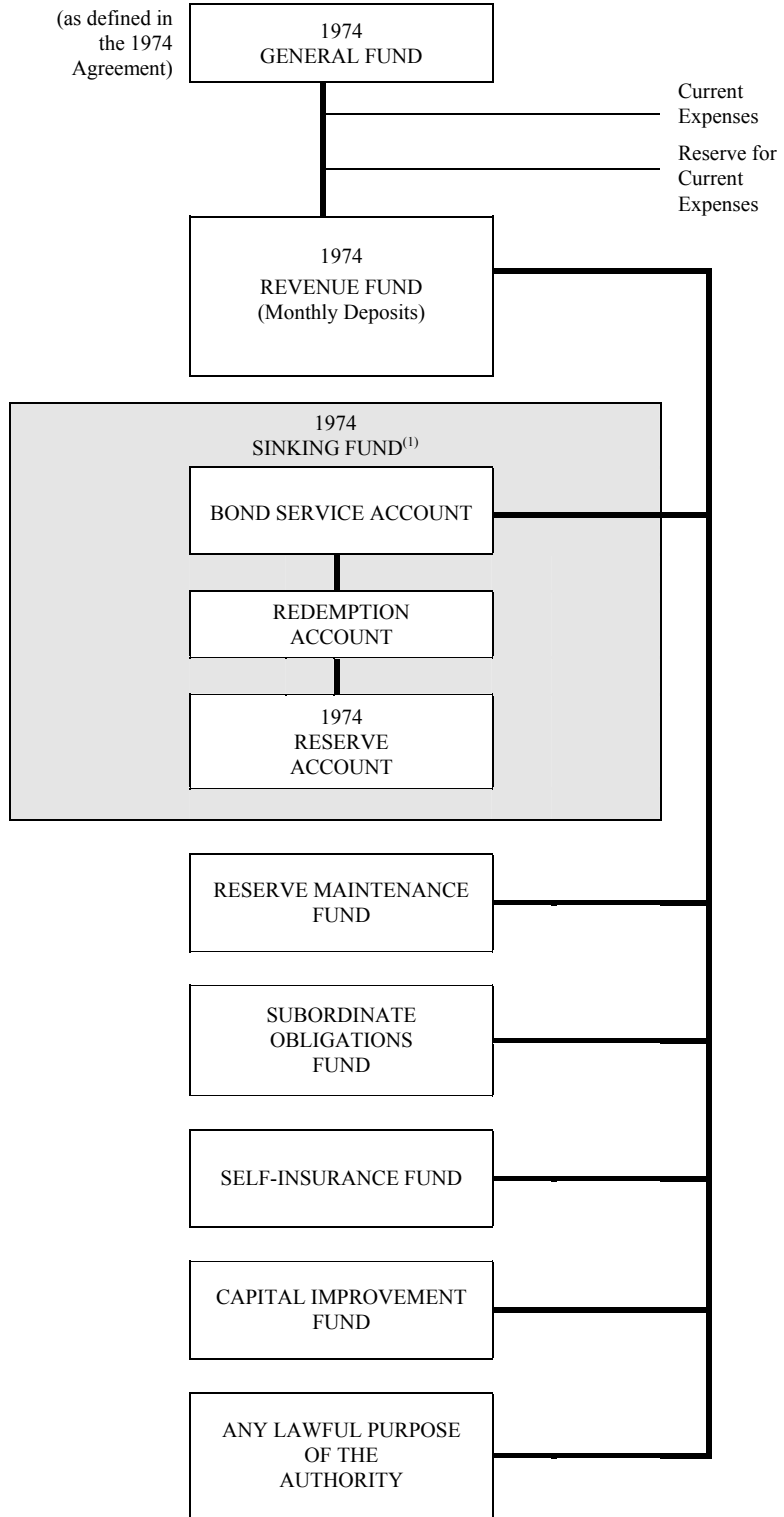
### **Source of Payment**

The Power Revenue Bonds are payable solely from the Revenues of the System after payment of the Current Expenses of the Authority and any reserve therefor. For purposes of the 1974 Agreement and this Official Statement, the “System” means all the properties owned and operated by the Authority as a single integrated system in connection with the production, distribution or sale of electric energy, the acquisition or construction of which was financed in whole or in part from the proceeds of Power Revenue Bonds or from the proceeds of bonds issued under a previous indenture, or from moneys deposited to certain accounts established under the 1974 Agreement, or (to the extent specified by the Authority) from certain subordinated obligations; “Revenues” means all moneys received by the Authority as a result of the ownership or operation of the System, proceeds of certain insurance, and certain investment income; and “Current Expenses” means the Authority’s reasonable and necessary current expenses of maintaining, repairing and operating the System. The Authority has covenanted to deposit in the 1974 Sinking Fund a sufficient amount of such Revenues (after payment of Current Expenses) to pay the principal of and the interest on all the Power Revenue Bonds and to provide a reserve therefor. See Appendix I, *Summary of Certain Provisions of the 1974 Agreement Excluding Proposed Supplemental Agreement*, which should be read in conjunction herewith.

### **Flow of Funds under 1974 Agreement**

The following schematic representation is provided only to guide readers and does not purport to be complete.

**REVENUES**



(1) Monthly deposits to the Bond Service Account and the Redemption Account for all Power Revenue Bonds are capped at 1/6 of the interest due on the next interest payment date and 1/12 of the principal due on the next principal payment date and 1/12 of Amortization Requirements for the current fiscal year.

## **Rate Covenant**

The Authority has covenanted in the 1974 Agreement to fix, charge and collect reasonable rates and charges so that Revenues of the System will be sufficient to pay Current Expenses and to provide an amount at least equal to 120% of the aggregate Principal and Interest Requirements for the next fiscal year on account of all outstanding Power Revenue Bonds, reduced by any accrued interest thereon for such fiscal year. For purposes of calculating Principal and Interest Requirements under the rate covenant and the additional bonds tests described below, the Accreted Value of any capital appreciation bonds of the Authority on their maturity dates shall be included as principal due and payable on said maturity dates. The Accreted Value at any date of a capital appreciation bond currently outstanding equals the original principal amount of such capital appreciation bond plus the interest accrued from its date of issuance to such date, based upon the interest rate used to calculate the yields thereof, compounded in the manner provided in the 1974 Agreement, and for future issues of capital appreciation bonds will be determined as provided in the respective resolutions of the Authority authorizing such issues. See "Rate Covenant" in Appendix I, *Summary of Certain Provisions of the 1974 Agreement Excluding Proposed Supplemental Agreement*.

## **Reserve Account**

The Authority has covenanted in the 1974 Agreement to accumulate in the 1974 Reserve Account an amount equal to the interest payable on all outstanding Power Revenue Bonds within the next 12 months, provided that for Power Revenue Bonds issued for other than refunding purposes, the amount to be so deposited in any month, as set forth in "Disposition of Revenues" in Appendix I, *Summary of Certain Provisions of the 1974 Agreement Excluding Proposed Supplemental Agreement*, need not exceed one-sixtieth of the amount of the increase in the interest payable within the next 12 months resulting from the issuance of such Power Revenue Bonds. In connection with the capital appreciation bonds of the Authority, the minimum amount required to be on deposit in the 1974 Reserve Account with respect to the interest accrued thereon is to be derived from the interest rate used to calculate the assumed yields through their maturity times the Accreted Value of such Power Revenue Bonds determined in the manner provided in the 1974 Agreement on the valuation date therefor occurring on or after the first day of the twelfth month succeeding the date of calculation.

As of January 31, 2005, approximately \$249.3 million was on deposit to the credit of the 1974 Reserve Account. The amount required to be accumulated in the 1974 Reserve Account will be approximately \$263.4 million after giving effect to (i) the issuance of Power Revenue Bonds issued for non-refunding purposes within the previous 60 months and (ii) the issuance of the Bonds and the Authority's Series QQ Bonds, which are expected to be delivered on April 4, 2005, and the refunding of the Refunded Bonds and the Power Revenue Bonds to be refunded with the Series QQ Bonds. The difference between the current balance in the 1974 Reserve Account and the amount required to be accumulated therein will be covered by monthly deposits by the Authority in the required monthly amounts as described above.

## **Reserve Maintenance Fund, Self-insurance Fund and Capital Improvement Fund**

The 1974 Agreement establishes the Reserve Maintenance Fund, the Self-insurance Fund and the Capital Improvement Fund. Revenues are deposited monthly into each of such Funds after the required deposits into the 1974 Sinking Fund as set forth in the schematic representation above for purposes of (a) paying the cost of unusual or extraordinary maintenance or repairs, maintenance or repairs not recurring annually and renewals and replacements, including major items of equipment, in the case of the Reserve Maintenance Fund, (b) paying the cost of repairing, replacing or reconstructing any property damaged or destroyed from, or extraordinary expenses incurred as a result of, a cause which is not covered by insurance required by the 1974 Agreement, in the case of the Self-insurance Fund, and (c) paying the cost of anticipated extensions and improvements which cost has not otherwise been provided for from the proceeds of the Power Revenue Bonds, in the case of the Capital Improvement Fund. Each of these Funds serves as an additional reserve for the payment of principal of and interest on Power Revenue Bonds and meeting the Amortization

Requirements to the extent that moneys in the 1974 Sinking Fund (including the 1974 Reserve Account) are insufficient for such purpose. As of December 31, 2004, the balances of the Reserve Maintenance Fund and the Self-insurance Fund were \$46.7 million and \$62.5 million, respectively. In addition, as of such date, the Authority had set aside \$32.3 million for the Capital Improvement Fund. See “Disposition of Revenues” in Appendix I, *Summary of Certain Provisions of the 1974 Agreement Excluding Proposed Supplemental Agreement*.

### **Additional Bonds**

Additional Power Revenue Bonds may be issued under the 1974 Agreement for the purpose of paying all or any part of the cost of any improvements to the System or for any other proper corporate purpose of the Authority; provided that, among other requirements, Net Revenues (as defined in the 1974 Agreement) of the Authority for 12 consecutive months out of the preceding 18 months, adjusted to reflect rates in effect on the date of issuance of such bonds, shall be not less than 120% of maximum aggregate annual Principal and Interest Requirements for all Power Revenue Bonds then outstanding, and that the average annual Net Revenues for the five fiscal years succeeding the issuance of such bonds, adjusted to reflect any rate schedule the Authority has covenanted to put in effect during such five fiscal years, as estimated by the Authority and approved by its Consulting Engineers, shall be not less than 120% of the maximum aggregate annual Principal and Interest Requirements for all Power Revenue Bonds then outstanding and the Power Revenue Bonds then to be issued.

Power Revenue Refunding Bonds may also be issued under the 1974 Agreement for the purpose of refunding all or any part of the outstanding Power Revenue Bonds of any series, provided that, among other requirements, either (i) the earnings tests described above for the issuance of additional Power Revenue Bonds are satisfied (except that effect is given to the retirement of the bonds to be refunded) or (ii) the maximum aggregate Principal and Interest Requirements for any fiscal year thereafter on account of all outstanding Power Revenue Bonds and the bonds then to be issued (after giving effect to the retirement of the bonds to be refunded) shall be less than the maximum aggregate Principal and Interest Requirements on account of all outstanding Power Revenue Bonds (excluding the bonds then to be issued). See “Issuance of Power Revenue Bonds - Sections 208, 209 and 210 of the 1974 Agreement” in Appendix I, *Summary of Certain Provisions of the 1974 Agreement Excluding Proposed Supplemental Agreement*.

Under the earnings coverage tests of the 1974 Agreement, Net Revenues for the twelve months ended December 31, 2004 of \$633.8 million were 143% of the maximum aggregate annual Principal and Interest Requirements of \$442.4 million on all outstanding Power Revenue Bonds. Estimated average annual Net Revenues for the five fiscal years ending June 30, 2010 of \$749.3 million would be 158% of the maximum aggregate annual Principal and Interest Requirements of \$473.8 million on all outstanding Power Revenue Bonds (including the Bonds, but excluding the Refunded Bonds; see *Debt* below).

### **Subordinate Obligations**

The Authority may incur or issue obligations for any proper corporate purpose secured by a pledge of moneys in the Subordinate Obligations Fund. If the Authority incurs any such obligations, Net Revenues of the Authority must be deposited monthly to the credit of the Subordinate Obligations Fund (after the required deposits have been made to the 1974 Sinking Fund and the Reserve Maintenance Fund) in amounts sufficient to pay such obligations as they become due.

The Authority may, in connection with the incurrence of any such obligations, limit the deposit to the Reserve Maintenance Fund as described above to not more than \$400,000 per month, notwithstanding any higher amounts recommended by the Authority’s Consulting Engineers. If such deposit is so limited, the Authority will be required, immediately after each monthly deposit to the Subordinate Obligations Fund, to deposit to the Reserve Maintenance Fund (and prior to any deposits to the Self-insurance Fund and the Capital Improvement Fund) the lesser of the amount remaining in the 1974 Revenue Fund and the amount of any such deficiency.

Unless a particular project financed with any such obligations is specified by the Authority as being part of the System, any revenues attributable to such project will not be pledged to the payment of Power Revenue Bonds and any expenses associated with such project will not be payable from Revenues as Current Expenses of the System. See “Disposition of Revenues” in Appendix I, *Summary of Certain Provisions of the 1974 Agreement Excluding Proposed Supplemental Agreement*.

## **BOND INSURANCE**

### **The CIFGNA Bond Insurance Policy**

The following information has been furnished by CIFGNA for use in this Official Statement. No representation is made by the Authority or the Underwriters as to the accuracy or completeness of this information.

*CIFGNA and the CIFGNA Insurance Policy.* CIFGNA is a monoline financial guaranty insurance company incorporated under the laws of the State of New York, with its principal place of business in New York City.

The claims-paying ability (also referred to as its financial strength) of CIFGNA is rated “AAA” by Fitch, “Aaa” by Moody’s, and “AAA” by Standard and Poor’s, the highest rating assigned by each such rating agency. Each rating of CIFGNA should be evaluated independently. The ratings reflect the respective rating agency’s current assessment of the creditworthiness of CIFGNA and its ability to pay claims on its policies of insurance based upon, among other factors, the adequacy of the net worth maintenance and reinsurance agreements provided by CIFG described below under “Capitalization.” Any further explanation as to the significance of the above ratings may be obtained only from the applicable rating agency. The above ratings are not recommendations to buy, sell or hold the CIFGNA Insured Bonds, and such ratings may be subject to revision or withdrawal at any time by the rating agencies. Any downward revision or withdrawal of any of the above ratings may have an adverse effect on the market price of the CIFGNA Insured Bonds. CIFGNA does not guarantee the market price of the CIFGNA Insured Bonds nor does it guaranty that the ratings on the CIFGNA Insured Bonds will not be revised or withdrawn.

CIFGNA is licensed and subject to regulation as a financial guaranty insurance corporation under the laws of the State of New York, its state of domicile, and is licensed to do business in over 40 jurisdictions. CIFGNA is subject to Article 69 of the New York Insurance Law which, among other things, limits the business of such insurers to financial guaranty insurance and related lines, requires that each such insurer maintain a minimum surplus to policyholders, establishes contingency, loss and unearned premium reserve requirements for each such insurer, and limits the size of individual transactions (“single risks”) and the volume of transactions (“aggregate risks”) that may be underwritten by such insurers. Other provisions of the New York Insurance Law applicable to non-life insurance companies such as CIFGNA regulate, among other things, permitted investments, payment of dividends, transactions with affiliates, mergers, consolidations, acquisitions or sales of assets and incurrence of liabilities for borrowings. CIFGNA is required to file quarterly and annual statutory financial statements with the New York State Insurance Department (“NYSID”), and is subject to statutory restrictions concerning the types and quality of its investments and the filing and use of policy forms and premium rates. Additionally, CIFGNA’s accounts and operations are subject to periodic examination by the NYSID.

**THE INSURANCE PROVIDED BY THE CIFGNA INSURANCE POLICY IS NOT COVERED BY THE PROPERTY/CASUALTY INSURANCE SECURITY FUND SPECIFIED BY THE INSURANCE LAWS OF THE STATE OF NEW YORK.**

*Capitalization.* In addition to its capital and surplus as set forth below, CIFGNA is supported by a net worth maintenance agreement from its indirect parent, CIFG Guaranty, a French reinsurance corporation



(“CIFG”). The net worth maintenance agreement provides that CIFG will maintain CIFGNA’s U.S. statutory capital and surplus at no less than \$80 million. In addition, through a facultative reinsurance agreement, CIFGNA may cede up to 90% of its exposure on each transaction to CIFG; however, the facultative reinsurance agreement does not require that CIFG reinsure its exposure under any transaction. CIFG’s claims paying ability is rated “Aaa” by Moody’s, “AAA” by Standard & Poor’s and “AAA” by Fitch, the highest rating assigned by each such rating agency. Notwithstanding these net worth maintenance and reinsurance agreements, the holders of the CIFGNA Insured Bonds will have direct recourse only against CIFGNA, and neither CIFG nor any other affiliate of CIFGNA will be directly liable to the holders of the CIFGNA Insured Bonds.

The following table sets forth the capitalization of CIFGNA as of December 31, 2004, on the basis of accounting principles prescribed or permitted by the NYSID (in thousands):

Common capital stock	\$ 19,700
Gross paid in and contributed surplus	\$ 120,925
Unassigned funds (retained deficit)	\$ (26,997)
Surplus as regards policyholders	\$ 113,628

There has been no material adverse change in the capitalization of CIFGNA from December 31, 2004 to the date of this Official Statement.

Audited financial statements of CIFGNA as of December 31, 2003, prepared in accordance with statutory accounting principles applicable to insurance companies, may be obtained by writing to CIFGNA at 825 Third Avenue, 6th Floor, New York, New York 10022, Attention: Finance Department. The toll-free telephone number of CIFGNA is (866) CIFG -212.

The CIFGNA insurance policy for the CIFGNA Insured Bonds (“CIFGNA Policy”) does not protect investors against changes in market value of the CIFGNA Insured Bonds, which market value may be impaired as a result of changes in prevailing interest rates, changes in applicable ratings or other causes. CIFGNA makes no representation regarding the CIFGNA Insured Bonds or the advisability of investing in the CIFGNA Insured Bonds. CIFGNA makes no representation regarding this Official Statement, nor has it participated in the preparation thereof, except that CIFGNA has provided to the Authority the information presented under this subheading for inclusion in this Official Statement.

Effective February 23, 2005, the Department of Insurance of the State of New York approved the change of the Company’s name to CIFG Assurance North America, Inc. Applications for approval of the name change are being filed with regulators in all other jurisdictions in which the Company is licensed, including the Commonwealth, and in the event the name change is approved by the Commissioner of Insurance of the Commonwealth prior to the delivery date of the CIFGNA Policy, the CIFGNA Policy will be issued under the Company’s new name.

### **The FGIC Bond Insurance Policy**

The following information has been supplied by FGIC for inclusion in this Official Statement. No representation is made by the Authority or the Underwriters as to the accuracy or completeness of this information.

*Payments under the FGIC Policy.* Concurrently with the issuance of the FGIC Insured Bonds, FGIC will issue its FGIC insurance policy for the FGIC Insured Bonds (the “FGIC Policy”). The FGIC Policy unconditionally guarantees the payment of that portion of the principal or accreted value (if applicable) of and interest on the FGIC Insured Bonds, which has become due for payment, but shall be unpaid by reason of nonpayment by the Authority. FGIC will make such payments to U.S. Bank Trust National Association, or its successor as its agent (the “Fiscal Agent”), on the later of the date on which such principal, accreted value or interest (as applicable) is due or on the business day next following the

day on which FGIC shall have received notice (in accordance with the terms of the FGIC Policy) from an owner of FGIC Insured Bonds or the 1974 Trustee or paying agent (if any) of the nonpayment of such amount by the Authority. The Fiscal Agent will disburse such amount due on any FGIC insured bond to its owner upon receipt by the Fiscal Agent of evidence satisfactory to the Fiscal Agent of the owner's right to receive payment of the principal, accreted value or interest (as applicable) due for payment and evidence, including any appropriate instruments of assignment, that all of such owner's rights to payment of such principal, accreted value or interest (as applicable) shall be vested in FGIC. The term "nonpayment" in respect of a FGIC insured bond includes any payment of principal, accreted value or interest (as applicable) made to an owner of a FGIC insured bond which has been recovered from such owner pursuant to the United States Bankruptcy Code by a trustee in bankruptcy in accordance with a final, non-appealable order of a court having competent jurisdiction.

Once issued, the FGIC Policy is non-cancelable by FGIC. The FGIC Policy covers failure to pay principal (or accreted value, if applicable) of the FGIC Insured Bonds on their stated maturity dates and their mandatory sinking fund redemption dates, and not on any other date on which the FGIC Insured Bonds may have been otherwise called for redemption, accelerated or advanced in maturity. The FGIC Policy also covers the failure to pay interest on the stated date for its payment. If the payment of any of the FGIC Insured Bonds is accelerated, or become subject to mandatory redemption, FGIC will only be obligated to pay principal (or accreted value, if applicable) and interest on the originally scheduled principal amounts (including mandatory sinking fund redemption) and interest payment dates. Upon such payment, FGIC will become the owner of the FGIC insured bond, appurtenant coupon or right to payment of principal or interest on such FGIC insured bond and will be fully subrogated to all of the bondholder's rights thereunder.

The FGIC Policy does not insure any risk other than nonpayment by the Authority, as defined in the FGIC Policy. Specifically, the FGIC Policy does not cover: (i) payment on acceleration, as a result of a call for redemption (other than mandatory sinking fund redemption) or as a result of any other advancement of maturity; (ii) payment of any redemption, prepayment or acceleration premium; or (iii) nonpayment of principal (or accreted value, if applicable) or interest caused by the insolvency or negligence or any other act or omission of the 1974 Trustee, paying agent or registrar, if any.

As a condition of its commitment to insure FGIC Insured Bonds, FGIC may be granted certain rights under the 1974 Agreement. The specific rights, if any, granted to FGIC in connection with its insurance of the FGIC Insured Bonds may be set forth in the description of the principal legal documents appearing elsewhere in this Official Statement, and reference is made thereto.

The FGIC Policy is not covered by the Property/Casualty Insurance Security Fund specified in Article 76 of the New York Insurance Law.

FGIC, a New York stock insurance corporation, is a direct, wholly-owned subsidiary of FGIC Corporation, a Delaware corporation, and provides financial guaranty insurance for public finance and structured finance obligations. FGIC is licensed to engage in financial guaranty insurance in all 50 states, the District of Columbia and the Commonwealth of Puerto Rico and, through a branch, in the United Kingdom.

On December 18, 2003, an investor group consisting of The PMI Group, Inc. ("PMI"), affiliates of The Blackstone Group L.P. ("Blackstone"), affiliates of The Cypress Group L.L.C. ("Cypress") and affiliates of CIVC Partners L.P. ("CIVC") acquired FGIC Corporation (the "FGIC Acquisition") from a subsidiary of General Electric Capital Corporation ("GE Capital"). PMI, Blackstone, Cypress and CIVC acquired approximately 42%, 23%, 23% and 7%, respectively, of FGIC Corporation's common stock. FGIC paid GE Capital approximately \$284.3 million in pre-closing dividends from the proceeds of dividends it, in turn, had received from FGIC, and GE Capital retained approximately \$234.6 million in liquidation preference of FGIC Corporation's convertible participating preferred stock and approximately 5% of FGIC Corporation's

common stock. Neither FGIC Corporation nor any of its shareholders is obligated to pay any debts of FGIC or any claims under any insurance policy, including the FGIC Policy, issued by FGIC.

FGIC is subject to the insurance laws and regulations of the State of New York, where it is domiciled, including Article 69 of the New York Insurance Law (“Article 69”), a comprehensive financial guaranty insurance statute. FGIC is also subject to the insurance laws and regulations of all other jurisdictions in which it is licensed to transact insurance business. The insurance laws and regulations, as well as the level of supervisory authority that may be exercised by the various insurance regulators, vary by jurisdiction, but generally require insurance companies to maintain minimum standards of business conduct and solvency, to meet certain financial tests, to comply with requirements concerning permitted investments and the use of policy forms and premium rates and to file quarterly and annual financial statements on the basis of statutory accounting principles (“SAP”) and other reports. In addition, Article 69, among other things, limits the business of each financial guaranty insurer, including FGIC, to financial guaranty insurance and certain related lines.

For the years ended December 31, 2004, and December 31, 2003, FGIC had written directly or assumed through reinsurance, guaranties of approximately \$59.5 billion and, \$42.4 billion par value of securities, respectively (of which approximately 56% and 79%, respectively, constituted guaranties of municipal bonds), for which it had collected gross premiums of approximately \$323.6 million and, \$260.3 million, respectively. For the year ended December 31, 2004, FGIC had reinsured, through facultative and excess of loss arrangements, approximately 2.3% of the risks it had written.

As of December 31, 2004, FGIC had net admitted assets of approximately \$3.116 billion, total liabilities of approximately \$1.943 billion, and total capital and policyholders’ surplus of approximately \$1.173 billion, determined in accordance with statutory accounting practices prescribed or permitted by insurance regulatory authorities.

The audited financial statements of FGIC as of December 31, 2004, and the audited financial statements of FGIC as of December 31, 2003, which have been filed with the NRMSIRs, are hereby included by specific reference in this Official Statement. Any statement contained herein under “The FGIC Bond Insurance Policy” under *Bond Insurance* or in any documents included by specific reference herein, shall be modified or superseded to the extent required by any statement in any document subsequently filed by FGIC with such NRMSIRs, and shall not be deemed, except as so modified or superseded, to constitute a part of this Official Statement. All financial statements of FGIC (if any) included in documents filed by the Authority with the NRMSIRs subsequent to the date of this Official Statement and prior to the termination of the offering of the Bonds shall be deemed to be included by specific reference into this Official Statement and to be a part hereof from the respective dates of filing of such documents.

FGIC also prepares quarterly and annual financial statements on the basis of generally accepted accounting principles. Copies of FGIC’s most recent GAAP and SAP financial statements are available upon request to: FGIC, 125 Park Avenue, New York, NY 10017, Attention: Corporate Communications Department. FGIC’s telephone number is (212) 312-3000.

*FGIC’s Credit Ratings.* The financial strength of FGIC is rated “AAA” by Standard & Poor’s, a Division of The McGraw-Hill Companies, Inc., “Aaa” by Moody’s Investors Service, and “AAA” by Fitch Ratings. Each rating of FGIC should be evaluated independently. The ratings reflect the respective ratings agencies’ current assessments of the insurance financial strength of FGIC. Any further explanation of any rating may be obtained only from the applicable rating agency. These ratings are not recommendations to buy, sell or hold the FGIC Insured Bonds, and are subject to revision or withdrawal at any time by the rating agencies. Any downward revision or withdrawal of any of the above ratings may have an adverse effect on the market price of the FGIC Insured Bonds. FGIC does not guarantee the market price or investment value of the FGIC Insured Bonds nor does it guarantee that the ratings on the FGIC Insured Bonds will not be revised or withdrawn.

NEITHER FGIC NOR ANY OF ITS AFFILIATES ACCEPTS ANY RESPONSIBILITY FOR THE ACCURACY OR COMPLETENESS OF THE OFFICIAL STATEMENT OR ANY INFORMATION OR DISCLOSURE THAT IS PROVIDED TO POTENTIAL PURCHASERS OF THE FGIC INSURED BONDS, OR OMITTED FROM SUCH DISCLOSURE, OTHER THAN WITH RESPECT TO THE ACCURACY OF INFORMATION WITH RESPECT TO FGIC OR THE FGIC POLICY UNDER THIS SUBHEADING. IN ADDITION, FGIC MAKES NO REPRESENTATION REGARDING THE BONDS OR THE ADVISABILITY OF INVESTING IN THE BONDS.

### **The FSA Bond Insurance Policy**

The following information has been supplied by FSA for inclusion in this Official Statement. No representation is made by the Authority or the Underwriters as to the accuracy or completeness of this information.

Concurrently with the issuance of the Bonds, FSA will issue its Municipal Bond Insurance Policy for the Bonds (the "FSA Policy"). The FSA Policy guarantees the scheduled payment of principal of and interest when due on the FSA Insured Bonds.

The FSA Policy is not covered by any insurance security or guaranty fund established under New York, California, Connecticut or Florida insurance law.

FSA is a New York domiciled financial guaranty insurance company and a wholly owned subsidiary of Financial Security Assurance Holdings Ltd. ("Holdings"). Holdings is an indirect subsidiary of Dexia, S.A., a publicly held Belgian corporation, and of Dexia Credit Local, a direct wholly-owned subsidiary of Dexia, S.A. Dexia, S.A., through its bank subsidiaries, is primarily engaged in the business of public finance, banking and asset management in France, Belgium and other European countries. No shareholder of Holdings or FSA is liable for the obligations of FSA.

At September 30, 2004, FSA's total policyholders' surplus and contingency reserves were approximately \$2,255,933,000 and its total unearned premium reserve was approximately \$1,561,771,000 in accordance with statutory accounting practices. At September 30, 2004, FSA's total shareholder's equity was approximately \$2,612,989,000 and its total net unearned premium reserve was approximately \$1,286,985,000 in accordance with generally accepted accounting principles.

The financial statements included as exhibits to the annual and quarterly reports filed by Holdings with the Securities and Exchange Commission are hereby incorporated herein by reference. Also incorporated herein by reference are any such financial statements so filed from the date of this Official Statement until the termination of the offering of the Bonds. Copies of materials incorporated by reference will be provided upon request to FSA: 350 Park Avenue, New York, New York 10022, Attention: Communications Department (telephone (212) 826-0100).

THE FSA POLICY DOES NOT PROTECT INVESTORS AGAINST CHANGES IN MARKET VALUE OF THE FSA INSURED BONDS, WHICH MARKET VALUE MAY BE IMPAIRED AS A RESULT OF CHANGES IN PREVAILING INTEREST RATES, CHANGES IN APPLICABLE RATINGS OR OTHER CAUSES. FSA MAKES NO REPRESENTATION REGARDING THE FSA INSURED BONDS OR THE ADVISABILITY OF INVESTING IN THE FSA INSURED BONDS. FSA MAKES NO REPRESENTATION REGARDING THIS OFFICIAL STATEMENT, NOR HAS IT PARTICIPATED IN THE PREPARATION THEREOF, EXCEPT THAT FSA HAS PROVIDED TO THE AUTHORITY THE INFORMATION PRESENTED UNDER THIS SUBHEADING FOR INCLUSION IN THIS OFFICIAL STATEMENT.

## **The MBIA Bond Insurance Policy**

The following information has been furnished by MBIA Insurance Corporation for use in this Official Statement. No representation is made by the Authority or the Underwriters as to the accuracy or completeness of this information.

The MBIA Bond Insurance Policy unconditionally and irrevocably guarantees the full and complete payment required to be made by or on behalf of the Authority to the 1974 Trustee or its successor of an amount equal to (i) the principal of (either at the stated maturity or by an advancement of maturity pursuant to a mandatory sinking fund payment) and interest on, the MBIA Insured Bonds as such payments shall become due but shall not be so paid (except that in the event of any acceleration of the due date of such principal by reason of mandatory or optional redemption or acceleration resulting from default or otherwise, other than any advancement of maturity pursuant to a mandatory sinking fund payment, the payments guaranteed by the MBIA bond insurance policy for the MBIA Insured Bonds (“MBIA Policy”) shall be made in such amounts and at such times as such payments of principal would have been due had there not been any such acceleration, unless MBIA elects in its sole discretion, to pay in whole or in part any principal due by reason of such acceleration); and (ii) the reimbursement of any such payment which is subsequently recovered from any owner of the MBIA Insured Bonds pursuant to a final judgment by a court of competent jurisdiction that such payment constitutes an avoidable preference to such owner within the meaning of any applicable bankruptcy law (a “Preference”).

The MBIA Policy does not insure against loss of any prepayment premium which may at any time be payable with respect to any MBIA Insured Bond. The MBIA Policy does not, under any circumstance, insure against loss relating to: (i) optional or mandatory redemptions (other than mandatory sinking fund redemptions); (ii) any payments to be made on an accelerated basis; (iii) payments of the purchase price of MBIA Insured Bonds upon tender by an owner thereof; or (iv) any Preference relating to (i) through (iii) above. The MBIA Policy also does not insure against nonpayment of principal of or interest on the MBIA Insured Bonds resulting from the insolvency, negligence or any other act or omission of the 1974 Trustee or any other paying agent for the MBIA Insured Bonds.

Upon receipt of telephonic or electronic notice, such notice subsequently confirmed in writing by registered or certified mail, or upon receipt of written notice by registered or certified mail, by MBIA from the 1974 Trustee or any owner of a MBIA Insured Bond the payment of an insured amount for which is then due, that such required payment has not been made, MBIA on the due date of such payment or within one business day after receipt of notice of such nonpayment, whichever is later, will make a deposit of funds, in an account with U.S. Bank Trust National Association, in New York, New York, or its successor, sufficient for the payment of any such insured amounts which are then due. Upon presentment and surrender of such MBIA Insured Bonds or presentment of such other proof of ownership of the MBIA Insured Bonds, together with any appropriate instruments of assignment to evidence the assignment of the insured amounts due on the MBIA Insured Bonds as are paid by MBIA, and appropriate instruments to effect the appointment of MBIA as agent for such owners of the MBIA Insured Bonds in any legal proceeding related to payment of insured amounts on the MBIA Insured Bonds, such instruments being in a form satisfactory to U.S. Bank Trust National Association, U.S. Bank Trust National Association shall disburse to such owners or the 1974 Trustee payment of the insured amounts due on such MBIA Insured Bonds, less any amount held by the 1974 Trustee for the payment of such insured amounts and legally available therefor.

MBIA is the principal operating subsidiary of MBIA Inc., a New York Stock Exchange listed company (the “Company”). The Company is not obligated to pay the debts of or claims against MBIA. MBIA is domiciled in the State of New York and licensed to do business in and subject to regulation under the laws of all 50 states, the District of Columbia, the Commonwealth of Puerto Rico, the Commonwealth of the Northern Mariana Islands, the Virgin Islands of the United States and the Territory of Guam. MBIA has three branches, one in the Republic of France, one in the Republic of Singapore and one in the Kingdom of Spain. New York has laws prescribing minimum capital requirements, limiting classes and concentrations of investments and requiring the approval of policy rates and forms. State laws also regulate the amount of both

the aggregate and individual risks that may be insured, the payment of dividends by MBIA, changes in control and transactions among affiliates. Additionally, MBIA is required to maintain contingency reserves on its liabilities in certain amounts and for certain periods of time.

MBIA does not accept any responsibility for the accuracy or completeness of this Official Statement or any information or disclosure contained herein, or omitted herefrom, other than with respect to the accuracy of the information regarding the MBIA Policy and MBIA set forth under this subheading. Additionally, MBIA makes no representation regarding the Bonds or the advisability of investing in the Bonds.

The MBIA Policy is not covered by the Property/Casualty Insurance Security Fund specified in Article 76 of the New York Insurance Law.

*MBIA Information.* The following document, filed by the Company with the Securities and Exchange Commission (the "SEC"), is incorporated herein by reference:

- (1) The Company's Annual Report on Form 10-K for the year ended December 31, 2004.

Any documents filed by the Company pursuant to Sections 13(a), 13(c), 14 or 15(d) of the Securities Exchange Act of 1934, as amended, after the date of this Official Statement and prior to the termination of the offering of the MBIA Insured Bonds offered hereby shall be deemed to be incorporated by reference in this Official Statement and to be a part hereof. Any statement contained in a document incorporated or deemed to be incorporated by reference herein, or contained in this Official Statement, shall be deemed to be modified or superseded for purposes of this Official Statement to the extent that a statement contained herein or in any other subsequently filed document which also is or is deemed to be incorporated by reference herein modifies or supersedes such statement. Any such statement so modified or superseded shall not be deemed, except as so modified or superseded, to constitute a part of this Official Statement.

The Company files annual, quarterly and special reports, information statements and other information with the SEC under File No. 1-9583. Copies of the SEC filings (including (1) the Company's Annual Report on Form 10-K for the year ended December 31, 2004, and (2) the Company's Quarterly Reports on Form 10-Q for the quarters ended March 31, 2004, June 30, 2004 and September 30, 2004), are available (i) over the Internet at the SEC's web site at <http://www.sec.gov>, (ii) at the SEC's public reference room in Washington D.C.; (iii) over the Internet at the Company's web site at <http://www.mbia.com>; and (iv) at no cost, upon request to MBIA Insurance Corporation, 113 King Street, Armonk, New York 10504. The telephone number of MBIA is (914) 273-4545.

As of December 31, 2003, MBIA had admitted assets of \$9.9 billion (audited), total liabilities of \$6.2 billion (audited), and total capital and surplus of \$3.7 billion (audited) determined in accordance with statutory accounting practices prescribed or permitted by insurance regulatory authorities. As of December 31, 2004, MBIA had admitted assets of \$10.3 billion (unaudited), total liabilities of \$6.9 billion (unaudited), and total capital and surplus of \$3.3 billion (unaudited) determined in accordance with statutory accounting practices prescribed or permitted by insurance regulatory authorities.

*Financial Strength Ratings of MBIA.* Moody's Investors Service, Inc. rates the financial strength of MBIA "Aaa." Standard & Poor's Ratings Services, a division of The McGraw-Hill Companies, Inc., rates the financial strength of MBIA "AAA." Fitch Ratings rates the financial strength of MBIA "AAA."

Each rating of MBIA should be evaluated independently. The ratings reflect the respective rating agency's current assessment of the creditworthiness of MBIA and its ability to pay claims on its policies of insurance. Any further explanation as to the significance of the above ratings may be obtained only from the applicable rating agency.

THE ABOVE RATINGS ARE NOT RECOMMENDATIONS TO BUY, SELL OR HOLD THE MBIA INSURED BONDS, AND SUCH RATINGS MAY BE SUBJECT TO REVISION OR WITHDRAWAL AT ANY TIME BY THE RATING AGENCIES. ANY DOWNWARD REVISION OR WITHDRAWAL OF ANY OF THE ABOVE RATINGS MAY HAVE AN ADVERSE EFFECT ON THE MARKET PRICE OF THE MBIA INSURED BONDS. MBIA DOES NOT GUARANTY THE MARKET PRICE OF THE MBIA INSURED BONDS NOR DOES IT GUARANTY THAT THE RATINGS ON THE MBIA INSURED BONDS WILL NOT BE REVISED OR WITHDRAWN.

### **The XLCA Bond Insurance Policy**

The following information has been supplied by XLCA for inclusion in this Official Statement. No representation is made by the Authority or the Underwriters as to the accuracy or completeness of this information.

XLCA accepts no responsibility for the accuracy or completeness of this Official Statement or any other information or disclosure contained herein, or omitted herefrom, other than with respect to the accuracy of the information regarding XLCA and its affiliates set forth under this heading. In addition, XLCA makes no representation regarding the Bonds or the advisability of investing in the Bonds.

*General.* XLCA is a monoline financial guaranty insurance company incorporated under the laws of the State of New York. XLCA is currently licensed to do insurance business in, and is subject to the insurance regulation and supervision by, the State of New York, forty-eight other states, the District of Columbia, Puerto Rico, the U.S. Virgin Islands and Singapore. XLCA has a license application pending with the State of Wyoming, the only state in which it is not currently licensed.

XLCA is an indirect wholly owned subsidiary of XL Capital Ltd, a Cayman Islands corporation (“XL Capital Ltd”). Through its subsidiaries, XL Capital Ltd is a leading provider of insurance and reinsurance coverages and financial products to industrial, commercial and professional service firms, insurance companies and other enterprises on a worldwide basis. The common stock of XL Capital Ltd is publicly traded in the United States and listed on the New York Stock Exchange (NYSE: XL). XL Capital Ltd is not obligated to pay the debts of or claims against XLCA.

XLCA was formerly known as The London Assurance of America Inc. (“London”), which was incorporated on July 25, 1991 under the laws of the State of New York. On February 22, 2001, XL Reinsurance America Inc. (“XL Re”) acquired 100% of the stock of London. XL Re merged its former financial guaranty subsidiary, known as XL Capital Assurance Inc. (formed September 13, 1999) with and into London, with London as the surviving entity. London immediately changed its name to XL Capital Assurance Inc. All previous business of London was 100% reinsured to Royal Indemnity Company, the previous owner at the time of acquisition.

*Reinsurance.* XLCA has entered into a facultative quota share reinsurance agreement with XL Financial Assurance Ltd (“XLFA”), an insurance company organized under the laws of Bermuda, and an affiliate of XLCA. Pursuant to this reinsurance agreement, XLCA expects to cede up to 90% of its business to XLFA. XLCA may also cede reinsurance to third parties on a transaction-specific basis, which cessions may be any or a combination of quota share, first loss or excess of loss. Such reinsurance is used by XLCA as a risk management device and to comply with statutory and rating agency requirements and does not alter or limit XLCA's obligations under any financial guaranty insurance policy. With respect to any transaction insured by XLCA, the percentage of risk ceded to XLFA may be less than 90% depending on certain factors including, without limitation, whether XLCA has obtained third party reinsurance covering the risk. As a result, there can be no assurance as to the percentage reinsured by XLFA of any given financial guaranty insurance policy issued by XLCA, including policy for the XLCA Insured Bonds.

Based on the audited financials of XLFA, as of December 31, 2004, XLFA had total assets, liabilities, redeemable preferred shares and shareholders' equity of \$1,173,450,000, \$558,655,000, \$39,000,000 and

\$575,795,000, respectively, determined in accordance with generally accepted accounting principles in the United States (“U.S. GAAP”). XLFA’s insurance financial strength is rated “Aaa” by Moody’s and “AAA” by S&P and Fitch Inc. In addition, XLFA has obtained a financial enhancement rating of “AAA” from S&P.

The obligations of XLFA to XLCA under the reinsurance agreement described above are unconditionally guaranteed by XL Insurance (Bermuda) Ltd (“XLI”), a Bermuda company and one of the world's leading excess commercial insurers. XLI is a wholly owned indirect subsidiary of XL Capital Ltd. In addition to A.M. Best’s rating of “A+” (Negative Outlook), XLI’s insurance financial strength rating is “Aa2” (Outlook Negative) by Moody’s, “AA-” by Standard & Poor’s and “AA” (Ratings Watch Negative) by Fitch. The ratings of XLFA and XLI are not recommendations to buy, sell or hold securities, including the Bonds and are subject to revision or withdrawal at any time by Moody’s, Standard & Poor’s or Fitch.

Notwithstanding the capital support provided to XLCA described in this section, the bondholders will have direct recourse only against XLCA, and neither XLFA nor XLI will be directly liable to the bondholders.

*Financial Strength and Financial Enhancement Ratings of XLCA.* XLCA’s insurance financial strength is rated “Aaa” by Moody’s and “AAA” by Standard & Poor’s and Fitch, Inc. (“Fitch”). In addition, XLCA has obtained a financial enhancement rating of “AAA” from Standard & Poor’s. These ratings reflect Moody’s, Standard & Poor’s and Fitch's current assessment of XLCA's creditworthiness and claims-paying ability as well as the reinsurance arrangement with XLFA described under “Reinsurance” above.

The above ratings are not recommendations to buy, sell or hold securities, including the Bonds and are subject to revision or withdrawal at any time by Moody’s, Standard & Poor’s or Fitch. Any downward revision or withdrawal of these ratings may have an adverse effect on the market price of the Bonds. XLCA does not guaranty the market price of the Bonds nor does it guaranty that the ratings on the Bonds will not be revised or withdrawn.

*Capitalization of XLCA.* Based on the audited financials of XLCA, as of December 31, 2004, XLCA had total assets, liabilities, and shareholder’s equity of \$827,815,000, \$593,849,000, and \$233,966,000, respectively, determined in accordance with U.S. GAAP.

Based on the unaudited statutory financial statements for XLCA as of December 31, 2004 filed with the State of New York Insurance Department, XLCA has total admitted assets of \$341,937,445, total liabilities of \$144,232,151 and total capital and surplus of \$197,705,294 determined in accordance with statutory accounting practices prescribed or permitted by insurance regulatory authorities (“SAP”). Based on the audited statutory financial statements for XLCA as of December 31, 2003 filed with the State of New York Insurance Department, XLCA has total admitted assets of \$329,701,823, total liabilities of \$121,635,535 and total capital and surplus of \$208,066,288 determined in accordance with SAP.

*Incorporation by Reference of Financials.* For further information concerning XLCA and XLFA, see the financial statements of XLCA and XLFA, and the notes thereto, incorporated by reference to this Official Statement. The financial statements of XLCA and XLFA are included as exhibits to the periodic reports filed with the Securities and Exchange Commission (the “Commission”) by XL Capital Ltd and may be reviewed at the EDGAR website maintained by the Commission. All financial statements of XLCA and XLFA included in, or as exhibits to, documents filed by XL Capital Ltd pursuant to Section 13(a), 13(c), 14 or 15(d) of the Securities Exchange Act of 1934 on or prior to the date of this Official Statement, or after the date of this Official Statement but prior to termination of the offering of the Bonds, shall be deemed incorporated by reference in this Official Statement. Except for the financial statements of XLCA and XLFA, no other information contained in XL Capital Ltd’s reports filed with the Commission is incorporated by reference. Copies of the statutory quarterly and annual statements filed with the State of New York Insurance Department by XLCA are available upon request to the State of New York Insurance Department.



*Regulation of XLCA.* XLCA is regulated by the Superintendent of Insurance of the State of New York. In addition, XLCA is subject to regulation by the insurance laws and regulations of the other jurisdictions in which it is licensed. As a financial guaranty insurance company licensed in the State of New York, XLCA is subject to Article 69 of the New York Insurance Law, which, among other things, limits the business of each insurer to financial guaranty insurance and related lines, prescribes minimum standards of solvency, including minimum capital requirements, establishes contingency, loss and unearned premium reserve requirements, requires the maintenance of minimum surplus to policyholders and limits the aggregate amount of insurance which may be written and the maximum size of any single risk exposure which may be assumed. XLCA is also required to file detailed annual financial statements with the New York Insurance Department and similar supervisory agencies in each of the other jurisdictions in which it is licensed.

The extent of state insurance regulation and supervision varies by jurisdiction, but New York and most other jurisdictions have laws and regulations prescribing permitted investments and governing the payment of dividends, transactions with affiliates, mergers, consolidations, acquisitions or sales of assets and incurrence of liabilities for borrowings.

THE FINANCIAL GUARANTY INSURANCE POLICIES ISSUED BY XLCA, INCLUDING THE XLCA POLICY OF THE XLCA INSURED BONDS, ARE NOT COVERED BY THE PROPERTY/CASUALTY INSURANCE SECURITY FUND SPECIFIED IN ARTICLE 76 OF THE NEW YORK INSURANCE LAW.

The principal executive offices of XLCA are located at 1221 Avenue of the Americas, New York, New York 10020 and its telephone number at this address is (212) 478-3400.

#### **Certain Rights of the Bond Insurers**

As provided in the insurance agreements to be entered into by the Authority and the 1974 Trustee for the benefit of each of CIFGNA, FGIC, FSA, MBIA and XLCA concurrently with the delivery of their respective municipal bond insurance policies, as long as CIFGNA, FGIC, FSA, MBIA and XLCA shall not be in default on their respective obligations under the municipal bond insurance policies, CIFGNA, FGIC, FSA, MBIA and XLCA shall be deemed to be the owner of the respective Bonds insured by each of them for purposes of, among other things, (1) taking remedial actions under the 1974 Agreement and (2) the giving of consents to the execution of any supplemental agreement to the 1974 Agreement.

#### **PROPOSED SUPPLEMENTAL AGREEMENT**

The Authority has proposed to execute a supplemental agreement (the “Supplemental Agreement”) to the 1974 Agreement. Purchasers of the Bonds will have consented by their purchase to the terms of the Supplemental Agreement. The underwriters of the Bonds and the providers of the municipal bond insurance policies insuring some of the Bonds will also consent to such Supplemental Agreement.

The Supplemental Agreement, which was initially proposed in 1985, will permit the Authority to secure its obligations to providers of credit or liquidity facilities securing Power Revenue Bonds by granting liens on Revenues on parity with Power Revenue Bonds. The Supplemental Agreement will be executed when owners of 100% of the outstanding Power Revenue Bonds consent thereto. Upon the issuance of the Bonds (and the refunding of the Refunded Bonds), the owners of approximately 99% of the outstanding Power Revenue Bonds will have consented to the execution of the Supplemental Agreement. See Appendix I, *Summary of Certain Provisions of Proposed Supplemental Agreement*, for additional information respecting the provisions of the Supplemental Agreement.

Copies of the proposed Supplemental Agreement are on file for inspection with the 1974 Trustee.

## DESCRIPTION OF THE BONDS

### General

The Bonds will bear interest at such rates and will mature on the dates and in the principal amounts set forth on the inside cover page of this Official Statement. The Bonds will be dated their date of delivery. Interest on the Bonds will be payable on each January 1 and July 1, commencing on January 1, 2006. Principal of and premium, if any, and interest on the Bonds will be payable in the manner described below under “Book-Entry Only System.” The Bonds are being issued in fully registered form and, when issued, are to be registered in the name of Cede & Co., as nominee of The Depository Trust Company, New York, New York (“DTC”). DTC is to act as securities depository for the Bonds. Individual purchases of interests in the Bonds will be made in book-entry form only, in denominations of \$5,000 or any multiple thereof. Purchasers of such interests will not receive definitive Bonds. Principal, redemption premium, if any, and interest are payable directly to DTC by the 1974 Trustee. Upon receipt of such payments, DTC will remit such principal and interest to the DTC Participants (as such term is hereinafter defined) for subsequent disbursement to the purchasers of beneficial interests in the Bonds.

### Book-Entry Only System

The information in this section concerning DTC and DTC’s book-entry system has been obtained from DTC. The Authority, the 1974 Trustee and the Underwriters assume no responsibility for the accuracy of such information.

DTC will act as securities depository for the Bonds. The Bonds will be issued as fully registered bonds registered in the name of Cede & Co. (DTC’s partnership nominee) or such other name as may be requested by an authorized representative of DTC. One fully registered bond will be issued for each maturity of the Bonds, each in the aggregate principal amount of such maturity of the Bonds and will be deposited with DTC. So long as the nominee of DTC is the registered owner of the Bonds, such nominee will, subject to the limitations set forth under *Bond Insurance* above, be considered the sole owner or holder of the Bonds for all purposes under the 1974 Agreement and any applicable laws. Except as otherwise provided below, a Beneficial Owner (as hereinafter defined) of interests in the Bonds will not be entitled to have the Bonds registered in such owner’s name, will not be entitled to definitive Bonds and will not be considered an owner or holder of the Bonds under the 1974 Agreement.

DTC, the world’s largest depository, is a limited-purpose trust company organized under the New York Banking Law, a “banking organization” within the meaning of the New York Banking Law, a member of the Federal Reserve System, a “clearing corporation” within the meaning of the New York Uniform Commercial Code, and a “clearing agency” registered pursuant to the provisions of Section 17A of the Securities Exchange Act of 1934. DTC holds and provides asset servicing for over two million issues of U.S. and non-U.S. equity issues, corporate and municipal debt issues, and money market instruments from over 85 countries that DTC’s participants (“Direct Participants”) deposit with DTC. DTC also facilitates the post-trade settlement among Direct Participants of sales and other securities transactions in deposited securities through electronic computerized book-entry transfers and pledges in Direct Participants’ accounts. This eliminates the need for physical movement of securities certificates. Direct Participants include both U.S. and non-U.S. securities brokers and dealers, banks, trust companies, clearing corporations, and certain other organizations. DTC is a wholly owned subsidiary of The Depository Trust & Clearing Corporation (“DTCC”). DTCC, in turn, is owned by a number of its Direct Participants, by members of the National Securities Clearing Corporation, the Government Securities Clearing Corporation, the MBS Clearing Corporation, and Emerging Markets Clearing Corporation (all subsidiaries of DTCC), by the New York Stock Exchange, Inc., the American Stock Exchange LLC, and the National Association of Securities Dealers, Inc. Access to the DTC system is also available to others, such as both U.S. and non-U.S. securities brokers and dealers, banks, trust companies, and clearing corporations that clear through or maintain a custodial relationship with a Direct Participant, either directly or indirectly (the “Indirect Participants” and together with the Direct Participants, the “Participants”). DTC has Standard & Poor’s highest rating: AAA. The DTC

rules applicable to DTC and its Participants are on file with the Securities and Exchange Commission. More information about DTC can be found at [www.dtcc.com](http://www.dtcc.com).

Purchases of Bonds under the DTC system must be made by or through Direct Participants, which will receive a credit for the Bonds in DTC's records. The ownership interest of each actual purchaser of each Bond (a "Beneficial Owner") will in turn be recorded in the Direct and Indirect Participants' records. Beneficial Owners will not receive written confirmation from DTC of their purchases. Beneficial Owners are, however, expected to receive written confirmations providing details of the transaction, as well as periodic statements of their holdings, from the Direct or Indirect Participant through which the Beneficial Owner entered into the transaction. Transfers of ownership interests in the Bonds will be accomplished by entries made in the books of Participants acting on behalf of the Beneficial Owners. Beneficial Owners will not receive certificates representing their ownership interest in the Bonds, except in the event that use of the book-entry system for the Bonds is discontinued.

To facilitate subsequent transfers, all Bonds deposited by Direct Participants with DTC are registered in the name of DTC's partnership nominee, Cede & Co., or such other name as may be requested by an authorized representative of DTC. The deposit of Bonds with DTC and their registration in the name of Cede & Co. or such other nominee do not effect any change in beneficial ownership. DTC has no knowledge of the actual Beneficial Owners of the Bonds; DTC's records reflect only the identity of the Direct Participants to whose accounts such Bonds are credited, which may or may not be the Beneficial Owners. The Participants will remain responsible for keeping account of their holdings on behalf of their customers.

Conveyance of notices and other communications by DTC to Direct Participants, by Direct Participants to Indirect Participants, and by Direct Participants and Indirect Participants to Beneficial Owners will be governed by arrangements among them, subject to any statutory or regulatory requirements as may be in effect from time to time. Beneficial Owners of Bonds may wish to take certain steps to augment transmission to them of notices of significant events with respect to the Bonds, such as redemptions, tenders, defaults, and proposed amendments to the documents governing the Bonds. For example, Beneficial Owners of Bonds may wish to ascertain that the nominee holding the Bonds for their benefit has agreed to obtain and transmit notices to Beneficial Owners. In the alternative, Beneficial Owners may wish to provide their names and addresses to the trustee and request that copies of the notices are provided directly to them.

Redemption notices will be sent to DTC. If less than all of the Bonds within a maturity are being redeemed, DTC's practice is to determine by lot the amount of the interest of each Direct Participant in the Bonds of that maturity to be redeemed.

Neither DTC nor Cede & Co. (nor any other DTC nominee) will consent or vote with respect to the Bonds unless authorized by a Direct Participant in accordance with DTC's procedures. Under its usual procedures, DTC mails an Omnibus Proxy to the Authority as soon as possible after the record date. The Omnibus Proxy assigns Cede & Co.'s consenting or voting rights to those Direct Participants to whose accounts the Bonds are credited on the record date (identified in a listing attached to the Omnibus Proxy).

Principal, redemption premium, if any, and interest payments on the Bonds will be made to Cede & Co. or such other nominee as may be requested by an authorized representative of DTC. DTC's practice is to credit Direct Participants' accounts upon DTC's receipt of funds and corresponding detail information from the Authority or the 1974 Trustee on the payable date in accordance with their respective holdings shown on DTC's records. Payments by Participants to Beneficial Owners will be governed by standing instructions and customary practices, as is the case with securities held for the accounts of customers in bearer form or registered in "street name," and will be the responsibility of such Participant and not of DTC, the 1974 Trustee or the Authority, subject to any statutory or regulatory requirements as may be in effect from time to time. Payment of the principal, redemption premium, if any, and interest to Cede & Co. (or such other nominee as may be requested by an authorized representative of DTC) is the responsibility of the Authority or the 1974 Trustee. Disbursement of such payments to Direct Participants will be the responsibility of DTC,

and disbursement of such payments to the Beneficial Owners will be the responsibility of Direct and Indirect Participants.

Each person for which a DTC Participant acquires an interest in the Bonds, as nominee, may desire to make arrangements with such DTC Participant to receive a credit balance in the records of such DTC Participant, to have all communications to DTC which may affect such persons forwarded in writing by such DTC Participant, and to have notification made of all interest payments.

*The Authority, the 1974 Trustee and the Underwriters will have no responsibility or obligation to DTC, Participants, Beneficial Owners or other nominees of such Beneficial Owners for: (i) sending transaction statements; (ii) maintaining, supervising or reviewing the accuracy of any records maintained by DTC or any DTC Participant or other nominees of such Beneficial Owners; (iii) payment or the timeliness of payment by DTC to any DTC Participant, or by any DTC Participant or other nominees of Beneficial Owners to any Beneficial Owner, of any amount due with respect to the principal of or interest on the Bonds; (iv) delivery or timely delivery by DTC to any DTC Participant, or by any DTC Participant or other nominees of Beneficial Owners to any Beneficial Owners, of any notice or other communication which is required or permitted under the terms of the 1974 Agreement to be given to the registered owners of the Bonds; or (v) any consent given or any action taken by DTC or its nominee as the registered owner of the Bonds.*

### **Discontinuance of the Book-Entry Only System**

DTC may discontinue providing its services as securities depository with respect to the Bonds at any time by giving reasonable notice to the Authority or the 1974 Trustee. Under such circumstances, in the event that a successor securities depository is not obtained, certificates representing ownership interests in the Bonds will be printed and delivered.

The Authority, in its sole discretion and without the consent of any other person, may terminate the services of DTC as securities depository with respect to the Bonds. In such event, certificates representing ownership interests in the Bonds will be printed and delivered.

In the event that such book-entry only system is discontinued or terminated, the following provisions will apply: (i) payment of the principal of and the interest on the Bonds will be made in lawful money of the United States of America; (ii) payment of the principal will be made at the corporate trust office of the 1974 Trustee in New York, New York; (iii) interest on the Bonds will be paid by check mailed to the respective addresses of the registered owners thereof as of the fifteen day of the month immediately preceding the interest payment date as shown on the registration books of the Authority maintained by the 1974 Trustee; (iv) the Bonds will be issued only as registered bonds without coupons in authorized denominations; and (v) the transfer of the Bonds will be registrable and the Bonds may be exchanged at the principal corporate trust office of the 1974 Trustee in New York, New York upon the payment of any taxes or other governmental charges required to be paid with respect to such transfer or exchange.

### **Mandatory Redemption**

#### *The Series RR Bonds*

The Series RR Bonds maturing on July 1, 2035 will be redeemed in part on July 1, 2031, and on each July 1 thereafter for which there is an Amortization Requirement in respect of such Series RR Bonds, in amounts equal to the Amortization Requirements for such Series RR Bonds (less the principal amount of any Series RR Bonds retired by purchase and otherwise subject to adjustment as provided in the 1974 Agreement), from moneys in the 1974 Sinking Fund, at a redemption price equal to the principal amount of the Bonds to be redeemed plus accrued interest to the redemption date, without premium, in the years and amounts set forth below:

**Amortization Requirements for the Series RR Bonds due on July 1, 2035**

<u>Year</u>	<u>Amortization Requirement</u>
2031	\$36,945,000
2032	38,840,000
2033	40,835,000
2034	42,930,000
2035*	45,130,000

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\* Maturity

*The Series SS Bonds*

The Series SS Term Bonds maturing on July 1, 2030 will be redeemed in part on July 1, 2028, and on each July 1 thereafter for which there is an Amortization Requirement in respect of such Series SS Term Bonds, in amounts equal to the Amortization Requirements for such Series SS Term Bonds (less the principal amount of any Series SS Term Bonds retired by purchase and otherwise subject to adjustment as provided in the 1974 Agreement), from moneys in the 1974 Sinking Fund, at a redemption price equal to the principal amount of the Bonds to be redeemed plus accrued interest to the redemption date, without premium, in the years and amounts set forth below:

**Amortization Requirements for the Series SS Term Bonds due on July 1, 2030**

<u>Year</u>	<u>Amortization Requirement</u>
2028	\$ 135,000
2029	145,000
2030*	32,620,000

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\* Maturity

**Optional Redemption**

The Bonds that mature after July 1, 2015 may be redeemed at the option of the Authority prior to maturity, from any available moneys (except moneys deposited in the 1974 Sinking Fund in respect of an Amortization Requirement), upon not less than 30 days' prior notice by mail, either in whole or in part, in such order of maturity as directed by the Authority, on any date not earlier than July 1, 2015, at a redemption price equal to the principal amount of the Bonds to be redeemed plus accrued interest to the redemption date, without premium.

## THE AUTHORITY

The Authority was created a body corporate and politic constituting a public corporation and governmental instrumentality of the Commonwealth by the Puerto Rico Electric Power Authority Act, Act No. 83 of the Legislature of Puerto Rico, approved May 2, 1941, as amended (the “Act”).

The Authority was created for the purpose of conserving, developing and utilizing the water and power resources of the Commonwealth in order to promote the general welfare of the Commonwealth. It supplies virtually all the electricity consumed in Puerto Rico and is one of the largest municipal utilities in the United States.

The executive offices of the Authority are located at 1110 Ponce de León Avenue, San Juan, Puerto Rico 00907, telephone number (787) 289-4666.

### Powers

The Authority has broad powers under the Act, including, among others: to make contracts; to acquire properties by eminent domain or otherwise; to borrow money and to issue bonds for any of its corporate purposes; to secure the payment of its bonds and all other obligations by pledge of its revenues; to determine, fix, alter, charge and collect reasonable rates, fees, rentals and other charges for use of its facilities; and to have complete control and supervision of its properties and activities. In addition, the Authority has the power to create, acquire and maintain corporations, partnerships or subsidiary corporations.

### Management

The Act provides that the Governing Board of the Authority (the “Board”) shall be composed of nine members. The Secretary of Transportation and Public Works of the Commonwealth serves *ex officio* as a member of the Board, and six other members are appointed by the Governor with the advice and consent of the Senate of Puerto Rico. The remaining two members are client representatives elected directly by the Authority’s clients. Members of the Board serve for a term of four years and members who are not *ex officio* can be reappointed or reelected. There is currently one vacancy ( a client representative) on the Board. The members of the Board are set forth below.

<u>Name</u>	<u>Principal Occupation</u>	<u>Term Ends</u>
José A. Del Valle-Vázquez, Chairman	Certified Public Accountant and Consultant	Holding Over
Eliezel Rodríguez Seda, Vice-Chairman	Engineer	February 2006
Gabriel D. Alcaraz-Emmanuelli	Secretary of Transportation and Public Works	<i>Ex Officio</i>
José A. Bechara-Bravo	Businessman	February 2007
José A. Fernández-Polo	Civil Engineer and General Contractor	February 2007
José Luis Rodríguez-Homs	Engineer	February 2007
Miguel Nazario-Franco	Consultant	February 2007
Zoilo López-Nieves*	Medical Doctor	Holding Over

\* Mr. López-Nieves is one of the client representatives on the Governing Board. He will continue on the Governing Board until his successor is appointed. The other client representative position is currently vacant.

The Board appoints an Executive Director who is the chief executive officer of the Authority and is responsible for the general operation of the Authority. The Board also appoints a Vice Executive Director who has the administrative power delegated unto him by the Executive Director and has the administrative supervision over all functions of the Authority, unless expressly reserved for himself by the Executive Director. The Vice Executive Director position is currently vacant.

*Héctor M. Alejandro Narváez* was appointed Acting Executive Director on March 17, 2005. Mr. Alejandro holds a Juris Doctor degree and is a professional chemical engineer. He has 33 years of service with the Authority. Among other positions he has held, he has acted as Vice Executive Director, Director of Planning and Environmental Protection, Head of the Environmental Protection and Quality Assurance Division, Technical Advisor in Environmental Protection and Supervisor - Environmental Program Department.

Other principal officers of the Authority include the following:

*Edwin Rivera*, Director of Electric System, is a professional electrical engineer with 31 years of service with the Authority. During that time, he has occupied various positions, including Director of Engineering, Assistant Head - Electric Conservation Division, Superintendent - Electric System, and Administrator of the Project Administration Office in the Engineering Directorate.

*Luis Vázquez García*, Acting Director of Transmission and Distribution, is a professional electrical engineer, holds a Juris Doctor and a Master's Degree in Business Administration. During his 20 years of service with the Authority, he has occupied various positions, such as Administrator of Technical Operations - Caguas Area, Project Manager and District Engineer.

*Wanda L. Ramos Vera*, Acting Director of Customer Service, holds a Bachelor's Degree in Business Administration. She has 22 years of service with the Authority. During that time, she has occupied various positions, including Associate Director of Customer Service, Administrator of Customer Services - San Juan Area, Customer Service District Manager and Customer Service Supervisor.

*Luis Figueroa*, Director of Finance, is a certified public accountant with 16 years of service with Authority. During that time, he has occupied the positions of Assistant Comptroller - General Accounting, Assistant Comptroller - Payroll and Budget, and Technical Advisor to the Director of Finance.

*Juan F. Alicea Flores*, Director of Planning and Environmental Protection, is a professional mechanical engineer with 23 years of service with the Authority. He has occupied positions such as Division Head - Palo Seco Steam Power Plant, Maintenance Head - Aguirre Steam Power Plant, Operations Head - Aguirre Steam Power Plant, and Shift Engineer - Aguirre Combined Cycle Plant.

*Ramón Burgos Medina*, Acting Director of Administrative Services, is a professional electrical engineer with 21 years of service with the Authority. He has occupied the positions of Technical Operations Director, District Engineer and Supervisor Engineer II.

*Milagros Calixto*, Director of Engineering, is a professional electrical engineer and has 23 years of service with the Authority. Among the positions she has held: are Superintendent of Norms and Procedures Office, Supervising Engineer II, Norms and Procedures Engineer, Special Assistant to the Electrical Distribution Division Head and Supervisor of Specifications and Procurement - Electrical Distribution Division.

*María M. Méndez*, General Counsel, holds a Juris Doctor and a Bachelor's Degree in Business Administration, and has 17 years of service with the Authority. She has occupied the positions of Acting General Counsel, Acting Assistant General Counsel and Attorney at the Opinion, Legislation and Contract Division.

*María E. Hernández Torrales*, Human Resources Director, holds a Juris Doctor and a Master's in Arts. During her 31 years of service with the Authority, among other positions, she has acted as Personnel General Administrator, Personnel Services Administrator, and Labor Lawyer.

The Authority retains the firm of Washington Group International, Inc., successor to Raytheon Engineers & Constructors, Inc., as the consulting engineers (the "Consulting Engineers") to perform certain responsibilities under the 1974 Agreement. Washington Group International Inc., was formed in July 2000 following the acquisition by Morrison Knudsen Corporation of Raytheon Engineers & Constructors, Inc. The Consulting Engineer's responsibilities include submitting an annual report to the 1974 Trustee setting forth their recommendations: (a) as to any necessary or advisable revisions of the Authority's rates and charges, (b) as to the amount that should be deposited monthly by the Authority during the ensuing fiscal year to the credit of various funds established under the 1974 Agreement for the purposes specified in the 1974 Agreement, and (c) as to any advice and recommendations as they deem advisable.

Ernst & Young LLP currently acts as the Authority's independent accountants responsible for auditing the Authority's financial statements for fiscal year 2004.

## **THE SYSTEM**

The Authority is the supplier of virtually all of the electric power consumed in the Commonwealth. As of December 31, 2004, the Authority served approximately 1.4 million clients.

### **Generating Facilities**

As of December 31, 2004, investment in Authority-owned production plant in service totaled approximately \$2.4 billion based on original cost, the total nameplate rating of the Authority-owned generating facilities of the System was 4,427 MW and their total dependable generating capacity was 4,404 MW. In addition, the Authority purchases power under long-term power purchase agreements from two cogeneration facilities. Under its agreement with EcoEléctrica, it has the right to purchase 507 MW of net dependable generating capacity. Under its agreement with AES-PR, it has the right to purchase 454 MW of net dependable generating capacity. The Authority has dispatch control over both facilities, and their output is fully integrated into the System.



### Existing Generating Facilities (in MW)

<u>Generating Plants</u>	<u>Dependable Generating Capacity</u>						
	<u>Nameplate Rating (84 Units)</u>	<u>Total (84 Units)</u>	<u>Steam (18 Units)</u>	<u>Combined Cycle Power Blocks (13 Units)</u>	<u>Combustion Turbine (25 Units)</u>	<u>Hydro (21 Units)</u>	<u>Other<sup>(1)</sup> (7 Units)</u>
Aguirre.....	1,554	1,534	900 <sup>(2)</sup>	592 <sup>(3)</sup>	42 <sup>(4)</sup>	—	—
Costa Sur.....	1,118	1,132	1,090	—	42 <sup>(4)</sup>	—	—
Palo Seco.....	731	728	602	—	126 <sup>(5)</sup>	—	—
San Juan.....	400	400	400	—	—	—	—
Mayagüez.....	90	84	—	—	84 <sup>(6)</sup>	—	—
Arecibo.....	249	249	—	—	249 <sup>(7)</sup>	—	—
Other Locations.....	285	277	—	—	168 <sup>(8)</sup>	100	9
Subtotal.....	4,427	4,404	2,992	592	711	100	9
Peñuelas – EcoEléctrica.....	507	507	—	507 <sup>(9)</sup>	—	—	—
Guayama – AES-PR.....	454	454	454 <sup>(10)</sup>	—	—	—	—
Total.....	5,388	5,365	3,446	1,099	711	100	9

- (1) Consists of four diesel units in the Municipality of Culebra and three in the Municipality of Vieques with an aggregate dependable capacity of approximately 9 MW held on standby reserve.
- (2) Consists of the Authority's two largest units, Aguirre Units 1 and 2, each with a dependable generating capacity of 450 MW.
- (3) Consists of two combined-cycle power blocks, each made up of four 50 MW combustion turbine units and one 96 MW steam-turbine unit.
- (4) Consists of two 21 MW units.
- (5) Consists of six 21 MW units.
- (6) Consists of four 21 MW units.
- (7) Consists of three 83 MW units.
- (8) Consists of eight 21 MW units.
- (9) Consists of one combined cycle power block, made up of two 165 MW combustion turbine units and a 177 MW steam turbine unit.
- (10) Consists of two 227 MW units.

The EcoEléctrica plant is a cogeneration facility located in the Municipality of Peñuelas. The facility includes a combined cycle power block, consisting of one steam and two combustion turbine units, and a liquefied natural gas terminal. The Authority began purchasing power from EcoEléctrica in September of 1999 during the testing and start-up phase of the facility. Commercial operation began in March of 2000. The Authority has entered into an agreement with EcoEléctrica to purchase all of the power produced by the facility for a term of 22 years. The agreement requires EcoEléctrica to provide 507 MW of dependable generating capacity to the Authority. The Authority may purchase any energy produced by the facility in excess of 507 MW, if made available, by paying an energy charge only. No capacity charge would be imposed on the Authority for this "excess" power. EcoEléctrica has entered into a long-term supply agreement to meet its expected needs for natural gas at the facility. Deliveries of natural gas to the facility commenced in July of 2000.

The power purchase agreement with EcoEléctrica includes monthly capacity and energy charges to be paid by the Authority for the 507 MW of capacity, which EcoEléctrica is committed to provide. The capacity charge is subject to reduction, progressively to zero, if the facility does not achieve certain availability guarantees determined on a 12-month rolling average basis. The energy charges for power purchases are based on a number of factors including a natural gas related charge on a per kWh of energy basis and inflation indices. The EcoEléctrica purchased power costs incorporate a minimum monthly power or fuel purchase requirement based on an average capacity utilization factor on the part of the Authority. After paying this minimum requirement, the Authority only pays for energy actually received (including energy in excess of the 507 MW guaranteed by EcoEléctrica). This element of the agreement, when combined with the possible reduction in the capacity charge described above, effectively transfers substantially all of the economic risk of operating the facility to EcoEléctrica.

The AES-PR plant is a co-generation facility located in the Municipality of Guayama. The plant commenced commercial operation in November of 2002. This clean burning coal technology facility consists of two identical fluidized bed boilers and two steam turbines with 454 MW of dependable generating

capacity. The Authority has entered into an agreement with AES-PR to purchase all of the power produced by this facility for a term of 25 years from the date of commencement of commercial operation. The contract with AES-PR is substantially similar to the EcoEléctrica contract described above. Above a certain minimum amount, the Authority is only obligated to purchase energy actually produced by the facility. AES-PR is an affiliate of the AES Corporation.

The AES-PR and EcoEléctrica projects contribute to the Authority's efforts towards fuel diversification and improved reliability of service. In the past, oil-fired units produced approximately 99% of the Authority's energy. After the incorporation of the EcoEléctrica and AES-PR facilities to the System, approximately 27% of the Authority's annual energy requirements are being provided by non-oil-fired generating facilities. This percentage is expected to increase to 33% upon EcoEléctrica and AES-PR reaching full contracted availability.

Among other benefits, the integration of the EcoEléctrica and AES-PR cogeneration facilities into the Authority's System reduces the impact of changes in energy costs to the Authority's clients resulting from short-term changes in fuel costs due to the manner of calculation of the energy charges under the EcoEléctrica and AES-PR agreements. While the agreements provide that energy charges will change based on different formulas relating to the prior year, each agreement fixes the energy price for each year of the contract at the beginning of such year. Fixing the energy component of the price for the whole year reduces the impact of seasonal or short duration variations in the market price of electricity. Because the energy price is fixed and known for the entire year, the Authority is able to achieve better economic dispatching and scheduling of maintenance outages of all of its generating units. In addition, the year delay in the effect of energy price changes for these two facilities on the Authority's energy costs reduces variations of the fuel and purchased power components in the price of electricity sold by the Authority by postponing the impact of the price changes and bringing these changes out of step with price changes in the other components of the Authority's fuel mix.

All of the Authority's purchased power costs under the EcoEléctrica and AES-PR power purchase agreements are accounted for as operating expenses on the Authority's financial statements, are treated as a Current Expense under the 1974 Agreement, and are being recovered by the Authority pursuant to the purchased power charge under its current rate structure.

### **Transmission and Distribution Facilities**

The Authority's transmission and distribution system interconnects its power plants with major switching and load centers throughout Puerto Rico in order to allow the flow of power to and between these locations. The System is integrated and each generating unit is able to provide electric power to the transmission and distribution system. During the period from fiscal year 2000 to fiscal year 2004, the Authority invested \$1.1 billion (or 52.0% of its capital improvement program) in its transmission and distribution system. The capital improvement program for the five fiscal years ending June 30, 2009 includes \$973 million (or 45.8% of such program) for transmission and distribution facilities.

Transmission plant in service as of December 31, 2004 totaled \$1.0 billion based on original installed cost. As of that date, there were 2,338 circuit miles of transmission lines and 162 transmission switchyards. Transmission lines include 331 circuit miles of 230 kV lines, 676 circuit miles of 115 kV lines and 1,331 circuit miles of 38 kV lines. There are also 34 miles of underground 38 kV cable and 55 miles of 38 kV submarine cable. Seventy-one transmission substations located at generating sites and at other sites throughout the island have a total transformer capacity of 16,727,250 kilovolt amperes ("kVA").

After completing construction of the transmission loop on the western part of Puerto Rico in fiscal year 2002, the Authority is now constructing new 230 kV transmission lines to complete the transmission loop on the eastern part of the island. This eastern loop will connect major switching and load centers on the eastern part of the island, and boost electric system capacity in Puerto Rico's eastern region. The eastern loop is expected to be operating during August of 2005.

The Authority is also constructing a new 50-mile long 230 kV transmission line between its South Coast steam plant and the transmission center in Aguas Buenas. The construction of this new transmission line commenced in March of 2003 and is expected to be completed during June of 2008. Once in operation, this major infrastructure project will enhance the reliability of the transmission system, and will permit the increase of power transfers from the south coast of Puerto Rico to the northern and central regions. The Authority is constructing an underground 115 kV transmission circuit line around the San Juan metropolitan area in order to reduce the incidents of loss of power in the aftermath of hurricanes and other major storms, which strike Puerto Rico from time to time. The estimated cost for this project, which is expected to be completed in fiscal year 2006, is \$135 million. The Federal Emergency Management Agency has committed to provide \$75 million for the investment in construction for this project through grants to the Authority. In cooperation with several municipalities, the Authority is currently designing and building major underground systems located in high-density metropolitan areas. These underground systems will permit the replacement of overhead sub-transmission and distribution lines, thereby improving reliability and assisting municipalities undertaking urban renewal projects by removing unsightly poles, lines and transformers.

A program to improve the 38 kV sub-transmission system is in effect which includes construction of underground 38 kV lines in Mayaguez, Vega Baja, Carolina, Viaducto, Humacao and San Fernando in San Juan. In addition, most of the 38 kV lines in the central part of the island are being replaced. These projects will improve the reliability of the sub-transmission system.

Other relevant projects related to the load growth forecast of the San Juan metropolitan area are the recently energized 90,000 kVA Covadonga gas insulated substation and the new gas insulated 115/38 kV transmission centers and distribution substations of Isla Grande and Martín Peña, which are expected to be operational in fiscal years 2005 and 2006, respectively. There are other new substations in the commissioning process at Barrio Piña (Toa Alta), Dorado and Fajardo, which also are expected to be operational in fiscal year 2005. In addition, new distribution substations at Hacienda San José (Caguas), Veredas (Gurabo) and La Parguera (Lajas) are under construction. These substations are expected to be in service during fiscal year 2006.

A new 115/38 kV transmission center in the municipality of Comerío started operating in fiscal year 2004. In addition, two new 115/38 kV transmission centers under construction in the municipalities of Juana Díaz and Hatillo will increase the load flow capability and improve the voltage regulation of the 38 kV system under emergency conditions.

Investment in distribution plant in service as of December 31, 2004 totaled \$2.2 billion based on original cost. The capital improvement program for the five fiscal years ending June 30, 2009 includes \$468 million (or 22.0% of the total) for extensions and improvements to existing distribution lines to serve new clients and substations for accommodating new load growth areas. As of December 31, 2004, the electric distribution system included approximately 30,248 circuit miles of distribution lines and 1,086 distribution substations (766 are client-owned) with a total installed transformer capacity of 6,793,100 kVA.

The Authority has a continuing program to digitize all the transmission and distribution facilities into a geographic information system. This will allow the Authority to create a common database for all its transmission and distribution facilities. Approximately 70% of the distribution facilities and all of the 230 kV and 115 kV transmission facilities have been digitized. The program is scheduled to be completed in fiscal year 2006.

The Authority's field operations are being computerized at the district level through the implementation of a work management system that has been in operation since December of 1999. The Authority has completed communications facilities to link all the regions and district offices. Integration between the geographic information system and the work management system has been completed. This integration enables the Authority to track all work from initiation to completion through the same system, while keeping all geographic information (such as maps) updated with necessary additions and modifications.

The Authority has also upgraded its computer technology relating to this integration, achieving greater service reliability for its clients.

With the implementation of these systems, real time data of transmission and distribution activities are now available. This has produced further automation of the reporting and analysis pertaining to the operations of these systems, and has helped improve productivity and reduce costs.

The Authority regularly reviews and upgrades its operating and maintenance practices, with an emphasis on improving the reliability of its transmission and distribution system. In order to improve the productivity of its transmission and distribution employees, the Authority has instituted programs to assist them in both technical and supervisory training. In addition, as part of its continuous effort to improve service quality, the Authority has acquired new software applications and trained its personnel for the analysis and monitoring of power quality.

The Authority has developed a 441-mile fiber optic telecommunications network. This network was designed and installed on the Authority's rights-of-way (mainly its transmission lines). It has allowed the Authority to modernize its internal communication systems, which provide operations, load management, system protection and security, and other controls. The Authority is also developing strategies for commercializing the surplus capacity of the installed fiber, adding flexibility and diversification to its operations.

The Consulting Engineers are of the opinion that the Authority's production plant and transmission and distribution system are in good repair and sound operating condition. See Appendix III, *Letter of the Consulting Engineers*.

## **Adequacy of Capacity**

### *General*

Electric utilities provide reliable service by establishing a level of dependable generating capacity that is at least equal to their load plus a reserve sufficient to allow for scheduled maintenance, forced or unscheduled outages (defined below), reductions in generating capacity due to partial outages, and other unforeseen events. Unlike most electric utilities in the United States, which are able to purchase power from neighboring systems in the event of unscheduled outages of generating units or temporary surges in demand, the Authority, as an island utility, is not able to do so. In addition, the absence of significant seasonal variations in demand results in a relatively high load factor (approximately 80.2% in fiscal year 2003, 78.4% in fiscal year 2004 and 79.0% for the six months ended December 31, 2004), which affords the Authority less flexibility to schedule maintenance. Therefore, the Authority must have greater total reserve capacity than other utilities in the United States to cover instances of generating unit outages (scheduled and unscheduled, partial or total).

Improvements to the Authority's generating units since the early 1990s have extended their life and increased their availability, thereby substantially improving the System's equivalent availability. This has enabled the Authority to improve the quality of service to its clients. When coupled with the additional generating capacity included in the capacity expansion plan described below, maintaining the level of equivalent availability at current levels should allow the Authority to provide a better quality of service to its clients and meet forecasted increases in demand.

The Authority's program to extend the life and increase the availability of its generating units is composed of two parts. The first is a comprehensive preventive maintenance program pursuant to which the Authority continuously trains its maintenance employees and adheres to a schedule designed to ensure proper operating levels of all major generating units by removing units from service at regular intervals for necessary maintenance ("scheduled outages"). The second part of this program is a design modification program which includes a commitment by the Authority to improve the operation of generating units and the ability of units to operate at design capability, and in some cases at increased capability, and to reduce the risk of units being

forced out of service or being forced to operate at partial output (“forced or unscheduled outages”). About one-third of the \$651.7 million in capital expenditures for the five fiscal years ended June 30, 2004 for production plant was spent for such design modification program.

The table below shows annualized equivalent availability and the equivalent forced outage rate (an indication of the average percentage of total dependable generating capacity which is unavailable throughout the year due to forced outages or partial generating capacity outages) for fiscal years 2000 through 2004 and for the twelve months ended December 31, 2004.

	<b>Electric Generation Equivalent Availability and Reliability</b>					<b>Twelve Months</b>
	<b>Years Ended June 30,</b>					<b>Ended</b>
	<b>2000</b>	<b>2001</b>	<b>2002</b>	<b>2003</b>	<b>2004</b>	<b>December 31,</b>
	<b>2000</b>	<b>2001</b>	<b>2002</b>	<b>2003</b>	<b>2004</b>	<b>2004</b>
Equivalent availability.....	78%	80%	80%	81%	81%	85%
Equivalent forced outage rate.....	9%	8%	7%	9%	9%	7%

For planning purposes, the Authority determines adequacy of capacity using probabilistic analytic methods widely used throughout the electric utility industry. The use of these methods takes into account the unique operational aspects of the Authority.

By more effectively utilizing scheduled outages, and by implementing major design modifications, the Authority has reduced the need for extended maintenance downtime and increased the overall reliability of all of its generating facilities. In addition, the Authority anticipates that by including the EcoEléctrica and AES-PR facilities will help the Authority improve its availability even further over time. The additional reserve capacity represented by these two cogeneration facilities gives the Authority more flexibility in scheduling maintenance periods on its own generation facilities and favorably affect the System’s equivalent availability. As a result, total production plant availability increased from an average of 72% in fiscal year 1995, to an average of 81% in fiscal years 2003 and 2004, and of 85% during the twelve months ended on December 31, 2004. The Authority calculates that each percentage point increase of System availability is equivalent to adding approximately 90 MW of available capacity to the System.

*Projected Load Growth*

Projections of future load growth are a key component in the Authority’s capacity planning. In its financial and capacity planning, the Authority receives information from three sources relating to economic activity: Econométrica Inc., Inter-American University, and the Commonwealth Planning Board. The Inter-American University uses a macroeconomic model developed in conjunction with Global Insight. Econométrica and the Commonwealth Planning Board use data provided by Government Development Bank in association with Global Insight. The Authority’s forecasts of electric energy sales and income are based in part on the correlations between the consumption of electricity and various economic and financial activities in the Commonwealth as represented in the above-mentioned models. The Authority continuously monitors actual performance relative to its forecasts and prepares new forecasts at least once a year.

The Authority incorporates the highest of the three forecasts as its base case for planning the additional generating capacity required by the System. Recognizing the inherent uncertainty of forecasting growth, the Authority ordinarily uses the lowest of the three forecasts in preparing its base case revenue forecast.

The Consulting Engineers have reviewed the Authority’s projections of future load growth and estimates of peak load and have found them to provide a reasonable basis for planning purposes. See Appendix III, *Letter of the Consulting Engineers*.

### *Additional Generating Facilities*

The Authority recently commenced construction of new generating units projected to provide a total of 464 MW of combined cycle dependable generating capacity which will replace two 44 MW steam-generating units of the San Juan Steam Plant (Units 5 and 6), removed from service in fiscal year 1997. The new generating units are scheduled to be in service during fiscal year 2007.

Based on the Authority's current projections of peak load and the continued level of production plant equivalent availabilities of its generating units, the Authority and the Consulting Engineers believe that completion of this project will provide the additional generating capacity needed to continue to provide reliable service to its clients through fiscal year 2009. Based on the Authority's projections of peak load, the System's capacity, and the maintenance by the Authority of the System's equivalent availability at near to its current level, the Authority believes that a delay in the completion of this project will not materially affect its ability to furnish reliable service.

The Authority has projected a need for additional capacity after fiscal year 2009. Accordingly, the Authority's Governing Board has approved the construction by a private company of a co-generation plant on the western part of the island that will add approximately 526 MW of generating capacity in fiscal year 2010.

The following table summarizes the Authority's projected peak load, dependable capacity, reserve margin and dependable reserve margin through fiscal year 2009 under the peak load projections shown below and incorporating the assumptions for 464 MW of additional capacity from the repowering of San Juan Steam Plant units 5 and 6. Projections of future peak load (for capacity planning purposes) from fiscal year 2005 to fiscal year 2009 prepared by the Authority show an average annual increase of 3.0%.

<b>Fiscal Years Ending June 30,</b>	<b>Peak Load</b>	<b>Dependable Capacity</b>	<b>Reserve Margin</b>	<b>Dependable Reserve Margin (%)</b>
(in MW, except percentages)				
2005	3,624	5,315	1,691	47
2006	3,727	5,265	1,538	41
2007	3,845	5,729	1,884	49
2008	3,952	5,729	1,777	45
2009	4,083	5,729	1,646	40

The Consulting Engineers have examined the Authority's proposed long-term capacity expansion plan (and the methodologies and assumptions upon which it is based) and have found its development to be reasonable and generally consistent with utility industry practice and appropriate for the Authority. See Appendix III, *Letter of the Consulting Engineers*.

### **Statistical Information**

The following table sets forth certain statistical information regarding the System for the five fiscal years ended June 30, 2004 and for the six-month periods ended December 31, 2003 and 2004. The information below reflects the inclusion of 507 MW of capacity provided pursuant to the EcoEléctrica contract since March 21, 2000, and of 454 MW of capacity provided pursuant to the AES-PR contract since November 29, 2002.

## Statistical Information

	Years Ended June 30,					Six Months Ended December 31,	
	2000	2001	2002	2003	2004	2003	2004
Nameplate rating at end of period (in MW)	4,421	4,421	4,421	4,421	5,382	4,421	5,388
Dependable generating capacity at end of period (in MW).....	4,905 <sup>(1)</sup>	4,905 <sup>(1)</sup>	4,905 <sup>(1)</sup>	5,359 <sup>(2)</sup>	5,359 <sup>(2)</sup>	5,359 <sup>(2)</sup>	5,365 <sup>(2)</sup>
Peak load, 60-minute (in MW).....	3,133	3,202	3,297	3,376	3,499	3,499	3,560
Reserve Margin (%).....	56.6	53.2	48.8	58.7	53.1	53.2	50.5
Average load (in MW).....	2,443	2,526	2,576	2,707	2,744	2,806	2,813
Load factor (%).....	78.0	78.9	78.1	80.2	78.4	80.2	79.0
Energy generated, purchased and sold (in millions of kWh):							
Electric energy generated and purchased	20,306 <sup>(3)</sup>	22,132 <sup>(3)</sup>	22,562 <sup>(3)</sup>	23,717 <sup>(4)</sup>	24,100 <sup>(4)</sup>	12,392 <sup>(4)</sup>	12,424 <sup>(4)</sup>
Auxiliary equipment use.....	<u>(1,064)</u>	<u>(1,124)</u>	<u>(1,076)</u>	<u>(1,076)</u>	<u>(1,085)</u>	<u>(549)</u>	<u>(591)</u>
Net electric energy generated and purchased.....	19,242	21,008	21,486	22,641	23,015	11,843	11,833
Losses and unaccounted for.....	<u>(1,097)</u>	<u>(2,285)</u>	<u>(2,356)</u>	<u>(2,754)</u>	<u>(2,755)</u>	<u>(1,319)</u>	<u>(1,392)</u>
Electric Energy Sold.....	<u>18,145</u>	<u>18,723</u>	<u>19,130</u>	<u>19,887</u>	<u>20,260</u>	<u>10,524</u>	<u>10,441</u>
Electric Energy Sales:							
Residential.....	6,385	6,631	6,910	7,280	7,338	3,873	3,833
Commercial.....	7,206	7,583	7,865	8,167	8,400	4,331	4,301
Industrial.....	4,091	4,019	3,876	3,963	4,092	2,092	2,105
Other.....	<u>463</u>	<u>490</u>	<u>479</u>	<u>477</u>	<u>430</u>	<u>228</u>	<u>202</u>
Total.....	<u>18,145</u>	<u>18,723</u>	<u>19,130</u>	<u>19,887</u>	<u>20,260</u>	<u>10,524</u>	<u>10,441</u>
Electric Energy Revenues (in thousands):							
Residential.....	\$633,151	\$779,682	\$725,797	\$867,684	\$897,965	\$459,461	\$503,949
Commercial.....	878,697	1,026,219	969,182	1,117,317	1,171,110	588,581	632,700
Industrial.....	391,906	436,313	382,140	432,296	444,070	219,251	244,177
Other.....	<u>80,473</u>	<u>86,889</u>	<u>85,052</u>	<u>91,461</u>	<u>87,123</u>	<u>43,826</u>	<u>43,981</u>
Total.....	<u>\$1,984,227</u>	<u>\$2,329,103</u>	<u>\$2,162,171</u>	<u>\$2,508,758</u>	<u>\$2,600,268</u>	<u>\$1,311,119</u>	<u>\$1,424,807</u>
Average revenue per kWh(in cents):							
Residential.....	9.92	11.76	10.50	11.92	12.24	11.86	13.15
Commercial.....	12.19	13.53	12.32	13.68	13.94	13.59	14.71
Industrial.....	9.58	10.86	9.86	10.91	10.85	10.48	11.60
Other.....	17.39	17.74	17.77	19.19	20.29	19.26	21.81
All Classes.....	10.94	12.44	11.30	12.61	12.83	12.46	13.65
Average number of clients:							
Residential.....	1,217,584	1,237,053	1,254,043	1,270,371	1,287,010	1,282,674	1,300,090
Commercial.....	122,243	123,380	124,759	125,890	127,705	127,278	129,006
Industrial.....	1,986	1,929	1,874	1,804	1,679	1,688	1,674
Other.....	<u>3,094</u>	<u>3,306</u>	<u>3,212</u>	<u>3,236</u>	<u>3,208</u>	<u>3,209</u>	<u>3,212</u>
Total.....	<u>1,344,907</u>	<u>1,365,668</u>	<u>1,383,888</u>	<u>1,401,301</u>	<u>1,419,602</u>	<u>1,414,849</u>	<u>1,433,982</u>
Monthly average revenue per client:							
Residential.....	\$43.33	\$52.52	\$48.23	\$56.92	\$58.14	\$59.70	\$64.60
Commercial.....	599.01	693.13	647.37	739.61	764.20	770.73	817.40
Industrial.....	16,444.53	18,848.84	16,993.06	19,969.33	22,040.40	21,648.01	24,310.73
Other.....	2,167.45	2,190.18	2,206.62	2,355.30	2,263.17	2,276.20	2,282.12
All classes.....	122.95	142.12	130.20	149.19	152.64	154.45	165.60

(1) Includes generating capacity of the EcoEléctrica cogeneration facility.

(2) Includes generating capacity of the EcoEléctrica and AES-PR cogeneration facilities.

(3) Includes power purchased from the EcoEléctrica cogeneration facility.

(4) Includes power purchased from the EcoEléctrica and AES-PR cogeneration facilities.

## Historical Capital Improvement and Financing Program

Capital improvements and their financing are made pursuant to a program established by the Authority and reviewed annually by the Consulting Engineers. The program for the five fiscal years ended June 30, 2004 and for the six-month periods ended December 31, 2003 and 2004 is shown in the following table.

	Years Ended June 30,					Total <sup>(1)</sup>	Six Months Ended December 31,	
	2000	2001	2002	2003	2004		2003 <sup>(1)</sup>	2004 <sup>(1)</sup>
Capital Improvements	(in thousands)							
Production plant.....	\$179,119	\$116,775	\$123,646	\$105,579	\$126,605	\$651,724	\$68,661	\$52,518
Transmission facilities.....	48,826	80,741	82,015	111,893	109,004	432,479	43,361	64,222
Distribution facilities.....	86,848	129,139	149,479	124,469	133,098	623,033	66,509	71,552
Other <sup>(2)</sup> .....	85,591	67,393	60,874	50,165	78,236	342,259	30,782	46,692
Total.....	<u>\$400,384</u>	<u>\$394,048</u>	<u>\$416,014</u>	<u>\$392,106</u>	<u>\$446,943</u>	<u>\$ 2,049,495</u>	<u>\$209,313</u>	<u>\$234,984</u>
Financing								
Internally generated funds..	\$74,265	\$100,500	\$77,307	\$144,537	\$43,066	\$439,675	\$44,505	\$32,254
Borrowed funds <sup>(3)</sup> .....	326,119	293,548	338,707	247,569	403,877	1,609,820	164,808	202,730
Total.....	<u>\$400,384</u>	<u>\$394,048</u>	<u>\$416,014</u>	<u>\$392,106</u>	<u>\$446,943</u>	<u>\$2,049,495</u>	<u>\$209,313</u>	<u>\$234,984</u>
Allowance for funds used during construction.....	\$12,138	\$22,966	\$15,993	\$16,795	\$20,279	\$88,171	\$8,454	\$2,067

(1) Includes allowance for funds used during construction of \$88.2 million for the five fiscal years ended June 30, 2004, and \$8.5 million and \$2.1 million for the six-month periods ended December 31, 2003 and 2004, respectively. The inclusion of such funds increases the carrying value of improvements by the amount of interest on borrowed construction funds used to finance plant additions during the period. See Note 2 to the Financial Statements under Utility Plant included in Appendix II hereto.

(2) Includes general land and buildings, general equipment, preliminary surveys and investigations.

(3) Includes interim financing for capital improvements and bond proceeds applied directly to construction.

## Projected Five-Year Capital Improvement and Financing Program

Following a public hearing and approval by the Consulting Engineers, the Board must adopt the Authority's capital budget on or before the first day of the ensuing fiscal year. If revisions are required, the Board may amend the capital budget at any time during the fiscal year with the approval of the Consulting Engineers. The capital budget for fiscal year 2005 was adopted in June 2004.

The projected capital improvement program for the five fiscal years ending June 30, 2009 aggregates approximately \$2.1 billion. It is currently estimated that \$414.6 million, or approximately 19.5%, of the projected five-year capital improvement program will be financed by internally generated funds. Estimated capital costs reflect, among other factors, construction contingency allowances and annual cost escalations.

The five-year capital improvement program includes \$803.6 million for production plant. Of this amount, the Authority projects that approximately \$420.2 million will be invested in the improvement of generating units to extend their useful life and continue to increase their reliability and efficiency and the generating capacity of the System. The projected capital improvement program includes the replacement of generating units 5 and 6 at the San Juan Steam Plant as described under "Adequacy of Capacity - Additional Generating Facilities" above and certain costs related to the proposed west coast co-generation plant described under the same heading.



The projected capital improvement program also includes \$505.2 million for transmission facilities and \$468.1 million for distribution facilities. During the next five fiscal years, the Authority will dedicate a significant amount of its resources to the improvement and expansion of its transmission and distribution facilities.

The Consulting Engineers have examined the projected capital improvement program and found it to be reasonable. The capital improvement program is subject to periodic review and adjustment because of changes in expected demand, environmental requirements, design, equipment delivery schedules, costs of labor, equipment and materials, interest rates and other factors. The following table presents a summary of the projected capital improvement program for the five fiscal years ending June 30, 2009 and its projected financing.

**Projected Capital Improvement Program  
(in thousands)**

	Years Ending June 30,					Total <sup>(2)</sup>
	2005 <sup>(1)</sup>	2006	2007	2008	2009	
<u>Capital Improvements</u>						
Production plant.....	\$ 128,802	\$ 172,314	\$ 192,089	\$ 171,906	\$ 138,519	\$ 803,630
Transmission facilities.....	122,888	98,934	99,757	104,786	78,794	505,159
Distribution facilities.....	119,222	98,893	98,297	87,368	64,281	468,061
Other <sup>(3)</sup> .....	81,300	74,376	77,652	71,043	46,115	350,486
Total.....	<u>\$ 452,212</u>	<u>\$ 444,517</u>	<u>\$ 467,795</u>	<u>\$ 435,103</u>	<u>\$ 327,709</u>	<u>\$ 2,127,336</u>
<u>Financing Sources</u>						
Internally generated funds.....	\$ 82,995	\$ 77,379	\$ 80,191	\$ 90,190	\$ 83,807	\$ 414,562
Borrowed funds <sup>(4)</sup> .....	369,217	367,138	387,604	344,913	243,902	1,712,774
Total.....	<u>\$ 452,212</u>	<u>\$ 444,517</u>	<u>\$ 467,795</u>	<u>\$ 435,103</u>	<u>\$ 327,709</u>	<u>\$ 2,127,336</u>
Allowance for funds used during construction ...	<u>\$ 9,328</u>	<u>\$ 9,758</u>	<u>\$ 21,771</u>	<u>\$ 26,014</u>	<u>\$ 25,092</u>	<u>\$ 91,963</u>

- (1) Based on actual results for the six-month period ended on December 31, 2004, and an estimate for the last six months of fiscal year 2005.
- (2) Includes allowance for funds used during construction of \$91.9 million for the five-year period ending June 30, 2009. The inclusion of such funds increases the carrying value of improvements by the amount of interest on borrowed construction funds used to finance plant additions during the period. See Note 2 to the Financial Statements under Utility Plant included in Appendix II hereto.
- (3) Includes general land and buildings, general equipment, preliminary surveys and investigations.
- (4) For the purpose of this table, it is assumed that of the total \$1.5 billion Power Revenue Bonds expected to be issued in the five-year period ending June 30, 2009, \$850 million is expected to be used to repay lines of credit with Government Development Bank anticipated to be drawn during this period.

## Rates

The Authority has the power to determine, alter, establish and collect reasonable rates for electric service, which shall produce sufficient revenues to cover the operating costs of the Authority, the payment of the principal of and the interest on its bonds, and other contractual obligations. Public hearings are required before the setting of permanent rates, with the final approval vested solely within the Authority. Act No. 21 of the Legislature of Puerto Rico, approved May 31, 1985 (“Act No. 21”), provides uniform procedures for public hearings and review of the actions of certain public corporations, including the Authority, in connection with changes in the rates set by such public corporations. Act No. 21 also authorizes the Legislature by resolution to review rates of certain public corporations, including the Authority. At the request of another public corporation covered by Act No. 21, the Secretary of Justice has rendered an opinion to the effect that Act No. 21 does not grant a veto power to the Legislature over rates adopted properly by such public corporation.

Electric service rates consist primarily of (i) basic charges, made up of demand, client and energy related charges, (ii) fuel adjustment charges to recover the cost to the Authority of fuel oil, and (iii) purchased

power charges to recover the cost to the Authority of power purchased from the EcoEléctrica and AES-PR co-generation facilities (which went into effect in fiscal year 2000, when the Authority began purchasing power from the EcoEléctrica facility). Consequently, revenues will reflect changes in the fuel charge and the purchased power charge caused by fluctuations in the price of fuel oil or purchased power. Basic charges currently average 5.7 cents per kilowatt-hour. The Authority has not increased basic charges since 1989. The following table presents the electric sales revenues derived from basic charges, fuel adjustment charges and purchased power charges for the five fiscal years ended June 30, 2004 and the six-month periods ended December 31, 2003 and 2004.

	<b>Electric Sales Revenues</b>					<b>Six Months Ended</b>	
	<b>(in thousands)</b>					<b>December 31,</b>	
	<b>Years Ended June 30,</b>					<b>2003</b>	<b>2004</b>
	<b>2000</b>	<b>2001</b>	<b>2002</b>	<b>2003</b>	<b>2004</b>		
Basic charges.....	\$1,086,783	\$1,070,693	\$1,101,923	\$1,134,794	1,140,277	\$589,757	\$586,438
Fuel adjustment charges....	825,924	1,059,108	806,806	994,406	970,972	488,508	571,394
Purchased power charges..	71,520	199,302	253,442	379,558	489,019	232,854	266,975
Total.....	<u>\$1,984,227</u>	<u>\$2,329,103</u>	<u>\$2,162,171</u>	<u>\$2,508,758</u>	<u>\$2,600,268</u>	<u>\$1,311,119</u>	<u>\$1,424,807</u>

The fuel charges imposed in any month are based upon the average of (i) the actual average fuel oil costs for the second preceding month and (ii) the estimated average fuel oil costs for the current month. Purchased power charges are based on estimated purchased power costs for the current month. To the extent that such charges do not fully recover actual fuel or purchased power costs (or recover more than such costs), charges are adjusted in the second succeeding month.

Under the Act, certain residential clients receive a subsidy for the fuel adjustment charge. Residential clients who qualify for the subsidy are billed the full applicable basic charges and fuel adjustment charges, with the applicable subsidy taking the form of a credit against the bill. In addition, under legislation approved in July 1985, certain tourism facilities, such as hotels certified by the Tourism Company, receive subsidies from the Commonwealth. See “Subsidies, Contributions in Lieu of Taxes and Set Aside - Subsidies” below for a more detailed description of these subsidies.

Beginning in April of 2003, the Authority began offering industrial clients with manufacturing operations a 6% credit on their base charge for a two-year period provided that the average price of fuel oil used in the calculation of the fuel adjustment charge equaled or exceeded \$20 per barrel. The Governing Board of the Authority increased the 6% credit to 8% for the period from August of 2003 to March of 2005. Approximately 655 industrial clients benefited from this credit and during this two-year period, they saved approximately \$20.3 million. This credit ended in March of 2005.

To promote an increase in industrial development, the Authority instituted five new special rates. These special rates offer a discount of approximately 11% to those clients that qualify. New industrial clients will receive this discount on their total electric bill. Existing industrial clients that expand their operations will receive this discount on the demand, energy, and adjustment charges associated with the expansion. These rates became effective July 30, 2003 and will be available for five years. The Authority estimates that industry savings could be approximately \$18 million over this five-year period.

Pursuant to the 1974 Trust Agreement, the Consulting Engineers have reviewed the Authority’s rate schedules and believe that the Authority will receive sufficient Revenues to cover Current Expenses and to make the required deposits in the 1974 Sinking Fund, the Reserve Maintenance Fund, the Capital Improvement Fund and, if any are required, the Self-insurance Fund. See Appendix III, *Letter of the Consulting Engineers*.

## Major Clients

The public sector, which consists of the Commonwealth government and its public corporations and the municipalities (included primarily in the commercial category), accounted for 12.1% of kWh sales and 13.7% of revenues from electric energy sales for the twelve-month period ended December 31, 2004.

The ten largest industrial clients accounted for 4.2% of kWh sales and 3.1% of revenues from electric energy sales for the twelve months ended December 31, 2004. No single client accounted for more than 0.5% of electric energy sales or more than 0.3% of revenues from electric energy sales.

In September 1997, the Authority established a new reduced rate for large industrial clients connected at an 115 kV voltage level and meeting certain criteria such as a minimum demand and a high load factor and power factor. This new rate is designed to induce such large clients to whom it may be economical to produce their own electricity to buy more electricity from the Authority and discourage their independent power production. As of December 31, 2004, four of the Authority's industrial clients were using such rate.

## Fuel

For the fiscal year ended June 30, 2004, fuel oil expenses amounted to \$864.7 million, or 43.7% of total Current Expenses (\$886.4 million or 47.4% of total Current Expenses for the preceding fiscal year). For the six months ended December 31, 2004, fuel oil expenses amounted to \$507.4 million, or 45.7% of total Current Expenses. For the five fiscal years ended June 30, 2004, fuel oil averaged 49.0% of average total Current Expenses for the same period. See "Management's Discussion and Analysis of Operating Results" under *Net Revenues and Coverage*.

The Authority's thermal generating units, which produced approximately 73% of the net electric energy generated by the System in fiscal year 2004, are fueled by No. 6 fuel oil, except for the twenty-two smaller combustion-turbine units, the two Aguirre combined-cycle units and the 249 MW combustion turbine plant in Arecibo, which burn No. 2 distillate fuel oil.

The Authority maintains some generating capacity as a reserve (referred to as a "controlled reserve") for frequency quality, in anticipation of unscheduled outages or other unforeseen events. The Authority controlled reserve criterion is 200 MW, but in order to maintain it, more than 500 MW of spinning reserve was needed. However, based on its experience, the Authority implemented improvements in the System that allowed to reduce its spinning reserve requirements while continuing to provide reliable service to clients and reducing its fuel cost.

The Authority's fuel requirements for its generation facilities are covered by one-year contracts, which expire at various times and are usually renewable at the option of the Authority. The Authority's contracted fuel oil prices consist of an escalation factor plus a fixed price differential. The escalation factor reflects the fuel oil price at the New York market at the time of purchase. The fixed price differential compensates for the fact that the fuel oil is delivered in the Commonwealth and not New York. It also takes into account other aspects of the delivery such as maximum cargo volume and draft restrictions. The Authority does not expect any difficulty in renewing its contracts at price differentials similar to those currently in effect.

Since the Authority's dependence on fuel oil has decreased with the coming on line of the EcoEléctrica and AES-PR co-generation plants, the Authority's customary inventory of fuel oil will cover 40 days of ordinary operations, up from 25 days in the past. Although sources of fuel oil are continually changing as a result of variations in relative price, availability and quality, the Authority has never been forced to curtail service to its clients because of fuel oil shortages. The Authority's total inventory capacity for fuel oil is 3.4 million barrels. As of December 31, 2004, the Authority had an inventory of 1.9 million barrels of fuel oil.

Average fuel oil costs and related costs of production for the five fiscal years ended June 30, 2004, and for the six months ended December 31, 2003 and 2004, are shown in the following table:

	<b>Fuel Costs</b>					<b>Six Months</b>	
	<b>Years Ended June 30,</b>					<b>Ended December 31,</b>	
	<b>2000</b>	<b>2001</b>	<b>2002</b>	<b>2003</b>	<b>2004</b>	<b>2003</b>	<b>2004</b>
Average fuel oil cost per barrel (net of handling costs).....	\$ 23.54	\$ 29.33	\$ 22.85	\$ 29.64	\$ 29.54	\$ 28.86	\$ 33.71
Number of barrels used (in millions).....	34.00	32.20	31.50	29.90	29.30	15.10	15.10
Fuel oil cost (in millions).....	\$801.4	\$944.8	\$720.3	\$886.4	\$864.7	\$435.1	\$507.4
Net kWh generated (excluding purchased power from 2000 to 2004) (in millions).....	19,065.1	18,159.2	18,247.4	17,259.0	16,740.6	8,591.6	8,654.0
Average net kWh per barrel.....	560.7	564.0	579.3	577.2	571.4	569.0	573.1
Average fuel oil cost per net kWh generated (in cents).....	4.20	5.20	3.95	5.14	5.17	5.06	5.86

With the addition of the output of the EcoEléctrica and AES-PR facilities to the Authority's System, the Authority's traditional dependence on oil-fired generation has decreased. The Authority estimates that 27% of its annual energy requirements are now being provided by non-oil-fired generating facilities, and that this percentage could increase to 33% upon EcoEléctrica and AES-PR reaching full contracted availability.

Starting in fiscal year 2002, the Authority entered into a series of hedging contracts intended to protect it against increases in the price of fuel oil. Under the guidelines adopted by the Authority's Governing Board, these hedging contracts could cover up to 16.5% of total fuel oil consumption (approximately 5.2 million barrels of fuel oil). Under these hedging contracts, the Authority receives in cash the amount by which the monthly average market price of No. 6 fuel oil exceeds a fixed price per barrel (ranging between \$22 to \$25 per barrel, depending on the contract). The most recent hedging contracts expired in June 30, 2004. At the present level of fuel oil prices, the Authority has determined that it is not cost effective to enter into new hedging contracts, however, the Authority could enter into new hedging contracts in the future if fuel oil prices decrease. In addition, the Authority used payments it received from its two co-generators in return for the granting by the Authority of certain waivers under their power purchase agreements to capitalize a special fund (referred to as the PREPA client fund) to provide billing credits to the Authority's clients to protect them against increases in the price of fuel oil. This fund served to smooth the effects of the fuel adjustment to the Authority's clients. As of December 31, 2004, such fund had been fully utilized. Nevertheless, the Authority may fund it in the future with income obtained from supplementary sources such as the net income generated by Authority's fiber optic subsidiary.

## **Subsidies, Contributions in Lieu of Taxes and Set Aside**

### *Subsidies*

Under the Act, a subsidy is provided for a portion of fuel charges to qualifying residential clients who use up to 425 kWh monthly or 850 kWh bi-monthly. This subsidy takes the form of a credit against their electric bills. The Act limits this subsidy to a maximum of \$100 million per year and limits the cost of fuel oil used in calculating the amount of such subsidy to a maximum of \$30 per barrel. The residential clients must pay any fuel adjustment charge resulting from a price of fuel oil in excess of \$30 per barrel.

Through fiscal year 1991, the subsidy was paid to the Authority by the Commonwealth each year and was recorded as a receivable on the Authority's financial statements. As of June 30, 1991, the amount owed by the Commonwealth to the Authority on account of this fuel oil subsidy program was \$94.9 million. In October 1991, the Authority and the Commonwealth entered into a non-interest bearing fifteen-year payment plan, starting in fiscal year 1993, for the payment of this amount. As of December 31, 2004, the amount owed

by the Commonwealth was approximately \$25.3 million. In addition, in 1991, the Authority revised its subsidy implementing regulations to reduce the number of qualifying clients. Under these regulations, the subsidy has amounted to approximately \$17.3 million per year for the five fiscal years ended June 30, 2004. All subsidy amounts arising since June 30, 1991 have been offset against a portion of the electric energy sales set aside as discussed in *Contributions in Lieu of Taxes and Set Aside* below.

Hotels receive a subsidy in an amount equal to 11% of their monthly billing, which has amounted to approximately \$3.3 million per year for the five fiscal years ended June 30, 2004. In order to receive this subsidy, hotels must maintain the Hotel's electric service accounts on a current basis. This subsidy takes the form of a credit against their electric bills. In addition, the Authority has recently been offering certain discounts and incentives in the form of credits to certain industrial clients, as described above under "Rates."

#### *Contributions In Lieu of Taxes and Set Aside*

Under the Act, the Authority is required to pay to the Secretary of the Treasury (for distribution to the municipalities) from its Net Revenues (as defined in the Act), after certain defined expenditures and subject to compliance with its obligations under the 1974 Agreement, contributions in lieu of taxes in accordance with a certain formula. Contributions in lieu of taxes to municipalities can be used to offset accounts receivable balances owed to the Authority, as permitted by law.

Prior to an amendment to the Act that became effective in September of 2004, the amount of the contribution in lieu of taxes was equal to 6% of the Authority's gross electric energy sales computed based on an annual average fuel oil price of up to \$30 per barrel. Under the Act, prior to its amendment, the Authority was also required to set aside annually from its Net Revenues an additional amount equal to 5% of its annual gross electric energy sales (based on kWh) (the "electric energy sales set aside"). One-fifth of the electric energy sales set aside was applied to cover the costs of the fuel oil subsidy program arising after June 30, 1991 (with any balance remaining being used to reduce the amounts owed by the Commonwealth to the Authority on account of such subsidy as of June 30, 1991). Another one-fifth of the electric energy sales set aside was paid to the Secretary of the Treasury for distribution among the municipalities (in addition to the contributions in lieu of taxes described above). The balance of the electric energy sales set aside was used to fund certain of the Authority's capital improvements and other purposes.

Prior to the Act's amendment, if the Authority's Net Revenues in any year were not sufficient to cover the full amount payable to the municipalities on account of contributions in lieu of taxes and the electric energy sales set aside, calculated as described above, the amount payable by the Authority to the municipalities was reduced to the amount available, and the excess was not carried forward as a liability for future years. During the five fiscal years ended June 30, 2004, the Net Revenues of the Authority were not sufficient to permit the payment to the municipalities of the full amount of contributions in lieu of taxes and to provide for the full amount of the electric energy sales set aside, due to the payment by the Authority of certain obligations under the 1974 Agreement, including deposits into the 1974 Sinking Fund.

The Act was amended in September of 2004 to change the formula for computing contributions in lieu of taxes and electric energy sales set aside. Under this amendment, 11% of the Authority's gross electric energy sales will be used by the Authority to fund its government subsidy programs, to pay contributions in lieu of taxes to the municipalities, and to finance the Authority's capital improvement program and for other purposes. This amendment also provides that the amount of the contribution in lieu of taxes payable to the municipalities will be the greater of the following amounts: (1) 20% of the Authority's Net Revenues, as defined in the 1974 Agreement, less the cost of its government subsidy programs; (2) actual electric power consumption by the municipalities; or (3) the prior five year average of the contributions in lieu of taxes paid to the municipalities. If the Authority does not have sufficient available funds in any year to pay such contribution to the municipalities, the difference will be accrued and carried forward for a maximum of three years.

For fiscal year 2004, contributions in lieu of taxes to municipalities amounted to \$120.6 million, of which \$6.1 million was reimbursed to the municipalities and \$114.5 million was used to offset or reduce outstanding accounts receivable balances. For the six-month period ended December 31, 2004, contributions in lieu of taxes to municipalities amounted to \$66.1 million.

## DEBT

The following table sets forth the bonds and notes of the Authority outstanding as of March 24, 2005, and as adjusted for the issuance of the Bonds and the expected issuance of the Authority's Power Revenue Refunding Bonds, Series QQ on April 4, 2005, and the refunding of the Refunded Bonds and the Power Revenue Bonds to be refunded with the Series QQ Bonds.

	<b>Outstanding as of March 24, 2005</b>	<b>As adjusted <sup>(1)</sup></b>
	(In Thousands)	
Power Revenue Bonds		
Publicly Offered .....	\$ 4,855,197	\$ 5,335,215
Rural Electrification.....	<u>29,574</u>	<u>29,574</u>
Sub-total.....	4,884,771	5,364,789
Notes.....	166,585	166,585
Government Development		
Bank lines of credit .....	<u>246,352<sup>(2)</sup></u>	<u>91,319</u>
Total.....	<u>\$ 5,297,708</u>	<u>\$ 5,622,693</u>

- (1) As adjusted for the issuance of the Bonds and the issuance of the Authority's Series QQ Bonds, and the refunding of the Refunded Bonds and the Power Revenue Bonds to be refunded with the Series QQ Bonds.
- (2) Excludes \$12,900,000 expected to be drawn under a Government Development Bank line of credit between the date of this Official Statement and the expected date of delivery of the Bonds, which amount is expected to be repaid from the proceeds of the Series RR Bonds.

## **Rural Electrification Bonds**

The Rural Utilities Service (formerly the Rural Electrification Administration) has purchased Power Revenue Bonds issued by the Authority to provide funds for the construction of distribution facilities to service qualified areas. As of March 24, 2005, \$29.6 million of such bonds were outstanding at an interest rate of 5%.

## **Notes**

The Authority has outstanding \$166.6 million aggregate principal amount in notes issued to certain commercial banks to finance the purchase of fuel oil and other expenses. Of this amount, \$125 million were issued to fund the purchase of fuel oil. These notes were issued under a facility that expires in July of 2005, but which is expected to be renewed on or prior to that date. In addition, the Authority has outstanding \$41.6 million aggregate principal amount of subordinated notes issued to a commercial bank that are payable from expected annual appropriations from the Legislature of Puerto Rico of \$6.3 million (or the outstanding balance if lower) until 2012. These notes are also payable from the subordinate obligations fund established under the 1974 Agreement, which is funded from the annual Revenues of the Authority remaining after all deposits to the 1974 Sinking Fund and the Reserve Maintenance Fund required by the 1974 Agreement have been made. The funds expected to be assigned by the Legislature to the Authority are intended to pay part of the accumulated debt of various government agencies with the Authority and the outstanding balance of certain subsidies as of December 31, 2004.

## **Government Development Bank Lines of Credit**

The Authority has five lines of credit approved by Government Development Bank. The first line of credit of \$200 million is for the interim financing of the Authority's capital improvement program. As of March 24, 2005, the Authority had drawn approximately \$155 million under this line of credit, which will be paid from the proceeds of the Series RR Bonds. Between the date of this Official Statement and the expected date of delivery of the Bonds, the Authority expects to draw an additional \$12.9 million under this line of credit, which will also be repaid from the proceeds of the Series RR Bonds. A second line of credit of \$68 million is to fund payments made under a settlement agreement relating to certain litigation with the municipalities of Puerto Rico (see *Litigation*). As of March 24, 2005, the Authority had drawn \$63.8 million under this line of credit. In connection with the same litigation, the Government Development Bank approved a third line of credit of \$57 million for electric infrastructure projects in the municipalities. As of March 24, 2005, the Authority had drawn \$40,067 under this line of credit. The fourth line of credit of \$25.3 million is to finance improvements to the Isabela irrigation system. The Authority expects that this fourth line of credit will be paid by the Commonwealth of Puerto Rico from the proceeds of future bond issues. As of March 24, 2005, the Authority had drawn \$2.4 million under this fourth line of credit. The fifth line of credit of \$25 million was approved to provide interim financing for the repair of damages caused by Tropical Storm Jeanne. The Authority expects to repay this fifth line of credit with funds to be provided by the Federal Emergency Management Agency.

## **Principal and Interest Requirements**

Principal and Interest Requirements, as used herein and as defined in the 1974 Agreement, means for any fiscal year the sum of all principal of, including Amortization Requirements for, and interest on, outstanding Power Revenue Bonds which is payable on January 1 in such fiscal year and on July 1 in the following fiscal year. The following table shows the annual Principal and Interest Requirements for the outstanding Power Revenue Bonds after giving effect to the issuance of the Bonds and the Series QQ Bonds and the refunding of the Refunded Bonds and the Power Revenue Bonds to be refunded from the proceeds of the Series QQ Bonds. The Amortization Requirements are subject to adjustment as provided in the definition thereof. See Appendix I, *Summary of Certain Provisions of the 1974 Agreement Excluding Proposed Supplemental Agreement*.

## Debt Service Requirements

Years Ending June 30	Outstanding Bond Principal and Interest Requirements <sup>(1)</sup>	The Bonds			Total Debt Service Requirements
		Maturity and Amortization Requirements	Interest	Total	
2005	\$398,451,173.15	-	-	-	\$398,451,173.15
2006	413,527,173.73	-	\$60,256,837.02	\$60,256,837.02	473,784,010.75
2007	400,070,603.73	\$8,115,000.00	48,528,996.26	56,643,996.26	456,714,599.99
2008	369,570,336.23	8,520,000.00	48,285,546.26	56,805,546.26	426,375,882.49
2009	370,677,732.48	8,830,000.00	47,995,046.26	56,825,046.26	427,502,778.74
2010	340,931,682.48	9,190,000.00	47,620,015.00	56,810,015.00	397,741,697.48
2011	336,420,969.98	9,540,000.00	47,234,890.00	56,774,890.00	393,195,859.98
2012	336,105,836.22	13,320,000.00	46,897,800.00	60,217,800.00	396,323,636.22
2013	327,252,623.72	27,205,000.00	46,424,940.00	73,629,940.00	400,882,563.72
2014	323,445,067.46	31,640,000.00	45,128,600.00	76,768,600.00	400,213,667.46
2015	324,137,397.46	17,260,000.00	43,670,693.76	60,930,693.76	385,068,091.22
2016	317,197,772.46	18,105,000.00	42,843,506.26	60,948,506.26	378,146,278.72
2017	315,974,042.44	19,215,000.00	41,938,256.26	61,153,256.26	377,127,298.70
2018	266,137,348.68	20,140,000.00	40,989,768.76	61,129,768.76	327,267,117.44
2019	223,139,843.66	63,045,000.00	39,982,768.76	103,027,768.76	326,167,612.42
2020	244,944,007.44	63,275,000.00	36,860,018.76	100,135,018.76	345,079,026.20
2021	244,532,562.44	66,440,000.00	33,733,468.76	100,173,468.76	344,706,031.20
2022	245,112,593.66	47,490,000.00	30,411,468.76	77,901,468.76	323,014,062.42
2023	244,821,581.18	49,885,000.00	28,045,587.50	77,930,587.50	322,752,168.68
2024	224,681,843.68	52,430,000.00	25,551,337.50	77,981,337.50	302,663,181.18
2025	198,278,556.16	55,075,000.00	22,937,975.00	78,012,975.00	276,291,531.16
2026	203,956,299.90	28,770,000.00	20,194,900.00	48,964,900.00	252,921,199.90
2027	203,957,012.50	30,245,000.00	18,756,400.00	49,001,400.00	252,958,412.50
2028	171,607,881.26	31,935,000.00	17,244,150.00	49,179,150.00	220,787,031.26
2029	136,530,350.00	33,575,000.00	15,647,400.00	49,222,400.00	185,752,750.00
2030	96,198,037.50	75,525,000.00	13,968,650.00	89,493,650.00	185,691,687.50
2031	96,199,075.00	36,945,000.00	10,234,000.00	47,179,000.00	143,378,075.00
2032	47,916,137.50	38,840,000.00	8,386,750.00	47,226,750.00	95,142,887.50
2033	47,917,887.50	40,835,000.00	6,444,750.00	47,279,750.00	95,197,637.50
2034	-	42,930,000.00	4,403,000.00	47,333,000.00	47,333,000.00
2035	-	45,130,000.00	2,256,500.00	47,386,500.00	47,386,500.00
<b>Total</b>	<b>\$7,469,693,429.60</b>	<b>\$993,450,000.00</b>	<b>\$942,874,020.88</b>	<b>\$1,936,324,020.88</b>	<b>\$9,406,017,450.48</b>

(1) Debt service requirements on all Power Revenue Bonds outstanding on March 1, 2005, after giving effect to the issuance of the Series QQ Bonds and the refunding of the Power Revenue Bonds to be refunded from the issuance of the Series QQ Bonds.

## NET REVENUES AND COVERAGE

The following table presents the Net Revenues of the Authority under the provisions of the 1974 Agreement for the five fiscal years ended June 30, 2004 and for the six-month periods ended December 31, 2003 and 2004 and the ratio of such Net Revenues to Principal and Interest Requirements on the Power Revenue Bonds. These calculations of Net Revenues differ in several important respects from the Authority's calculations of changes in net assets prepared in conformity with generally accepted accounting principles. For example, they do not include depreciation as a current expense and do not reflect interest expense as a deduction from Net Revenues.



## Historical Net Revenues and Coverage

	Years Ended June 30,					Six Months Ended December 31,	
	2000	2001	2002	2003	2004	2003	2004
Average number of clients .....	1,344,907	1,365,668	1,383,888	1,401,301	1,419,602	1,414,849	1,433,982
Electric energy sales (in millions of kWh) ....	18,145	18,723	19,130	19,887	20,260	10,524	10,441
<b>Source of Net Revenues</b>							
<b>(dollars in thousands)</b>							
Revenues:							
Sales of electric energy:							
Residential <sup>(1)</sup> .....	\$ 633,151	\$ 779,682	\$ 725,797	\$ 867,684	\$ 897,965	\$ 459,461	\$ 503,949
Commercial .....	878,697	1,026,219	969,182	1,117,317	1,171,110	588,581	632,700
Industrial.....	391,906	436,313	382,140	432,296	444,070	219,251	244,177
Other.....	<u>80,473</u>	<u>86,889</u>	<u>85,052</u>	<u>91,461</u>	<u>87,123</u>	<u>43,826</u>	<u>43,981</u>
	1,984,227	2,329,103	2,162,171	2,508,758	2,600,268	1,311,119	1,424,807
Revenues from Commonwealth							
for rural electrification .....	881	705	739	704	591	294	78
Other operating revenues .....	10,240	8,210	8,514	9,625	8,565	5,233	4,919
Other (principally interest earned).....	<u>29,936</u>	<u>35,059</u>	<u>22,257</u>	<u>17,163</u>	<u>3,582</u>	<u>642</u>	<u>8,883</u>
	2,025,284	2,373,077	2,193,681	2,536,250	2,613,006	1,317,288	1,438,687
Current Expenses:							
Operations:							
Fuel.....	801,433	944,760	720,292	886,425	864,700	435,083	507,440
Purchased power .....	64,517	177,330	227,923	339,082	436,763	208,059	238,680
Other production .....	55,690	56,301	56,029	44,990	48,787	24,450	27,180
Transmission and Distribution .....	94,793	105,034	114,971	119,408	136,509	68,270	74,747
Customer accounting and Collection .....	76,598	83,453	84,689	89,710	91,763	44,558	51,065
Administrative and General .....	151,069	139,117	146,497	163,517	163,049	82,865	90,487
Maintenance <sup>(2)</sup> .....	219,812	213,666	212,959	224,941	234,563	114,895	118,932
Other.....	<u>2,911</u>	<u>3,028</u>	<u>3,235</u>	<u>3,403</u>	<u>3,622</u>	<u>1,697</u>	<u>1,780</u>
	<u>1,466,823</u>	<u>1,722,689</u>	<u>1,566,595</u>	<u>1,871,476</u>	<u>1,979,756</u>	<u>979,877</u>	<u>1,110,311</u>
Net Revenues .....	<u>\$558,461</u>	<u>\$650,388</u>	<u>\$627,086</u>	<u>\$664,774</u>	<u>\$633,250</u>	<u>\$337,411</u>	<u>\$328,376</u>
<b>Coverage</b>							
Principal and Interest Requirements.....	<u>\$346,417</u>	<u>\$367,796</u>	<u>\$392,043</u>	<u>\$381,178</u>	<u>\$427,088</u>	-	-
Ratio of Net Revenues to Principal and Interest Requirements.....	1.61	1.77	1.60	1.74 <sup>(3)</sup>	1.48	-	-

(1) Net of residential subsidy. See "Subsidies, Contributions in Lieu of Taxes and Set Aside" under *The System*.

(2) Includes, for maintenance of generating facilities, \$115.6 million, \$113.0 million, \$112.2 million, \$122.6 million and \$135.7 million for fiscal years ended June 30, 2000, 2001, 2002, 2003 and 2004, respectively. For the six months ended December 31, 2004 and 2003, the maintenance expense of generating facilities was \$69.5 million and \$65.5 million, respectively.

(3) Takes into consideration the reduction in debt service caused by refunding transactions. Excluding the effect of refunding transactions, the ratio would have been 1.6 in 2003.

## Management's Discussion and Analysis of Operating Results

The following represents the Authority's analysis of its operations for the six-month periods ended December 31, 2003 and 2004, and for the five fiscal years ended June 30, 2004. For additional analysis of the Authority's results of operations, see *Management's Discussion and Analysis* in the Authority's audited financial statements, included as Appendix II.

For the six months ended December 31, 2004, as compared to the six months ended December 31, 2003, Revenues increased by \$121.4 and Current Expenses increased by \$130.4 million, resulting in a decrease in Net Revenues of \$9.0 million. Electric energy sales, and consequently revenues, were adversely affected by Tropical Storm Jeanne, which struck Puerto Rico in September of 2004. Electric energy sales decreased by 0.8% during this period, compared to the same period of the prior year, due to the impact of the storm, and as a result there was an estimated loss of revenue of approximately \$11.4 million. Apart from the impact of the storm, the increases in Revenues and Current Expenses were mainly due to an increase of \$4.85 per barrel (or 16.8%) in the price of fuel oil and an increase of \$0.012 per kWh (or 18.4%) in the average price of purchased power. Accounts receivable of the Authority increased slightly from \$558.4 million on June 30, 2004 to \$561.5 million on December 31, 2004. In addition, accounts receivable from the governmental sector decreased from \$158.9 million on June 30, 2004 to \$138.5 million on December 31, 2004. The Authority and the Government Development Bank have recently been discussing ways to reduce the amount of time government agencies and public corporations take in paying their energy bills to the Authority.

For the fiscal year ended June 30, 2004, as compared to the fiscal year ended June 30, 2003, Revenues increased by \$76.8 million and Current Expenses increased by \$108.3 million, resulting in a decrease in Net Revenues of \$31.5 million. The increases in Revenues and Current Expenses were due to an increase of \$0.007 per kWh (or 10.8%) in the average price of purchased power and an increase of 860.7 MWh (16.2%) in the amount of purchased power. Accounts receivable of the Authority increased from \$501.2 million on June 30, 2003 to \$558.4 million on June 30, 2004. In addition, accounts receivable from the governmental sector increased from \$103.6 million on June 30, 2003 to \$158.9 million on June 30, 2004, partly as a result of the increase in the price of purchased power.

For the fiscal year ended June 30, 2003, as compared to the fiscal year ended June 30, 2002, Revenues increased by \$342.6 million and Current Expenses increased by \$304.9 million, resulting in an increase in Net Revenues of \$37.7 million. These increases were mainly due to an increase of \$7.32 per barrel (or 32%) in the price of fuel oil. Accounts receivable of the Authority increased from \$438.6 million on June 30, 2002 to \$501.2 million on June 30, 2003. In addition, accounts receivable from the governmental sector decreased slightly from \$108.4 million on June 30, 2002 to \$103.6 million on June 30, 2003.

For the fiscal year ended June 30, 2002, as compared to the fiscal year ended June 30, 2001, Revenues decreased by \$179.4 million and Current Expenses decreased by \$156.1 million, resulting in a decrease in Net Revenues of \$23.3 million. These decreases were mainly due to a decrease of \$6.48 per barrel (or 22.1%) in the price of fuel oil. Accounts receivable of the Authority increased from \$410.7 million on June 30, 2001 to \$438.6 million on June 30, 2002. In addition, accounts receivable from the governmental sector increased from \$93.1 million on June 30, 2001 to \$108.4 million on June 30, 2002.

For the fiscal year ended June 30, 2001, as compared to the fiscal year ended June 30, 2000, Revenues increased by \$347.8 million and Current Expenses increased by \$255.9 million, resulting in an increase in Net Revenues of \$91.9 million. These increases were mainly due to an increase in electric energy sales in kWh of 3.2% and an increase of \$5.79 per barrel (or 24.6%) in the price of fuel oil. Accounts receivable of the Authority increased from \$385.2 million on June 30, 2000 to \$410.7 million on June 30, 2001. In addition, accounts receivable from the governmental sector decreased from \$113.6 million on June 30, 2000 to \$93.1 million on June 30, 2001. This decrease was mainly due to the increase in the amount paid

by the Authority as contributions in lieu of taxes from \$82.0 million in fiscal 2000 to \$115.5 million in fiscal 2001, which was used to offset the accounts receivable balance owed by the municipalities.

For the fiscal year ended June 30, 2000, as compared to the fiscal year ended June 30, 1999, Revenues increased by \$461.3 million and Current Expenses increased by \$414.1 million, resulting in an increase in Net Revenues of \$47.2 million. These increases were mainly due to the damage caused by Hurricane Georges in September of 1998, which affected the results for the 1999 fiscal year, and to an increase of \$8.98 (or 61.7%) in the price per barrel of fuel oil. The accounts receivable of the Authority increased from \$305.9 million on June 30, 1999 to \$385.2 million on June 30, 2000. In addition, accounts receivable from the governmental sector increased from \$83.0 million on June 30, 1999 to \$113.6 million on June 30, 2000 for the same reason.

The following table presents the disposition of Net Revenues, in the order of priority of payment, for the five fiscal years ended June 30, 2004 and for the six months ended December 31, 2003 and 2004, in accordance with the provisions of the 1974 Agreement. As discussed above, the Net Revenues shown below and in “Projected Net Revenues” under *Net Revenues and Coverage* are calculated in a manner that differs in several important respects from the Authority’s calculation of net income prepared in accordance with generally accepted accounting principles.

**Historical Disposition of Net Revenues  
(in thousands)**

Disposition of Net Revenues	Years Ended June 30,					Six Months Ended December 31,	
	2000	2001	2002	2003	2004	2003	2004
1974 Sinking Fund							
Interest.....	\$224,758	\$240,459	\$248,469	\$249,779	\$264,219	\$130,326	\$128,593
Principal .....	145,058	146,989	158,357	137,329	166,004	83,215	81,246
1974 Reserve Account .....	-	-	-	(30,000) <sup>(1)</sup>	-	-	-
Reserve Maintenance Fund .....	7,000	7,000	7,000	7,000	7,000	3,498	3,498
Self-insurance Fund .....	-	-	-	-	-	-	-
Capital Improvement Fund .....	74,265	100,500	77,307	144,537	43,066	44,505	32,254
General Obligation Notes							
Interest .....	103	-	-	-	1,979	335	1,873
Contributions in lieu of taxes and other uses <sup>(2)</sup> .....	<u>107,277</u>	<u>155,440</u>	<u>135,953</u>	<u>156,129</u>	<u>150,982</u>	<u>75,532</u>	<u>80,912</u>
Net Revenues .....	<u>\$558,461</u>	<u>\$650,388</u>	<u>\$627,086</u>	<u>\$664,774</u>	<u>\$633,250</u>	<u>\$337,411</u>	<u>\$328,376</u>

(1) The excess funds from this account were transferred to the 1974 Bond Service Account.

(2) Including the following amounts retained by the Authority to offset certain Commonwealth obligations to the Authority, the residential subsidy and other subsidies granted to the hotel industry: \$23.5 million, \$33.6 million, \$26.0 million, \$28.7 million and \$30.4 million for fiscal years ended June 30, 2000, 2001, 2002, 2003 and 2004, respectively. For the six months ended December 31, 2003 and 2004, those subsidies amounted to \$15.3 million and \$14.8 million, respectively. See “Subsidies, Contributions in Lieu of Taxes and Set Aside” under *The System*.

### Factors Affecting the Utility Industry

The electric utility industry generally has faced and is facing certain adverse factors. These include (1) the high cost of construction and operation of utility facilities, (2) the volatility and uncertainty of fuel prices, (3) the uncertain cost of capital, (4) regulations, licensing procedures, litigation and other factors

which may delay the construction and increase the cost of new facilities or limit the use of, or necessitate costly modifications to, existing facilities, and (5) the substantially increased capital outlays and longer construction periods required for new facilities. The Authority is unable to predict the future effect of these or other factors upon its operations and financial condition.

The electric utility industry in the United States mainland is changing from a regulated monopoly business to a deregulated competitive industry. The Federal Energy Regulatory Commission (“FERC”) has mandated wholesale wheeling and open access for transmission facilities owned by utilities that engage in interstate commerce. Many states have enacted or proposed laws and regulations that are designed to (i) insure open access to transmission facilities to promote wholesale power supply competition and (ii) phase in retail competition.

The Authority’s competitive situation is different from that of most United States mainland utilities. There are no wholesale clients in the Commonwealth. The application of FERC’s requirements to the Authority is limited because the Authority is not interconnected with any other utility. The Authority is not currently subject to FERC’s regulations regarding wholesale wheeling.

The absence of mandated open access to the Authority’s transmission and distribution system limits competition to on-site power for large industrial clients with little prospect of excess power sales. Additionally, the commercial availability of electric generating units depends heavily on economies of scale and tends not to be economic in small sizes, less than 60 MW, which size is more than twice the peak demand of the Authority’s largest industrial client.

**Projected Net Revenues**

The main assumptions used by the Authority in preparing the estimates of Net Revenues set forth below are the following:

Revenues..... Projected Revenues from sales of electric energy are based upon economic growth projections for the Commonwealth. The Revenue projections assume annual sales growth of 2.2%, and incorporate the Authority’s results for the first six months of fiscal year 2005.

Fuel..... Projected fuel prices are based upon an analysis prepared by the Authority, which takes into consideration the Annual Energy Outlook issued by the United States Department of Energy and the Authority’s historical fuel data. The Authority passes through the cost of fuel to its consumers and historically has not suffered significant reductions in demand as a result of higher energy prices. The following table sets forth projected average per barrel fuel prices:

**Projected Fuel Prices**

Years Ending June 30,	Average Price Per Barrel <sup>(1)</sup>
2005.....	\$ 32.03 <sup>(2)</sup>
2006.....	29.72
2007.....	30.66
2008.....	31.59
2009.....	31.88

(1) This is a blended price of No. 2 and No. 6 fuel oil prices. The prices exclude handling charges.  
 (2) Based on actual prices through December 31, 2004 and estimates for the remainder of the fiscal year.

The following table presents the Authority's estimates of Net Revenues for the five fiscal years ending June 30, 2009, in accordance with the provisions of the 1974 Agreement, and the ratio of Net Revenues to Principal and Interest Requirements for Power Revenue Bonds.

### Projected Net Revenues and Coverage

	Years Ending June 30,				
	2005 <sup>(1)</sup>	2006	2007	2008	2009
Average number of clients .....	1,417,718	1,435,492	1,451,494	1,467,257	1,483,712
Electric energy sales (in millions of kWh).....	20,474.3	21,335.5	21,843.5	22,227.8	22,657.1
Authority generation (gross)(in millions of KWh).....	19,610	17,220	16,729	16,995	17,819
Purchased generation (gross)(in millions of KWh).....	6,804	7,381	7,736	7,511	8,637
<b>Sources of Net Revenues</b>					
<b>(dollars in thousands)</b>					
Revenues:					
Sales of electric energy:					
Residential .....	\$ 945,547	\$ 932,257	\$ 948,313	\$ 972,547	\$ 990,276
Commercial .....	1,224,497	1,265,333	1,314,945	1,371,653	1,425,599
Industrial.....	470,258	473,687	479,943	492,712	507,139
Other.....	88,358	89,351	89,428	90,542	90,843
	<u>2,728,660</u>	<u>2,760,628</u>	<u>2,832,629</u>	<u>2,927,454</u>	<u>3,013,857</u>
Revenues from Commonwealth for					
Rural Electrification .....	161	116	76	26	19
Other (principally interests earned).....	27,507	29,403	31,403	33,403	35,403
	<u>2,756,328</u>	<u>2,790,147</u>	<u>2,864,108</u>	<u>2,960,883</u>	<u>3,049,279</u>
Current Expenses <sup>(2)</sup> :					
Operations:					
Fuel .....	918,616	869,098	886,653	948,386	925,539
Purchased Power .....	481,344	504,746	523,922	525,469	602,272
Other Production .....	52,253	51,179	52,238	53,319	54,423
Transmission and Distribution .....	136,477	126,000	128,608	131,270	133,988
Maintenance .....	244,452	256,253	261,557	266,971	272,497
Client accounting and collection.....	101,402	102,754	104,881	107,052	109,268
Administration and general .....	173,734	169,964	173,481	177,073	180,739
Other – Interest Charges.....	2,842	2,183	2,237	2,293	2,351
	<u>2,111,120</u>	<u>2,082,177</u>	<u>2,133,577</u>	<u>2,211,833</u>	<u>2,281,077</u>
Net Revenues.....	<u>\$ 645,208</u>	<u>\$ 707,970</u>	<u>\$ 730,531</u>	<u>\$ 749,050</u>	<u>\$ 768,202</u>
<b>Coverage</b>					
Principal and Interest Requirements <sup>(3)</sup> .....	\$ 398,450	\$ 455,302	\$ 470,632	\$ 474,802	\$ 496,942
Ratio of Net Revenues to Principal and Interest Requirements.....	1.62	1.55	1.55	1.58	1.55

(1) Based on actual results through December 31, 2004 and estimates for the remainder of the fiscal year.

(2) The Current Expenses (excluding fuel oil and purchased power) projections assume an annual growth of 2%.

(3) Includes debt service requirements for (i) the outstanding Power Revenue Bonds (including the Bonds and the Series QQ Bonds, but excluding the Refunded Bonds and the Power Revenue Bonds to be refunded from the proceeds of the Series QQ Bonds), and (ii) expected Power Revenue Bond issues, all at an assumed interest rate of 6% (\$463.9 million in fiscal year 2007, and \$489.7 million in fiscal year 2008) (no repayments of principal of these issues are assumed until after fiscal year 2005).

The Authority's estimates of Net Revenues, which were made as part of the adoption of its budget of Current Expenses for fiscal year 2005, have been reviewed and analyzed by the Consulting Engineers. The Consulting Engineers have concluded that (i) the methodology used by the Authority in preparing its revenue and capacity projections generally follows accepted utility practice and is appropriate for the Authority, (ii) the Authority's estimates of future growth form a reasonable basis for its projected operating results, and (iii) the Authority's rates should generate sufficient revenues to pay its Current Expenses and debt service and to finance that portion of its capital improvement program that is currently anticipated to be financed with current operating revenues. See Appendix III, *Letter of Consulting Engineers*.

Although the Authority and the Consulting Engineers believe that the assumptions upon which the estimates of Net Revenues are based are reasonable, actual results may differ from the estimates as circumstances change. In addition, such projections were not intended to comply with the guidelines established by the American Institute of Certified Public Accountants for preparation and presentation of financial projections. The projections have been prepared on the basis of Net Revenues as defined in the 1974 Trust Agreement which differs in several important respects from the Authority's net income prepared in conformity with generally accepted accounting principles in that they do not include, for example, depreciation as a current expense and do not reflect interest expense on Power Revenue Bonds as a deduction from Net Revenues.

The following table presents the projected disposition of Net Revenues, in the order of priority of payment, for the five fiscal years ending June 30, 2009, in accordance with the provisions of the 1974 Agreement.

**Projected Disposition of Net Revenues  
(in thousands)**

<u>Disposition of Net Revenues</u>	Years Ending June 30,				
	2005 <sup>(1)</sup>	2006	2007	2008	2009
1974 Sinking Fund:					
Interest.....	\$ 249,912	\$ 263,448	\$ 273,067	\$ 290,235	\$ 295,602
Principal .....	148,538	191,854	197,565	184,567	201,340
1974 Reserve Account.....	2,838	2,838	2,838	2,838	2,838
Reserve Maintenance Fund.....	7,000	7,000	7,000	7,000	7,000
Interest on Notes .....	1,873	-	-	-	-
Self-insurance Fund.....	-	-	-	-	-
Capital Improvement Fund.....	82,995	77,379	80,191	90,190	83,807
Contributions in lieu of taxes and other <sup>(2)</sup> .....	<u>152,052</u>	<u>165,451</u>	<u>169,870</u>	<u>174,220</u>	<u>177,615</u>
Total Net Revenues.....	<u>\$ 645,208</u>	<u>\$ 707,970</u>	<u>\$ 730,531</u>	<u>\$ 749,050</u>	<u>\$ 768,202</u>

(1) Based on actual results for the six-month period ended December 31, 2004 and an estimate for the last six months of fiscal year 2005.  
(2) Includes the following amounts to be retained by the Authority and used to pay interest on its General Obligation Notes and to offset certain Commonwealth obligations to the Authority, the residential subsidy and the subsidy granted to the hotel industry: \$28.8 million, \$29.8 million, \$29.7 million, \$30.5 million and \$29.9 million for fiscal years ending June 30 2005, 2006, 2007, 2008 and 2009, respectively. See "Subsidies, Contributions in Lieu of Taxes and Set Aside" under *The System*.

## ENVIRONMENTAL MATTERS

The Authority's Environmental Protection and Quality Assurance Division is responsible for ensuring the Authority's compliance with all applicable federal and Commonwealth environmental laws and regulations. The Division is in charge of developing and implementing a comprehensive program to improve the Authority's performance in all applicable environmental media, taking into account new regulatory requirements as well as alleged instances of noncompliance cited by the Environmental Protection Agency ("EPA") and any other environmental agencies.

### **Environmental Litigation and Administrative Proceedings**

#### *Consent Decree*

In February of 1992, EPA conducted a multimedia inspection of the Authority's four thermoelectric plants as well as the Monacillos Transmission Center. EPA released a report of its findings in December of 1992. In its findings, EPA identified several alleged instances of non-compliance related to the Authority's air, water and oil spill prevention control and countermeasures compliance programs.

The Authority and EPA undertook negotiations to resolve the issues regarding the deficiencies observed during the inspection and to ensure future compliance with all applicable laws and regulations. As a result of the negotiations, the Authority and EPA reached an agreement that resulted in a consent decree (the "Consent Decree") approved by the United States federal court in March of 1999. In the Consent Decree, the Authority agreed to pay a civil penalty of \$1.5 million, which has already been paid, and to implement additional compliance projects amounting to \$4.5 million, which have already been funded to the full extent required by the Consent Decree. In addition, the Consent Decree requires that the Authority improve and implement compliance programs and operations in order to assure compliance with environmental laws and regulations.

The Authority and EPA have had various disagreements as to the implementation of certain requirements of the Consent Decree. However, in September of 2004 the United States federal court approved a modification to the Consent Decree agreed by the Authority and EPA to resolve these disagreements, which substantially implemented EPA's interpretation of these requirements. Among other things, the Authority agreed to reduce in two steps the sulfur content in the No. 6 fuel oil used in certain generating units of its Costa Sur and Aguirre power plants, to 0.75% or less by March 1, 2005 and to 0.5% or less by March 1, 2007 (unless the Authority installs certain pollution control equipment and demonstrates compliance with EPA standards), and to continue to use No. 6 fuel oil with a sulfur content of not more than 0.5% through July 18, 2009 at its Palo Seco and San Juan power plants. The Authority also paid a \$300,000 civil fine and reserved \$200,000 to fund certain programs under the Consent Decree.

#### *Probation*

In September of 1995, while preparing for Hurricane Luis, approximately 270,000 gallons of acidic wastewater were discharged from the Palo Seco power plant into the Bayamón River, affecting a nearby mangrove swamp. After investigations by the EPA and the United States Department of Justice, in June of 1999, the Authority pleaded guilty to a misdemeanor of negligently discharging a pollutant into waters of the United States, in violation of the criminal provisions of the Clean Water Act, and was ordered to pay a \$140,000 fine, which it has paid. The Authority was placed on probation for two years.

In response to this violation, the Authority has undertaken an extensive program to prevent and detect violations of environmental law. Pursuant to this program, the Authority's plant personnel have been trained at seminars in methods to avoid and detect environmental violations.

In June of 2001, the U.S. Probation Office alleged in a motion filed with the court that the Authority had violated certain conditions of the Consent Decree, which in turn violated the conditions of the Authority's probation. In June of 2002, the United States Government and the Authority executed a settlement agreement resolving the dispute, and in July of 2002, the United States federal court entered an Amended Order of Probation, implementing the agreement and extending the Authority's probation for additional 18 months. Pursuant to the settlement agreement, the parties appointed a compliance auditor to monitor compliance with certain visible emissions standards at certain of the Authority's generating facilities during a certain period. The Authority was also required to pay for the purchase and operation of several air quality-monitoring stations provided to the Puerto Rico Environmental Quality Board, and to pay a \$10,000 fine. As of the date of this Official Statement, the Authority had paid approximately \$860,000 to purchase and operate these stations. Inspections by the compliance auditor have concluded at the Palo Seco power plant, but continue at the Costa Sur plant. The settlement agreement also provides that the Authority will burn fuel with a sulfur content not to exceed 0.5% at the Authority's Palo Seco and San Juan power plants for a period of not less than two years, which commenced in April of 2003. The use of 0.5% sulfur fuel increased the Authority's fuel costs by approximately \$42 million in fiscal year 2004.

#### *Other proceedings*

In June of 2002, the Authority received a "Special Notice Concerning Remedial Investigation/Feasibility Study for Soil at the Vega Baja Solid Waste Disposal Superfund Site." EPA has identified the Authority and six other entities as "potentially responsible parties," as defined in the Comprehensive Environmental Response, Compensation and Liability Act (CERCLA). In April of 2003, the Authority agreed to join the other potentially responsible parties in an Administrative Order on Consent for Remedial Investigation and Feasibility Study, with the understanding that such agreement did not constitute an acceptance of responsibility. The Authority believes that participation in this study will enable the Authority to demonstrate that it has no responsibility regarding the site or that its responsibility, if any, is *de minimis*. Under the Administrative Order on Consent, the Authority committed up to \$250,000 as its contribution to partially fund the Remedial Investigation and Feasibility Study. It is expected that this amount will be disbursed over a two-year period, which is the approximate time it will take to complete the study, which has already commenced.

In October of 2004, EPA filed a complaint against the Authority regarding an alleged Resource Conservation and Recovery Act (RCRA) violation at its Aguirre power plant and proposing a \$225,025 penalty. The alleged violation is related to an oil sheen observed by an EPA/RCRA compliance officer during an inspection in 2000. The Authority has filed an answer to the complaint disputing the allegations. The parties are currently negotiating a possible settlement of the complaint.

In December of 2004, the EPA sent a request for information to the Authority and to other potentially responsible parties that did business with certain recycling companies regarding the release of pollutants by these recycling companies in a Toa Baja superfund site. The EPA has stated that it is particularly interested in entities that disposed of batteries in this site. The Authority has responded to the request for information, stating that it only sold scrap metal to these recycling companies. The Authority does not believe it has any liability regarding this site.

#### **Compliance Programs**

The Authority continues to develop and implement a comprehensive program to improve environmental compliance in all applicable environmental media. This program has been and continues to be updated to conform to new regulatory requirements.



### *Air Quality Compliance*

In general, the Authority is consistently maintaining a 99% or better level of compliance with in-stack opacity requirements. The Authority continues in its effort to reduce visible emissions at the Aguirre and Costa Sur power plants, and believes that compliance with the terms of the Consent Decree relating to the use of fuel with lower sulfur content will improve air quality at these plants. Also, as part of the probation extension agreement discussed above, the Authority will continue to use No. 6 fuel oil with sulfur contents equal to or less than 0.5% at its Palo Seco and San Juan power plants, which should contribute maintain air quality.

The Authority continues the use of fuel additives in certain of its power plants under a test program. Since each power unit has its own characteristics, the program will allow the identification of the most suitable additive to improve maintenance and enhance environmental compliance. To date, water and oil-based fuel additives have been tested at the Aguirre, Costa Sur and Palo Seco power plants. Since the Authority has commenced using No. 6 fuel oil with 0.5% or less sulfur content at its Palo Seco power plant, the use of additives has been discontinued at that plant.

After implementing the air quality compliance programs of the Consent Decree and reducing the sulfur content of fuel used at certain of its power plants as contemplated by the Consent and the amended order of probation discussed above, the Authority expects to be in full compliance with all visible emission requirements.

### *Water Quality Compliance*

As of December 2004, the Authority had achieved a level of compliance with the Clean Water Act regulations in excess of 99%.

The Authority has completed compliance plans for abating water pollution at its four major power plants - Aguirre, San Juan, Costa Sur, and Palo Seco, as required by the Consent Decree. The cost of the projects scheduled for fiscal year 2005 is approximately \$2.9 million.

In April of 1995, the Authority submitted to EPA a request under Section 316(a) of the Clean Water Act that its Costa Sur power plant be permitted to discharge into the Caribbean Sea heated water that was previously used as part of the plant's combustion and generation process, known as "thermal effluent". In December of 2000 and again in January of 2005, EPA indicated that it would deny the Authority's request, although a final denial has not been issued. EPA and the Authority have continued to discuss alternatives related to the thermal effluent. The Authority also has pending before the EPA certain thermal waiver requests pursuant to Section 316 of the Clean Water Act for its San Juan, Palo Seco and Aguirre power plants. Both cases are under EPA's evaluation. EPA has requested additional studies which are on going.

### *Underground Injection Control Regulation*

The Authority has prepared a compliance plan in order to comply with the Puerto Rico Environmental Quality Board's underground injection control regulations. The compliance plan contemplates the construction of septic systems at certain sites, and the closing of septic systems at other sites where sanitary discharges can be connected to the facilities of the Puerto Rico Aqueduct and Sewer Authority. This project is at a very advanced state. For fiscal year 2005, the Authority has allocated \$1.2 million for this project.

### *Spill Prevention Control and Countermeasures Plan*

To meet its obligations under the Spill Prevention Control and Countermeasures (SPCC), a program under the Oil Pollution Act of 1990 plan requirements and the Consent Decree, the Authority continues to

implement corrective measures at all of its facilities. This program also includes scheduled major overhaul to dikes and fuel tanks. The Authority's SPCC plans were approved in 2003. In June of 2004, the Authority informed the EPA of slight delays in the project schedules and submitted a revised schedule for project completion. EPA accepted the revised schedule in December of 2004. In July of 2002, an amendment to the SPCC regulations was adopted that affects the Authority's oil filled equipment at its electrical transmission and distribution substations. The Authority has been inspecting its substations and evaluating the impact of these new requirements in order to develop a compliance schedule for the preparation of a new SPCC plan. EPA has established February 17, 2006 as the due date for submitting these new plans. Approximately \$2.9 million during current fiscal year has been spent during the six-month period ended December 31, 2004 in projects under this program. The implementation of this program is estimated to cost approximately \$16.7 million during the next five years. The Authority expects to spend approximately \$8.16 million for this program during fiscal year 2005.

#### *PCB Testing*

The Authority has completed a ten-year EPA-mandated program to sample and test its oil-filled transformers and other equipment in order to identify and dispose of PCB contaminated equipment. Pursuant to this program, the Authority has completed the removal and disposal of PCB transformers with PCB concentrations of more than 500 ppm. The Authority continues with the removal and disposal of transformers with PCB concentrations of between 50 and 499 ppm. As of February 2005, the Authority estimates that approximately 581 of these units remain to be disposed of. The Authority has requested and received verbal approval of a three-year extension of the original deadline. The Authority recently agreed to submit to EPA a final report of the status of the program by March 31, 2005. According to EPA, the Authority has been the only utility to go so far with a program to sample, test, identify, remove and dispose of PCB or PCB contaminated transformers. The budget assignment for this program for fiscal year 2005 is approximately \$1.9 million.

#### *Asbestos Abatement*

The Authority is engaged in encapsulating or gradually removing asbestos-containing insulation from its power plants. The Authority expects to spend approximately \$1.6 million during fiscal year 2005 for this purpose.

#### *Capital Improvement Program*

The Authority's capital improvement program for the five fiscal years ending June 30, 2009 includes \$80 million in order to comply with existing Commonwealth and federal environmental laws and regulations. The Authority believes it is taking the necessary steps to comply with all applicable environmental laws and regulations and the Consent Decree requirements.

## **INSURANCE**

### **Coverage**

The Authority maintains, among others, insurance policies covering all-risk property (excluding transmission and distribution lines other than underground lines), boiler and machinery and public liability. The combined insurance coverage of these policies is \$650 million, consisting of a maximum of \$200 million under the all-risk property insurance policy, \$200 million under the boiler and machinery insurance policy, and \$250 million under an excess umbrella policy.

The policies' self-retention in case of earthquake and windstorm losses is \$25 million, and \$2 million for all other covered risks.

The proceeds of the all-risk property and boiler and machinery policies are used prior to drawing upon the Reserve Maintenance Fund or the Self-insurance Fund established under the 1974 Agreement.

The public general liability policy covers property damage and bodily injury to third parties with a \$75 million aggregate limit in excess of the self-retention limit of \$1 million per occurrence.

As electric utilities located on the east coast of the United States, the Authority's transmission and distribution facilities are susceptible to adverse weather conditions, such as hurricanes. The Authority is currently self-insured with respect to property damage for its transmission and distribution systems, as are most other U.S. utilities. While the Authority and the Consulting Engineers believe that the Authority's reserves are generally sufficient, there can be no assurance that the Authority will be able to provide adequate coverage for damage that might be incurred as a result of any future adverse weather conditions.

In the Authority's opinion, its insurance coverage adequately protects it against property damage or bodily injury resulting from the possession, operation and maintenance of the System.

The State Insurance Fund, a Commonwealth agency which provides worker's compensation insurance, is funded by mandatory contributions from the Authority.

### **Self-insurance Fund**

The Authority has supplemented the 1974 Agreement to create a Self-insurance Fund, which is funded from Net Revenues (after deposits to the Sinking Fund and the Reserve Maintenance Fund) in the amounts recommended from time to time by the Consulting Engineers. The Authority has no obligation to make deposits to, or to replenish, the Self-insurance Fund in the event of withdrawals therefrom, except the extent recommended by the Consulting Engineers. Amounts on deposit in the Self-insurance Fund are also available for the payment of principal of and interest on the Power Revenue Bonds. During the first six months of fiscal year 2005, the Authority withdrew \$20 million from the Self-insurance Fund to finance the repair and other costs related to Tropical Storm Jeanne. As of December 31, 2004, approximately \$62.5 million was on deposit in the Self-insurance Fund. See "Disposition of Revenues" in Appendix I, *Summary of Certain Provisions of the 1974 Agreement Excluding Proposed Supplemental Agreement*.

## **LABOR RELATIONS**

As of December 31, 2004, the Authority had 9,966 employees, of which 686 were temporary unionized employees. Four local unions represent 6,983 employees. The Electrical Industry and Irrigation Workers Union or “UTIER” represents 5,600 employees engaged in operations and maintenance. The Insular Union of Industrial and Electrical Construction Workers or “UITICE” represents construction workers, the Professional Employees Independent Union or “UEPI” represents professional employees, and the Electric Power Authority Pilots Union or “UPAEE” represents the pilots employed by the Authority.

The collective bargaining agreement with UEPI expired on December 18, 2004 and the collective bargaining agreement with UITICE expired on January 29, 2005. The Authority is currently negotiating new collective bargaining agreements with both unions, and does not anticipate any significant issues that would prevent new collective bargaining agreements to be signed in the near future. The collective bargaining agreement with UTIER expires on November 14, 2005, and the Authority expects to commence negotiations aimed at signing a new collective bargaining agreement later this year. The collective bargaining agreement with UPAEE expires on July 2, 2006.

Of the Authority’s 9,966 employees, 3,333 are employed in the transmission and distribution facilities directorate, 2,271 are employed in the generating facilities directorate, 1,679 are employed in the customer service directorate, and the remaining employees are employed in the administrative directorates and other areas.

In order to improve the productivity of its employees, the Authority has instituted various programs to reduce absenteeism, increase safety measures, and minimize the level of illegal drug abuse among its employees. In addition, the Authority continues to implement programs to provide both technical and supervisory training to its employees. The Authority believes that the implementation of these programs helps the Authority provide service that is more reliable to its clients.

## **PENSION PLAN**

The Employees’ Retirement System of Puerto Rico Electric Power Authority (the “Retirement System”), a separate trust fund created by the Authority, administers the Authority’s defined benefit pension plan, which provides employee retirement and death benefits. The pension plan provides for contributions by both the Authority, based on annual actuarial valuations, and the plan members. The contributions recorded for the fiscal year ended June 30, 2004 were \$52.6 million, while the contributions recorded for the six months ended December 31, 2004 were \$34.3 million. This represented 6.03% of covered payroll for normal cost and 11.05% of unfunded actuarial accrued liability for fiscal year 2004, and 6.03% of covered payroll for normal cost and 15.04% of unfunded actuarial accrued liability for the six months ended December 31, 2004. Employee contributions and other withholdings are being paid to the Retirement System on a current basis. In the six months ended December 31, 2004, total pension expense of the Authority was approximately \$34.3 million, including approximately \$24.5 million for past service costs. Unfunded past service liability to be borne entirely by the Authority was approximately \$799.2 million as of June 30, 2003, the date of the last actuarial valuation of the Retirement System. As of that date, the pension plan was 63% funded. Currently, the Retirement System’s actuaries are in the process of preparing a new actuarial valuation.

The Retirement System’s financial statements are audited by a firm of independent public accountants that does not serve as independent accountants to the Authority.

## LITIGATION

There is no pending litigation seeking to restrain or enjoin the sale of the Bonds or contesting or affecting the validity of the Bonds, the proceedings of the Authority taken with respect to the authorization, issuance or sale of the Bonds, or the pledge or application of any moneys under the 1974 Agreement or the existence or powers of the Authority.

The Authority is involved in various lawsuits arising in the normal course of business, none of which, in the opinion of the Authority and its General Counsel, if decided against the Authority, would have a material adverse effect on the Authority's financial condition or operations. Among the cases currently pending, some deal with environmental issues. These are described above in "Environmental Litigation and Administrative Proceedings" under *Environmental Matters*.

In May 1998, the Municipality of Ponce filed a complaint (subsequently joined by all the other municipalities) against the Authority demanding the payment by the Authority of contributions in lieu of taxes and electric energy sales set aside for prior fiscal years that the municipalities claimed were owed to them. The complaint challenged the reduction of the amount paid to the municipalities by the amount of deposits made by the Authority to certain funds under the 1974 Agreement and a previous indenture and sought a payment by the Authority in the amount of such reduction. In April of 2003, the Authority made a settlement offer to the municipalities consisting of a payment in cash of \$68 million and \$57 million for electric infrastructure projects in the municipalities, for a total of \$125 million. (See "Notes" under *Debt*). All of the municipalities have now accepted the Authority's offer and a substantial portion of the settlement payment has already been made. This settlement has not materially affected the Authority's financial condition.

In May of 2000, Abengoa, Puerto Rico, S.E. ("Abengoa"), the Authority's original contractor for the construction of the new generating units (units 5 and 6) at the San Juan power plant, unilaterally declared a termination of the contract and filed a complaint for breach of contract. The Authority filed a counter claim for breach of contract and for all damages caused to the Authority by the contract termination. The case is in the discovery stage. The Authority continues to defend this claim vigorously, and has raised various defenses thereto. At the current stage, however, the Authority cannot predict with any certainty the outcome of this case or the range of potential loss, if any. In order to mitigate its possible losses, the Authority recently entered into an agreement with Washington Engineers P.S.C. for the completion of such generating units. The Authority expects the project to be completed during fiscal year 2007.

In June 2004, the Office of the Comptroller of the Commonwealth of Puerto Rico issued a report stating that the Authority overcharged its clients by approximately \$49.8 million, and should reimburse this amount to such clients. After this report was made public, two lawsuits were filed by clients of the Authority against the Authority demanding the reimbursement of such alleged overcharges. On June 17, 2004, the President of the Governing Board of the Authority sent a written response to the Comptroller and issued a press release in which the Authority denied that any overcharges were made. The Authority's position is that the Comptroller incorrectly based his conclusion on data that is not relevant to the calculation of the Authority's rates, and that the Authority's rates were properly established in the year 2000 in accordance with applicable laws and regulations. In particular, the Authority notes that its tariffs properly take into consideration the cost of the fuel used by the Authority's generating facilities and the cost of the electricity purchased from the two co-generating facilities that sell power to the Authority. See "Rates" under *The System* above. The Authority believes that the allegations of the complaints are similar to those made in a previous lawsuit in which the Authority prevailed on the merits of the case.

## TAX MATTERS

In the opinion of Squire, Sanders & Dempsey L.L.P., Bond Counsel, under existing law (i) interest on the Bonds is excluded from gross income for federal income tax purposes under Section 103 of the Internal Revenue Code of 1986, as amended (the “Code”), and is not an item of tax preference for purposes of the federal alternative minimum tax imposed on individuals and corporations, and (ii) the Bonds and the interest thereon are exempt from state, Commonwealth and local taxation. Bond Counsel will express no opinion as to any other tax consequences regarding the Bonds.

The opinion on federal tax matters will be based on and will assume the accuracy of certain representations and certifications, and continuing compliance with certain covenants, of the Commonwealth to be contained in the transcript of proceedings and that are intended to evidence and assure the foregoing, including that the Bonds are and will remain obligations the interest on which is excluded from gross income for federal income tax purposes. Bond Counsel will not independently verify the accuracy of those certifications and representations or that continuing compliance.

The Code prescribes a number of qualifications and conditions for the interest on state and local government obligations to be and to remain excluded from gross income for federal income tax purposes, some of which require future or continued compliance after issuance of the obligations in order for the interest to be and to continue to be so excluded from the date of issuance. Noncompliance with these requirements by the Commonwealth may cause the interest on the Bonds to be included in gross income for federal income tax purposes and thus to be subject to federal income tax retroactively to the date of issuance of the Bonds. The Commonwealth has covenanted, to the extent permitted by the Constitution and the laws of the Commonwealth, to take the actions required of it for the interest on the Bonds to be and to remain excluded from gross income for federal income tax purposes, and not to take any actions that would adversely affect that exclusion. Bond Counsel is not aware of any provision of the Constitution or laws of the Commonwealth that would prevent the Commonwealth from complying with the requirements of the Code.

A portion of the interest on the Bonds earned by certain corporations may be subject to a federal corporate alternative minimum tax. In addition, interest on the Bonds may be subject to a federal branch profits tax imposed on certain foreign corporations doing business in the United States and to a federal tax imposed on excess net passive income of certain S corporations.

Under the Code, the exclusion of interest from gross income for federal income tax purposes may have certain adverse federal income tax consequences on items of income, deduction or credit for certain taxpayers, including financial institutions, certain insurance companies, recipients of Social Security and Railroad Retirement benefits, those that are deemed to incur or continue indebtedness to acquire or carry tax-exempt obligations, and individuals otherwise eligible for the earned income tax credit. The applicability and extent of these and other tax consequences will depend upon the particular tax status or other tax items of the owner of the Bonds. Bond Counsel will express no opinion regarding those consequences.

Ownership of tax-exempt obligations, including the Bonds, may also result in collateral income tax consequences under Puerto Rico law to financial institutions doing business in Puerto Rico.

Purchasers of the Bonds at other than their original issuance at the respective prices indicated on the inside cover page of this Official Statement should consult their own tax advisers regarding other tax considerations such as the consequences of market discount.

### **Original Issue Discount and Original Issue Premium**

Certain of the Bonds (“Discount Bonds”) as indicated on the inside cover page of this Official Statement were offered and sold to the public at an original issue discount (“OID”). OID is the excess of the

stated redemption price at maturity (the principal amount) over the “issue price” of a Discount Bond. The issue price of a Discount Bond is the initial offering price to the public (other than to bond houses, brokers or similar persons acting in the capacity of underwriters or wholesalers) at which a substantial amount of the Discount Bonds of the same maturity is sold pursuant to that offering. For federal income tax purposes, OID accrues to the owner of a Discount Bond over the period to maturity based on the constant yield method, compounded semiannually (or over a shorter permitted compounding interval selected by the owner). The portion of OID that accrues during the period of ownership of a Discount Bond (i) is interest excluded from the owner's gross income for federal income tax purposes to the same extent, and subject to the same considerations discussed above, as other interest on the Bonds, and (ii) is added to the owner's tax basis for purposes of determining gain or loss on the maturity, redemption, prior sale or other disposition of that Discount Bond. A purchaser of a Discount Bond in the initial public offering at the price for that Discount Bond stated on the inside cover page of this Official Statement who holds that Discount Bond to maturity will realize no gain or loss upon the retirement of that Discount Bond.

Certain of the Bonds (“Premium Bonds”) as indicated on the inside cover page of this Official Statement were offered and sold to the public at a price in excess of their stated redemption price (the principal amount) at maturity. That excess constitutes bond premium. For federal income tax purposes, bond premium is amortized over the period to maturity of a Premium Bond, based on the yield to maturity of that Premium Bond (or, in the case of a Premium Bond callable prior to its stated maturity, the amortization period and yield may be required to be determined on the basis of an earlier call date that results in the lowest yield on that Premium Bond), compounded semiannually. No portion of that bond premium is deductible by the owner of a Premium Bond. For purposes of determining the owner's gain or loss on the sale, redemption (including redemption at maturity) or other disposition of a Premium Bond, the owner's tax basis in the Premium Bond is reduced by the amount of bond premium that accrues during the period of ownership. As a result, an owner may realize taxable gain for federal income tax purposes from the sale or other disposition of a Premium Bond for an amount equal to or less than the amount paid by the owner for that Premium Bond. A purchaser of a Premium Bond in the initial public offering at the price for that Premium Bond stated on the inside cover page of this Official Statement who holds that Premium Bond to maturity (or, in the case of a callable Premium Bond, to its earlier call date that results in the lowest yield on that Premium Bond) will realize no gain or loss upon the retirement of that Premium Bond.

Owners of Discount and Premium Bonds should consult their own tax advisers as to the determination for federal income tax purposes of the amount of OID or bond premium properly accruable in any period with respect to the Discount or Premium Bonds and as to other federal tax consequences and the treatment of OID and bond premium for purposes of state and local taxes on, or based on, income.

#### **VERIFICATION OF MATHEMATICAL COMPUTATIONS**

The Arbitrage Group, Inc. will verify from the information provided to them the mathematical accuracy as of the date of the delivery of the Bonds of (1) the computations contained in the provided schedules to determine that the anticipated receipts from the securities and cash deposits listed in such schedules, to be held in escrow, will be sufficient to pay, when due, the principal, interest and call premium payment requirements, if any, of the Refunded Bonds, and (2) the computations of yield on both the securities and the Bonds contained in such schedules used by Bond Counsel in its determination that the interest on the Bonds is excluded from gross income for federal income tax purposes. The verification agent will express no opinion on the assumptions provided or as to the exemption from taxation of the interest on the Bonds.

## **UNDERWRITING**

The Underwriters have jointly and severally agreed, subject to certain conditions, to purchase the Bonds from the Authority at an aggregate discount of \$6,233,074.27 from the initial public offering prices of such bonds. The obligation of the Underwriters to purchase the Bonds is subject to certain conditions precedent. The Underwriters will be obligated to purchase all the Bonds, if any such bonds are purchased. The Underwriters may offer to sell the Bonds to certain dealers (including dealers depositing the Bonds into unit investment trusts, certain of which may be sponsored or managed by the Underwriters) and others at prices lower than the initial public offering prices. The offering prices may be changed, from time to time, by the Underwriters. The Authority has agreed to indemnify the Underwriters, to the extent permitted by law, against certain liabilities, including liabilities under federal securities laws, or to contribute to payments that the Underwriters may be required to make in respect thereof.

J.P. Morgan Securities Inc., a managing underwriter, has entered into an agreement with R-G Investments Corporation, a Puerto Rico broker-dealer, pursuant to which R-G Investments Corporation has agreed to provide investment banking services to the Authority in connection with the issuance of the Bonds. Pursuant to this arrangement, the existence of which has been disclosed to the Authority and Government Development Bank, R-G Investments Corporation will be entitled to receive a portion of J.P. Morgan Securities Inc.'s net profits, if any, in connection with the underwriting of the Bonds. Other similar agreements with respect to the sharing of underwriting net profits have been entered into and disclosed to the Authority and Government Development Bank by the following Underwriters: Goldman, Sachs & Co. and FirstBank Puerto Rico; Merrill Lynch, Pierce, Fenner & Smith Incorporated and BBVA Securities of Puerto Rico Inc.; Banc of America Securities LLC and Oriental Financial Services Corp.; Lehman Brothers Inc. and Santander Securities Corporation; Morgan Stanley & Co. Incorporated and Popular Securities, Inc.; and Wachovia Bank, National Association and Doral Securities Inc.

## **MATERIAL RELATIONSHIPS**

Washington Group International, Inc. serves as the Consulting Engineers to the Authority under the provisions of the 1974 Agreement. The Authority recently entered into a professional services agreement with Washington Engineers P.S.C., an affiliate of Washington Group International, Inc., to provide services to the Authority in connection with the construction of the San Juan 5 and 6 combined cycle generating units described above in "Adequacy of Capacity - Additional Generating Facilities" under *The System*.

See also *Government Development Bank for Puerto Rico*, below.

## **LEGAL MATTERS**

The proposed form of opinion of Squire, Sanders & Dempsey L.L.P., Bond Counsel, is set forth in Appendix IV to this Official Statement. Certain legal matters will be passed upon for the Underwriters by O'Neill & Borges, San Juan, Puerto Rico.

## **LEGAL INVESTMENT**

The Bonds will be eligible for deposit by banks in the Commonwealth to secure public funds and will be approved investments for insurance companies to qualify them to do business in the Commonwealth as required by law.



## **GOVERNMENT DEVELOPMENT BANK FOR PUERTO RICO**

As required by Act No. 272 of the Legislature of Puerto Rico, approved May 15, 1945, as amended, Government Development Bank has acted as financial advisor to the Authority in connection with the Bonds offered hereby. As financial advisor, Government Development Bank participated in the selection of the Underwriters of the Bonds. Certain of the Underwriters have been selected by Government Development Bank to serve from time to time as underwriters of its obligations and the obligations of the Commonwealth, its instrumentalities and public corporations. Certain of the Underwriters or their affiliates also participate in other financial transactions with Government Development Bank.

### **INDEPENDENT ACCOUNTANTS**

The financial statements of the Authority as of and for the years ended June 30, 2004 and 2003 included in Appendix II hereto have been audited by Ernst & Young LLP, San Juan, Puerto Rico, independent accountants, as stated in their report appearing therein.

The prospective financial information included in this Official Statement has been prepared by, and is the responsibility of the management of the Authority. Ernst & Young LLP has neither examined nor compiled the accompanying prospective financial information, and accordingly, Ernst & Young LLP does not express an opinion or any other form of assurance with respect thereto. The Ernst & Young LLP report for fiscal years 2004 and 2003 included in Appendix II to this Official Statement relates to the historical financial information of the Authority. Such report does not extend to the prospective financial information and should not be read to do so.

### **RATINGS**

The Bonds have been assigned ratings of “A3” by Moody’s Investors Service and “A-” by Standard & Poor’s. These ratings do not reflect the municipal bond insurance policies that cover certain of the Bonds identified on the inside cover page of this Official Statement. Moody’s and Standard & Poor’s are expected to give ratings of “Aaa” and “AAA,” respectively, to the CIFGNA Insured Bonds, the FGIC Insured Bonds, the FSA Insured Bonds, the MBIA Insured Bonds and the XLCA Insured Bonds. These ratings reflect only the respective views of the rating agencies and an explanation of the significance of each rating may be obtained only from the respective rating agency. There is no assurance that such ratings will remain in effect for any given period of time or that they will not be revised downward or withdrawn entirely by either or both of such rating agencies, if in the judgment of either or both, circumstances so warrant. Any such downward revision or withdrawal of either of such ratings may have an adverse effect on the market prices of the Bonds. See *Bond Insurance*, above.

### **CONTINUING DISCLOSURE**

In accordance with the requirements of Rule 15c2-12, as amended (the “Rule”), promulgated by the SEC, the Authority has covenanted in its resolution authorizing the issuance of the Bonds for the benefit of the Beneficial Owners (as defined in such resolution and, generally, the tax owners of the Bonds):

(a) to file within 275 days after the end of each fiscal year with each NRMSIR and with any Commonwealth state information depository (“SID”), core financial information and operating data for the prior fiscal year, including (i) the Authority’s audited financial statements, prepared in accordance with generally accepted accounting principles in effect from time to time, and (ii) material historical quantitative

data (including financial information and operating data) on the Authority's System and revenues, expenditures, financial operations and indebtedness generally found in this Official Statement (but excluding the Commonwealth of Puerto Rico Financial Information and Operating Data Report incorporated by reference herein); and

(b) to file in a timely manner, with each NRMSIR or with the Municipal Securities Rulemaking Board ("MSRB"), and with any Commonwealth SID, notice of failure of the Authority to comply with clause (a) above and notice of any of the following events with respect to the Bonds, if material:

- (i) principal and interest payment delinquencies;
- (ii) non-payment related defaults;
- (iii) unscheduled draws on debt service reserves reflecting financial difficulties;
- (iv) unscheduled draws on credit enhancements reflecting financial difficulties;
- (v) substitution of credit or liquidity providers, or their failure to perform;
- (vi) adverse opinions or events, affecting the tax exempt status of the Bonds;
- (vii) modifications to rights of security holders (including Beneficial Owners) of the Bonds;
- (viii) Bond calls;
- (ix) defeasances;
- (x) release, substitution, or sale of property securing repayment of the Bonds; and
- (xi) rating changes.

With respect to the following events:

Events (iv) and (v). The Authority does not undertake to provide any notice with respect to credit enhancement added after the primary offering of the Bonds, unless the Authority applies for or participates in obtaining the enhancement.

Event (vi). For information on the tax status of the Bonds, see *Tax Matters*.

As of the date of this Official Statement, there is no Commonwealth SID, and the name and address of each NRMSIR is: Bloomberg Municipal Repository, 100 Business Park Drive, Skillman, New Jersey 08558; Standard & Poor's Securities Evaluations, Inc., 55 Water Street, 45<sup>th</sup> Floor, New York, New York 10041; FT Interactive Data, Attn: NRMSIR, 100 William Street, 15<sup>th</sup> floor, New York, New York 10038; and DPC Data Inc., One Executive Drive, Fort Lee, New Jersey 07024.

The Authority may from time to time choose to provide notice of the occurrence of certain other events in addition to those listed above if, in the judgment of the Authority, such other events are material with respect to the Bonds, but the Authority does not undertake to provide notice of the occurrence of any material event except those events listed above.

The Authority acknowledges that its undertaking pursuant to the Rule described above is intended for the benefit of the Beneficial Owners of the Bonds, and shall be enforceable by any such Beneficial Owners; provided that the right to enforce the provisions of its undertaking shall be limited to a right to obtain specific enforcement of the Authority's obligations hereunder.

No Beneficial Owner may institute any suit, action or proceeding at law or in equity ("Proceeding") for the enforcement of the foregoing covenants (the "Covenants") or for any remedy for breach thereof, unless such Beneficial Owner shall have filed with the Authority written notice of and request to cure such breach, and the Authority shall have refused to comply within a reasonable time. All Proceedings shall be instituted only in the Federal district court for the District of Puerto Rico or in a Commonwealth court located in the Municipality of San Juan, Puerto Rico for the equal benefit of all Beneficial Owners of the outstanding Bonds

benefited by the Covenants, and no remedy shall be sought or granted other than specific performance of the Covenant at issue. Notwithstanding the foregoing, no challenge to the adequacy of the information provided in accordance with the filings mentioned in paragraphs (a) or (b) above may be prosecuted by any Beneficial Owner except in compliance with the remedial and enforcement provisions contained in Article VIII of the 1974 Agreement. See “Remedies of Bondholders” in Appendix I, *Summary of Certain Provisions of the 1974 Agreement Excluding Proposed Supplemental Agreement*.

The Covenants may only be amended if:

(a) the amendment is made in connection with a change in circumstances that arises from a change in legal requirements, change in law, or change in the identity, nature, or status of the Authority, or type of business conducted; the Covenants, as amended, would have complied with the requirements of the Rule at the time of award of the Bonds, after taking into account any amendments or interpretations of the Rule, or any change in circumstances; and the amendment does not materially impair the interests of Beneficial Owners, as determined by parties unaffiliated with the Authority; or

(b) all or any part of the Rule, as interpreted by the staff of the SEC at the date of the adoption of the Covenants, ceases to be in effect for any reason, and the Authority elects that the Covenants shall be deemed amended accordingly.

The Authority has further agreed that the annual financial information containing any amended operating data or financial information will explain, in narrative form, the reasons for the amendment and the impact of the change in the type of operating data or financial information being provided.

Any assertion of beneficial ownership must be filed, with full documentary support, as part of the written request described above.

These Covenants have been made in order to assist the Underwriters to comply with the Rule.

## MISCELLANEOUS

The foregoing summaries of or references to certain provisions of the 1974 Agreement, the proposed Supplemental Agreement, the various acts and the Bonds are made subject to all the detailed provisions thereof to which reference is hereby made for further information and do not purport to be complete statements of any or all of such provisions.

There are appended to this Official Statement (i) summaries of the 1974 Agreement and the proposed Supplemental Agreement, (ii) the financial statements of the Authority for the fiscal years ended June 30, 2004 and June 30, 2003, together with the independent accountants’ report of Ernst & Young LLP, San Juan, Puerto Rico, (iii) a letter from the Authority’s Consulting Engineers, Washington Group International, Inc., regarding its opinion as to certain engineering matters in this Official Statement, (iv) the proposed form of opinion of Squire, Sanders & Dempsey L.L.P., Bond Counsel, (v) a specimen of the CIFGNA insurance policy, (vi) a specimen of the FGIC insurance policy, (vii) a specimen of the FSA insurance policy, (viii) a specimen of the MBIA insurance policy and (ix) a specimen of the XLCA insurance policy.

The information set forth in this Official Statement, except for certain information on the page following the inside cover page and the information appearing in *Underwriting*, *Material Relationships*, Appendices III through IX, and the information pertaining to DTC, CIFGNA, FGIC, FSA, MBIA and XLCA, was supplied by the Authority. The information pertaining to DTC, CIFGNA, FGIC, FSA, MBIA and XLCA was supplied by DTC, CIFGNA, FGIC, FSA, MBIA and XLCA, respectively.

This Official Statement will be filed with the repository established by the MSRB and each NRMSIR.

**PUERTO RICO ELECTRIC POWER AUTHORITY**

By:           /s/ Héctor M. Alejandro Narváez            
Acting Executive Director

**DEFINITIONS OF CERTAIN TERMS**

The following are definitions of certain terms defined in Section 101 of the 1974 Agreement and used in this Official Statement.

“Accreted Value” means with respect to any Capital Appreciation Bonds (i) as of any Valuation Date, the amount set forth for such date in the resolution authorizing such Capital Appreciation Bonds and (ii) as of any date other than a Valuation Date, the sum of (a) the Accreted Value on the preceding Valuation Date and (b) the product of (1) a fraction, the numerator of which is the actual number of days having elapsed from the preceding Valuation Date and the denominator of which is the actual number of days from such preceding Valuation Date to the next succeeding Valuation Date and (2) the difference between the Accreted Values for such Valuation Dates.

“Amortization Accrual” means for any period the amount of an Amortization Requirement that would accrue during such period if such Requirement accrued ratably on the basis of a year consisting of twelve (12) thirty-day months. Unless otherwise provided by resolution of the Authority or an agreement supplemental to the 1974 Agreement, the monthly accrual in respect of an Amortization Requirement for a term bond shall commence on the first day of each month in the fiscal year for which such Requirement has been established and shall end on the first day of the month succeeding the relevant Deposit Day.

As applied to the term bonds of any Series, “Amortization Requirement” for any fiscal year means the principal amount fixed or computed for such fiscal year for the retirement of such term bonds by purchase or redemption.

The Amortization Requirements for the term bonds of each Series shall be initially the respective principal amounts for each fiscal year as fixed in a resolution of the Board adopted prior to the issuance of the bonds of such Series; provided, however, that if any additional term bonds of such Series shall be issued under the provisions of the first paragraph of Section 210 of the 1974 Agreement, the respective Amortization Requirements for the term bonds of such Series shall be increased in proportion as nearly as may be practicable to the increase in the total principal amount of the term bonds of such Series. The aggregate amount of such Amortization Requirements for the term bonds of each Series shall be equal to the aggregate principal amount of the term bonds of such Series. The Amortization Requirements for the term bonds of each Series shall begin in the fiscal year determined by the Board.

If at the close of any fiscal year the total principal amount of term bonds of any Series retired by purchase or redemption, or prior to the close of such fiscal year called for redemption, shall be in excess of the amount of the Amortization Requirements for the term bonds of such Series for such fiscal year, then the amount of the Amortization Requirements for the term bonds of such Series shall be reduced for such subsequent fiscal years in such amounts aggregating the amount of such excess as shall be determined by the Executive Director in an order filed with the 1974 Trustee on or before the 10th day of July following the close of such fiscal year.

If at the close of any fiscal year the total principal amount of term bonds of any Series retired by purchase or redemption, or called for redemption, prior to the close of such fiscal year shall be less than the amount of the Amortization Requirements for the term bonds of such Series for such fiscal year, then the amount of the Amortization Requirements for the term bonds of such Series for the next succeeding fiscal year shall be increased by the amount of the excess of such deficiency over the amount then held to the credit of the Redemption Account.

It shall be the duty of the 1974 Trustee, on or before the 15th day of July in each fiscal year, to compute the Amortization Requirements for the then current fiscal year for the term bonds of each Series then outstanding. The Amortization Requirement for the then current fiscal year shall continue to be applicable during the balance of such current fiscal year and no adjustment shall be made therein by reason of term bonds purchased or redeemed or called for redemption during such current fiscal year.

“Capital Appreciation Bonds” means any bonds as to which interest is payable only at the maturity or prior redemption of such bonds. For the purposes of (i) receiving payment of the redemption price if a Capital Appreciation Bond is redeemed prior to maturity to the extent provided in the resolution authorizing the Capital Appreciation Bonds, or (ii) receiving payment of a Capital Appreciation Bond if the principal of all bonds is declared immediately due and payable following an event of default as provided in Section 802 of the 1974 Agreement, or (iii) computing the principal amount of bonds held by the registered owner of a Capital Appreciation Bond in giving to the Authority or the 1974 Trustee any notice, consent, request, or demand pursuant to the 1974 Agreement for any purpose whatsoever, the principal amount of a Capital Appreciation Bond shall be deemed to be its Accreted Value. In the case of Capital Appreciation Bonds that are convertible to bonds with interest payable prior to maturity or prior redemption of such bonds, the term “Capital Appreciation Bonds” shall be limited to the period prior to such conversion, and after such conversion, the bonds shall be viewed as any other bonds of the same type for purposes of the 1974 Agreement.

“Current Expenses” means the Authority’s reasonable and necessary current expenses of maintaining, repairing and operating the System and shall include, without limiting the generality of the foregoing, all administrative expenses, insurance premiums, expenses of preliminary surveys not chargeable to capital expenditures, engineering expenses relating to operations and maintenance, fees and expenses of the 1974 Trustee and the Paying Agents, legal expenses, any payment to pension or retirement funds, and all other expenses required to be paid by the Authority under the provisions of the 1974 Agreement or by law, or permitted by standard practices for public utility systems, similar to the properties and business of the Authority and applicable in the circumstances, but shall not include any deposits to the credit of the 1974 Sinking Fund, the Reserve Maintenance Fund, the Subordinate Obligations Fund, the Self-insurance Fund and the Capital Improvement Fund.

“Deposit Day” means the date by which all of the moneys then held to the credit of the Revenue Fund shall be withdrawn by the Treasurer and deposited in the manner set forth under “Disposition of Revenues” herein.

“Designated Maturity Bonds” means the indebtedness incurred by the Authority under the terms of a separate trust agreement or resolution, which indebtedness has a maturity of at

least ten (10) years and is secured, as to the unamortized principal thereof, on a subordinate basis to the bonds and for which (i) no amortization of principal has been established or (ii) the aggregate amount of the amortized principal that has been established is less than the principal amount of the indebtedness; provided that interest on said indebtedness and any amortized principal of said indebtedness may be payable on a parity, respectively, with interest on bonds and Amortization Requirements on term bonds, in which case said interest and amortized principal shall be included in the calculation of Principal and Interest Requirements on bonds for purposes of the 1974 Agreement and shall otherwise be deemed to be, and be payable as, interest and Amortization Requirements on bonds for purposes of the 1974 Agreement.

“Extendible Maturity Bonds” means bonds the maturities of which, by their terms, may be extended by and at the option of the bondholder or the Authority.

“Independent Consultant” means the consultant or consulting firm or corporation at the time employed by the Authority under the provisions of the 1974 Agreement to perform and carry out the duties of the Independent Consultant under the 1974 Agreement.

“Interest Accrual” means for any period the amount of interest that would accrue during such period if such interest accrued ratably on the basis of a year consisting of twelve (12) thirty-day months. Unless otherwise provided by resolution of the Authority or an agreement supplemental to the 1974 Agreement, the monthly accrual in respect of interest on the bonds shall commence on the later to occur of the date of issue of the bonds of such Series and the date that is six months prior to the due date of such interest and shall end on the first day of the month following the relevant Deposit Day. In the case of Variable Rate Bonds, the amount deposited shall be based on the sum of the interest accrued through the business day preceding the relevant Deposit Day and the interest (calculated at the maximum rate of interest on such Bonds, or if there is no such maximum rate, then at the rate on such Bonds on the business day preceding the Deposit Day plus one percent (1%)) that would accrue on such Bonds from the Deposit Day to the later to occur of the first day of the next calendar month and any interest payment date on such Bonds occurring prior to the next Deposit Day.

“Net Revenues” means, for any particular period, the amount of the excess of the Revenues for such period over the Current Expenses for such period.

“Prerefunded Municipals” means any bonds or other obligations of any state of the United States of America or Puerto Rico or of any agency, instrumentality or local governmental unit of any such state or Puerto Rico (a) which are (x) not callable prior to maturity or (y) as to which irrevocable instructions have been given to the trustee of such bonds or other obligations by the obligor to give due notice of redemption and to call such bonds or other obligations for redemption on the date or dates specified in such instructions, (b) which are secured as to principal, redemption premium, if any, and interest by a fund consisting only of cash or Government Obligations or Time Deposits, secured in the manner set forth in Section 601 of the 1974 Agreement, which fund may be applied only to the payment of such principal of and interest and redemption premium, if any, on such bonds or other obligations on the maturity date or dates thereof or the specified redemption date or dates pursuant to such irrevocable instructions, as appropriate, and (c) as to which the principal of and interest on such Government Obligations or Time Deposits, secured in the manner set forth in Section 601 of the 1974

Agreement, which have been deposited in such fund, along with any cash on deposit in such fund are sufficient to pay principal of and interest and redemption premium, if any, on the bonds or other obligations on the maturity date or dates thereof or on the redemption date or dates specified in the irrevocable instructions referred to in clause (a) above, as appropriate.

“Principal Accrual” means for any period the amount of principal that would accrue during such period if such principal accrued ratably on the basis of a year consisting of twelve (12) thirty-day months. Unless otherwise provided by resolution of the Authority or an agreement supplemental to the 1974 Agreement, the monthly accrual in respect of the principal of serial bonds shall commence on the first day of the twelfth month preceding the due date of such principal and shall end on the first day of the month succeeding the relevant Deposit Day.

“Principal and Interest Requirements” means, for any fiscal year, as applied to the bonds of any Series issued under the 1974 Agreement, the sum of:

- (a) the amount required to pay the interest on all outstanding bonds of such Series which is payable on January 1 in such fiscal year and on July 1 in the following fiscal year,
- (b) the amount required to pay the principal of all outstanding serial bonds of such Series which is payable after July 31 in such fiscal year and on or prior to July 31 in the following fiscal year, and
- (c) the Amortization Requirement for the term bonds of such Series for such fiscal year.

The Principal and Interest Requirements for the bonds of any Series issued under the 1974 Agreement shall be determined, as required from time to time, by the 1974 Trustee. In computing the Principal and Interest Requirements for any fiscal year for the bonds of any Series, the 1974 Trustee shall assume that an amount of the term bonds of such Series equal to the Amortization Requirement for the term bonds of such Series for such fiscal year will be retired by purchase or redemption on July 1 in the following fiscal year.

For purposes of determining the aggregate Principal and Interest Requirements in the covenant as to rates contained in Section 502 of the 1974 Agreement, the maximum Principal and Interest Requirements for purposes of Section 704 of the 1974 Agreement and the maximum aggregate Principal and Interest Requirements for purposes of Section 712 of the 1974 Agreement, the interest rate on Variable Rate Bonds shall be assumed to be one hundred ten percent (110%) of the greater of (i) the average interest rate on such Variable Rate Bonds during the twelve months ending with the month preceding the date of calculation, or such shorter period that such Variable Rate Bonds shall have been outstanding under the 1974 Agreement, or (ii) the rate of interest on such Variable Rate Bonds on the date of calculation. For purposes of determining the maximum aggregate Principal and Interest Requirements for purposes of Sections 208, 209 and 210 of the 1974 Agreement, the interest rate on Variable Rate Bonds outstanding or proposed to be issued on the date of calculation shall be determined in accordance with the formula in the previous sentence. If Variable Rate Bonds are payable at the option of the Bondholder and the source for said payment is a credit or liquidity facility, the “put” date or



dates shall be ignored and the stated dates for Amortization Requirements and principal payments thereof shall be used for purposes of this calculation. If the Authority has notified the 1974 Trustee that a SWAP agreement is in effect in respect of Variable Rate Bonds, then for all purposes of this paragraph, except for the purpose of determining the aggregate Principal and Interest Requirements in the covenant as to rates contained in Section 502 of the 1974 Agreement, in the certificate mentioned in clause (d) of Section 208 of the 1974 Agreement and in the covenant contained in Section 704 of the 1974 Agreement, the interest rate on such Variable Rate Bonds shall be the SWAP rate under such SWAP agreement.

For purposes of determining the above requirements in the case of Put Bonds, the “put” date or dates shall be ignored if the source for payment of said put is a credit or liquidity facility and the stated dates for Amortization Requirements and principal payments shall be used. For purposes of determining the above requirements in the case of Extendible Maturity Bonds, the bonds shall be deemed to mature on the later of the stated maturity date or the date to which such stated maturity date has been extended. For purposes of determining the above requirements in the case of Capital Appreciation Bonds, the principal and interest portions of the Accreted Value of Capital Appreciation Bonds becoming due at maturity or by virtue of an Amortization Requirement shall be included in the calculations of accrued and unpaid interest and principal requirements in such manner and during such period of time as is specified in the resolution authorizing such Capital Appreciation Bonds.

Principal and Interest Requirements on bonds shall be deemed to include the amount required to pay interest on outstanding Designated Maturity Bonds and any amortized principal of said Designated Maturity Bonds for any fiscal year, if said interest and amortized principal are payable, under the trust agreement or resolution providing for said Designated Maturity bonds, on a parity with interest and Amortization Requirements on bonds.

To the extent all or a portion of the principal of, Amortization Requirements for or interest on, any bonds of any Series are payable from moneys irrevocably set aside or deposited irrevocably for such purpose with a bank or trust company (which may include the 1974 Trustee) or from Investment Obligations irrevocably set aside or deposited irrevocably for such purpose with a bank or trust company (which may include the 1974 Trustee) or Time Deposits, secured in the manner set forth in Section 601 of the 1974 Agreement, and irrevocably set aside for such purpose, the principal of and the interest on which when due will provide sufficient moneys to make such payments, such principal, Amortization Requirements or interest shall not be included in determining Principal and Interest Requirements; provided, however, that for purposes of compliance with the Authority’s rate covenant (see “Rate Covenant” herein) said definition shall include any interest payable from any amount deposited to the credit of the Bond Service Account in the 1974 Sinking Fund from the proceeds of bonds to pay interest to accrue thereon. The Executive Director or his designee shall deliver to the 1974 Trustee a certificate describing the principal of, Amortization Requirements for and interest on any bonds for which moneys, Investment Obligations or Time Deposits have been set aside or deposited pursuant to this paragraph, and stating that such principal, Amortization Requirements and interest should not be included in determining the Principal and Interest Requirements. Upon request of the 1974 Trustee, the Authority shall cause to be delivered to the 1974 Trustee a certificate of an independent verification agent as to the sufficiency of the maturing principal amounts of any

Investment Obligations or Time Deposits, together with interest thereon, set aside or deposited to pay said principal, Amortization Requirements and interest.

“Put Bonds” means bonds, other than Variable Rate Bonds, which by their terms may be tendered by and at the option of the holders thereof for payment prior to the stated maturity thereof.

“Reserve Account Insurance Policy” and “Reserve Account Letter of Credit” mean (1) the insurance policy, surety bond or other acceptable evidence of insurance, if any, or (2) the irrevocable, transferable letter of credit, if any, respectively, to be deposited in the 1974 Reserve Account in lieu of or in partial substitution for cash or securities on deposit therein, for the purpose of making the payments required to be made from the 1974 Reserve Account under Section 510 of the 1974 Agreement. The issuer providing such insurance or letter of credit shall be a municipal bond insurer or a banking association, bank or trust company or branch thereof whose policy or bond or letter of credit results in the rating of municipal obligations secured by such policy or bond or such letter of credit, respectively, to be rated, at the time of deposit into the 1974 Reserve Account, in one of the three highest grades by (i) either Standard & Poor’s Corporation or its successor, or Moody’s Investors Service, Inc. or its successor or (ii) if both such corporations shall be dissolved or liquidated or shall no longer perform the functions of a securities rating agency, a nationally recognized rating agency.

“Revenues” means all money received by the Authority in connection with or as a result of its ownership or operation of the System, including the income derived by the Authority from the sale of electricity generated or distributed by the System, any proceeds of use and occupancy insurance on the System or any part thereof and income from the investment of moneys under the 1974 Agreement, except income from the investment of moneys in the 1974 Construction Fund, the Capital Improvement Fund and the Subordinate Obligations Fund to the extent such income has been derived from the investment of moneys in such Fund to be used to pay Subordinate Obligations incurred to pay the cost of any work or properties which have not been included by the Authority as part of the System as provided in “Disposition of Revenues” below, and the Reserve Maintenance Fund which shall be deemed to be a part of said Funds, respectively. Except for the purpose of determining the amount of the Revenues in the covenant as to rates contained in Section 502 of the 1974 Agreement, Revenues shall not include any amounts paid to the Authority by a SWAP party in connection with Variable Rate Bonds.

“Subordinate Obligations” means any obligations of the Authority incurred as provided in “Disposition of Revenues” below.

“SWAP agreement” means an agreement between the Authority and a SWAP party whereby the SWAP party agrees to pay to the Authority amounts calculated on the basis of all or a portion of the interest on Variable Rate Bonds at or prior to the times such interest is due and payable in consideration of the Authority’s payment to the SWAP party of amounts set forth in the SWAP agreement.

“SWAP party” means a person who is party to a SWAP agreement and whose senior obligations are rated at the time of the execution and delivery of such SWAP agreement in one of the three highest rating categories (without regard to gradations within a category) by (i)

Standard & Poor's Corporation or its successor and (ii) Moody's Investors Service or its successor.

“SWAP rate” means the fixed rate per annum on the principal amount of Variable Rate Bonds covered by a SWAP agreement equal to the percentage derived by dividing (i) the sum of the amounts in the last twelve months paid by the Authority in respect of interest on such bonds and to the SWAP party less the amount paid to the Authority by the SWAP party by (ii) such principal amount of Variable Rate Bonds; provided, however, that if such SWAP agreement has been in effect for less than twelve months, such percentage shall be multiplied by 360 divided by the number of days between the effective date of such SWAP agreement and the date of calculation determined on the basis of 30-day months.

“System” means all the properties presently owned and operated by the Authority as a single integrated system, together with all works and properties which may be after the date of the 1974 Agreement acquired or constructed by the Authority in connection with the production, distribution or sale of electric energy and the acquisition or construction of which shall be financed in whole or in part from the proceeds of bonds issued under the provisions of the 1974 Agreement or from moneys deposited to the credit of the 1974 Construction Fund, the Capital Improvement Fund or from Subordinate Obligations to the extent such works and properties have been included by the Authority as part of the System as provided in “Disposition of Revenues” below.

“Valuation Date” means with respect to any Capital Appreciation Bonds the date or dates set forth in the resolution authorizing such bonds on which Accreted Values are assigned to the Capital Appreciation Bonds.

“Variable Rate Bonds” means bonds issued with a variable, adjustable, convertible or similar interest rate which is not fixed in percentage at the date of issue for the term thereof, and which may or may not be convertible to a fixed interest rate for the remainder of their term.

**SUMMARY OF CERTAIN PROVISIONS OF  
THE 1974 AGREEMENT EXCLUDING PROPOSED  
SUPPLEMENTAL AGREEMENT**

*(See also Summary of Certain Provisions of Proposed Supplemental Agreement)*

The following statements are brief summaries of certain provisions of the 1974 Agreement. Said statements do not purport to be complete and reference is made to the 1974 Agreement, copies of which are available for examination at the office of the 1974 Trustee.

**Provision for Variable Rate Bonds, Put Bonds, Extendible Maturity Bonds, Capital Appreciation Bonds and other types of bonds**

Under the 1974 Agreement, the Authority may issue Capital Appreciation Bonds, Variable Rate Bonds, Put Bonds, Extendible Maturity Bonds and other types of bonds which may from time to time be created. The interest rate calculation methods and interest rate payment dates, which need not be semi-annual, shall be established by the Authority prior to the issuance of particular Series of bonds. The features of Variable Rate Bonds shall be established prior to their issuance and may provide, in addition to provisions for conversion to a fixed interest rate, that bondholders may demand payment of principal and interest within a stated period. In this connection, the Authority may provide for the remarketing of bonds that have been tendered pursuant to the demand features and for a credit facility or liquidity facility which may be drawn upon to make principal and interest payments on the Variable Rate Bonds. The terms for Put Bonds may contain some of the above provisions. The terms for Extendible Maturity Bonds may include an option to extend the maturity of such bonds granted to bondholders and the Authority. The terms for Capital Appreciation Bonds shall include Valuation Dates, the Accreted Value on such dates, the manner in which and the period during which principal and interest shall be deemed to accrue on said bonds and the amount of any deposit required for the 1974 Reserve Account. (1974 Agreement, Sections 208, 209 and 210).

**Security for the Power Revenue Bonds**

The Power Revenue Bonds are secured by a pledge of moneys in the Puerto Rico Electric Power Authority Power Revenue Bonds Interest and Sinking Fund (the “1974 Sinking Fund”), a special fund created by the 1974 Agreement. (1974 Agreement, Section 507).

The Authority covenants to deposit with the 1974 Trustee, to the credit of the 1974 Sinking Fund, a sufficient amount of the Revenues, over and above the expenses of maintaining, repairing and operating the System and any reserve therefor, to pay the principal of and the interest on all Power Revenue Bonds as the same shall become due and payable and to create a reserve for such purpose. (1974 Agreement, Section 507).

The Power Revenue Bonds shall not be deemed to constitute a debt or obligation of the Commonwealth or any of its municipalities or other political subdivisions. (1974 Agreement, Section 701).

## **Issuance of Power Revenue Bonds—Sections 208, 209 and 210 of the 1974 Agreement**

Section 208 of the 1974 Agreement provides for the issuance of Power Revenue Bonds for Improvements, as defined in the 1974 Agreement, including the repayment of advances therefor, and to provide moneys for deposit to the Reserve Account in the 1974 Sinking Fund (the “1974 Reserve Account”), subject to the conditions and limitations therein. Power Revenue Bonds may be issued under Section 208 if, among other things:

(i) the Net Revenues for any 12 consecutive calendar months out of the 18 calendar months immediately preceding the date of the issuance of such bonds, adjusted to reflect the then current rate schedule, are not less than 120% of the maximum aggregate Principal and Interest Requirements for any fiscal year thereafter on account of all outstanding Power Revenue Bonds (excluding the bonds then to be issued), and

(ii) the estimated average annual Net Revenues for each of the five fiscal years immediately following the fiscal year in which the issuance of such bonds occurs, adjusted to reflect the then current rate schedule and any rate schedule the Authority has covenanted to put in effect during such five fiscal years, shall be not less than 120% of the maximum aggregate Principal and Interest Requirements for any fiscal year thereafter on account of all outstanding Power Revenue Bonds and the bonds then to be issued. (1974 Agreement, Section 208).

Section 209 of the 1974 Agreement provides for the issuance of Power Revenue Bonds for any proper corporate purpose of the Authority (other than for refunding outstanding Power Revenue Bonds or for Improvements), upon the conditions and limitations set forth therein. Power Revenue Bonds may be issued under Section 209 if, among other things, the earnings tests described above for the issuance of bonds under Section 208 of the 1974 Agreement are satisfied. (1974 Agreement, Section 209).

Section 210 of the 1974 Agreement provides for the issuance of Power Revenue Bonds to refund prior to or at their maturities all or any part of the outstanding bonds of any Series issued under the 1974 Agreement, including the payment of any redemption premium, accrued interest and financing costs and for the purpose of providing moneys for deposit to the credit of the 1974 Reserve Account, subject to the conditions and limitations set forth therein. Power Revenue Refunding Bonds may be issued under Section 210 if, among other things, either (i) the earnings tests described above for the issuance of bonds under Section 208 of the 1974 Agreement (except that effect is given to the retirement of the bonds to be refunded) are satisfied or (ii) the maximum aggregate Principal and Interest Requirements for any fiscal year thereafter on account of all outstanding Power Revenue Bonds and the bonds then to be issued (after giving effect to the retirement of the bonds to be refunded) shall be less than the maximum aggregate Principal and Interest Requirements on account of all outstanding Power Revenue Bonds (excluding the bonds then to be issued). Power Revenue Refunding Bonds may be issued without compliance with the foregoing tests to refund serial bonds of any Series of Power Revenue Bonds maturing within one year thereafter (and to pay interest thereon to maturity, if deemed necessary by the Authority), if the Authority shall determine that the moneys in the 1974 Sinking Fund will not be sufficient for paying such serial bonds at their maturity. The proceeds of Power Revenue Refunding Bonds shall, to the extent practicable, be invested and reinvested by the 1974 Trustee,

with the approval of the Executive Director, in Government Obligations, Prerefunded Municipals or in Time Deposits, secured in the manner set forth in Section 601 of the 1974 Agreement, and the moneys so invested shall be available for use when required. (1974 Agreement, Section 210).

## **Collection of Revenues**

### *1974 General Fund*

A special fund is created by the 1974 Agreement and designated the “Puerto Rico Electric Power Authority General Fund” (the “1974 General Fund”). The Authority covenants that all Revenues, other than income from investments made under the provisions of the 1974 Agreement, will be deposited as received in the 1974 General Fund. (1974 Agreement, Section 503). On or before the 15th day of May in each year the Authority will cause to be prepared a proposed budget of Current Expenses and of Capital Expenditures for the ensuing fiscal year, showing separately, the amount to be expended during such fiscal year from moneys deposited to the credit of the 1974 Construction Fund and the amount of the working cash funds required for each month during such fiscal year. A public hearing on the proposed budget must be held on June 1 or on the first business day thereafter, and the Authority must finally adopt the Annual Budget on or before July 1. (1974 Agreement, Section 504). The Authority covenants that moneys in the 1974 General Fund will be used first for the payment of Current Expenses of the System, and that, if the amount expended in any fiscal year for Current Expenses shall exceed the amount provided therefor in the Annual Budget, the Authority will report such excess and the reasons therefor to the Consulting Engineers and to the 1974 Trustee as soon as practicable but not later than the end of the sixth month following the month in which such excess shall have occurred. (1974 Agreement, Section 505).

### *1974 Revenue Fund*

A special fund is created by the 1974 Agreement and designated the “Puerto Rico Electric Power Authority Power Revenue Fund” (the “1974 Revenue Fund”). The Treasurer of the Authority is required to transfer, on or before the 15<sup>th</sup> day of each month, from the 1974 General Fund to the 1974 Revenue Fund an amount equal to the amount of all moneys held in the 1974 General Fund on the last day of the preceding month less an amount to be held as a reserve for Current Expenses as the Treasurer may determine, equal to not more than 1/6 of the amount shown by the Annual Budget to be necessary for Current Expenses for the current fiscal year, such transfer to be made on the books of the Authority as of the close of the preceding month. (1974 Agreement, Section 506).

## **Disposition of Revenues**

### *1974 Sinking Fund, Reserve Maintenance Fund, Subordinate Obligations Fund, Self-insurance Fund and Capital Improvement Fund*

On or before the 25th day of each month, the Treasurer shall withdraw from the 1974 Revenue Fund, all the moneys then in such Fund and deposit the moneys so withdrawn to the credit of the following Accounts and Funds in the following order:

1. the Bond Service Account in the 1974 Sinking Fund, until there has been accumulated therein an amount equal to the sum of (i) the Interest Accrual on all the outstanding Power Revenue Bonds to and including the first day of the next calendar month, and (ii) the Principal Accrual on the outstanding serial bonds of each Series of outstanding Power Revenue Bonds to and including the first day of the next calendar month;

2. the Redemption Account in the 1974 Sinking Fund, until there has been deposited therein an amount equal to the Amortization Accrual for the term bonds of each Series of Power Revenue Bonds then outstanding to and including the first day of the next calendar month;

3. the 1974 Reserve Account until the balance therein is equal to the interest payable on all outstanding Power Revenue Bonds within the next ensuing 12 months; provided, however, that the monthly deposit in respect of any Series of Power Revenue Bonds issued under Section 208 or 209 of the 1974 Agreement need not exceed 1/60 of the amount of the increase in the interest payable within the next ensuing 12 months resulting from the issuance of bonds of such Series, and provided, further, that if the amount so deposited in any month to the 1974 Reserve Account shall be less than the required amount for such month, the requirement therefor shall nevertheless be cumulative and the amount of any deficiency in any month shall be added to the amount otherwise required to be deposited in each month thereafter until such time as the deficiency is made up; and that in the case of Variable Rate Bonds, the minimum amount to be deposited in the 1974 Reserve Account which shall be funded over the period required in the 1974 Agreement, shall be based initially on the interest rate in effect on the date of issuance of the Variable Rate Bonds and then shall be adjusted on the 25th day of each subsequent month based on the actual interest accrued from the 25th day of the previous month to the date of adjustment, except that in the case of Variable Rate Bonds in respect of which the Authority has notified the Trustee that a SWAP agreement is in effect, the Trustee shall use the SWAP rate in calculating the interest payable on such Bonds within the next ensuing twelve (12) months; and that in the case of Capital Appreciation Bonds, the minimum amount required to be deposited in the Reserve Account shall be an amount derived from the interest rate which has been used to calculate the assumed yield on such bonds through their maturity times the Accreted Value of such bonds on the Valuation Date occurring at or after the first day of the twelfth succeeding month to the date of calculation of this requirement, as may be further specified in the resolution authorizing Capital Appreciation Bonds;

4. the Puerto Rico Electric Power Authority Reserve Maintenance Fund (the "Reserve Maintenance Fund"), a special fund created by the 1974 Agreement, such amount, if any, of any balance remaining after making the deposits mentioned in paragraphs 1, 2 and 3 above as may be recommended by the Consulting Engineers; provided that the monthly requirements for deposit to the Reserve Maintenance Fund shall be cumulative, and provided further that in the event that the Authority shall covenant in respect of any Subordinate Obligation to limit the monthly deposit to the Reserve Maintenance Fund as described in Subordinate Obligations Fund below, the monthly deposit required by this paragraph shall be equal to the least of

(i) the amount described above in this paragraph,

(ii) \$400,000, and

(iii) an amount that when added to the amount then on deposit in the Reserve Maintenance Fund shall make the total amount on deposit equal to \$10,000,000;

5. one or more special accounts in the Puerto Rico Electric Power Authority Subordinate Obligations Fund (the “Subordinate Obligations Fund”), a special fund created under the 1974 Agreement, such amount, if any, of any balance remaining after making the deposits mentioned under paragraphs 1, 2, 3 and 4 above that together with amounts then on deposit in the Subordinate Obligations Fund will make the total amount then on deposit equal to any amounts required to be paid or accrued with respect to any Subordinate Obligations prior to the Deposit Day of the next succeeding month from or to the Subordinate Obligations Fund;

6. if the Authority shall have covenanted with respect to Subordinate Obligations to limit its deposit to the Reserve Maintenance Fund in accordance with the provisions of the second proviso of paragraph 4 above and in fact the deposit to said Fund pursuant to paragraph 4 was limited to the amount described in clause (ii) or (iii) of such paragraph, the Reserve Maintenance Fund, such amount of any balance remaining after making the deposits under paragraphs 1, 2, 3, 4 or 5 above as may be required to make the total amount deposited in the Reserve Maintenance Fund in such month equal to the amount described in clause (i) of clause (4) above;

7. the Puerto Rico Electric Power Authority Self-insurance Fund (the “Self-insurance Fund”), a special fund created by the 1974 Agreement, such amount of any balance remaining after making the deposits mentioned in paragraphs 1, 2, 3, 4, 5 and 6 above as may be determined by the Authority from time to time; and

8. the Puerto Rico Electric Power Authority Capital Improvement Fund (the “Capital Improvement Fund”), a special fund created by the 1974 Agreement, such amount of any balance remaining after making deposits mentioned under paragraphs 1, 2, 3, 4, 5, 6 and 7 above as may be determined by the Authority, with the approval of the Consulting Engineers; provided that the monthly requirements for deposit to the Capital Improvement Fund shall be cumulative.

Any balance remaining after making the deposits under paragraphs 1 through 8 above may be used for any lawful purpose of the Authority. (1974 Agreement, Section 507).

If amounts applied to the payment of interest, principal and redemption price on bonds are paid by a credit or liquidity facility issuer, the amounts deposited in the Bond Service Account allocable to said payment (other than a payment of the purchase price of bonds pursuant to a “put”) may be paid to said credit or liquidity facility issuer. (1974 Agreement, Section 509).

Moneys in the 1974 Reserve Account shall be used by the 1974 Trustee first for the purpose of paying the interest on the Power Revenue Bonds and maturing principal of serial



bonds whenever and to the extent moneys in the Bond Service Account are insufficient for such purposes and thereafter for the purpose of making the required deposits to the Redemption Account mentioned in paragraph 2 above whenever the withdrawal from the 1974 Revenue Fund is insufficient for such purpose. Excess moneys in the 1974 Reserve Account shall be transferred to the Bond Service Account or may be used to reduce any Reserve Account Insurance Policy or Letter of Credit. The Authority may deposit a Reserve Account Insurance Policy or Letter of Credit into the 1974 Reserve Account, in lieu, or in partial satisfaction, of any required deposit into the 1974 Reserve Account. Said Reserve Account Insurance Policy or Letter of Credit may be secured by a lien on Revenues not inconsistent with the provisions of the 1974 Agreement and shall be payable or available to be drawn upon, as the case may be (upon the giving of notice as required thereunder), on any date on which moneys are required to be paid out of the 1974 Reserve Account pursuant to Section 510 of the 1974 Agreement. If a disbursement is made under any Reserve Account Insurance Policy or Letter of Credit, the Authority shall be obligated either to reinstate the amount of such Reserve Account Insurance Policy or Reserve Account Letter of Credit following such disbursement or to deposit into the 1974 Reserve Account moneys, in accordance with the provisions of Section 507 of the 1974 Agreement, in the amount of the disbursement made under such Reserve Account Insurance Policy or Reserve Account Letter of Credit, or a combination of such alternatives. The Authority may at any time substitute (i) all or a portion of the moneys held to the credit of the 1974 Reserve Account with a Reserve Account Insurance Policy or Reserve Account Letter of Credit, (ii) all or a portion of any Reserve Account Insurance Policy on deposit in the 1974 Reserve Account with moneys or a Reserve Account Letter of Credit, or a combination of such alternatives, or (iii) all or a portion of any Reserve Account Letter of Credit on deposit in the 1974 Reserve Account with moneys or a Reserve Account Insurance Policy, or a combination of such alternatives. Any moneys on deposit in the 1974 Reserve Account in substitution of which a Reserve Account Insurance Policy or Reserve Account Letter of Credit is deposited shall, to the extent not required to fund any deficiencies in the amount then required to be on deposit in the 1974 Reserve Account, be released and immediately paid over to the Authority to be used by the Authority for any proper corporate purpose. Prior to the expiration date of any Reserve Account Insurance Policy or Reserve Account Letter of Credit then on deposit to the credit of the 1974 Reserve Account, the Authority shall (x) cause the term of such Reserve Account Insurance Policy or Reserve Account Letter of Credit to be extended, (y) replace any such Reserve Account Insurance Policy with moneys (which may include, without limitation, moneys available under the Reserve Account Insurance Policy or from any other source available for such purpose) or a Reserve Account Letter of Credit, or a combination of such alternatives, or (z) replace any such Reserve Account Letter of Credit with moneys (which may include, without limitation, moneys available under the Reserve Account Letter of Credit or from any other source available for such purpose) or a Reserve Account Insurance Policy, or a combination of such alternatives; provided that in the event that the Authority has not extended or replaced the expiring Reserve Account Insurance Policy or Reserve Account Letter of Credit by the fifth business day prior to its date of expiration, the expiring Reserve Account Insurance Policy or Reserve Account Letter of Credit shall, on such date, be drawn upon and the moneys so made available shall thereupon be deposited in the 1974 Reserve Account. (1974 Agreement, Section 510).

Moneys in the Reserve Maintenance Fund shall be used only for the purpose of paying the cost of unusual or extraordinary maintenance or repairs, maintenance or repairs not recurring annually and renewals and replacements, including major items of equipment. The Reserve

Maintenance Fund also serves as an additional reserve for the payment of the principal of and the interest on the Power Revenue Bonds and meeting the Amortization Requirements to the extent that moneys in the 1974 Sinking Fund, including moneys in the 1974 Reserve Account, are insufficient for such purpose. (1974 Agreement, Section 512).

Moneys in the Self-insurance Fund shall be used only for the purpose of paying the cost of repairing, replacing or reconstructing any property damaged or destroyed from, or extraordinary expenses incurred as a result of, a cause which is not covered by insurance required by the 1974 Agreement. See “Insurance” below. The Self-insurance Fund also serves as an additional reserve for the payment of the principal of and the interest on the Power Revenue Bonds and meeting the Amortization Requirements to the extent that moneys in the 1974 Sinking Fund, including the 1974 Reserve Account, and in the Reserve Maintenance Fund are insufficient for such purpose. (1974 Agreement, Section 512A).

Moneys in the Capital Improvement Fund shall be used only for the purpose of paying the cost of anticipated extensions and Improvements which cost has not otherwise been provided for from the proceeds of Power Revenue Bonds. The Capital Improvement Fund also serves as an additional reserve for the payment of principal of and the interest on Power Revenue Bonds and meeting the Amortization Requirements to the extent that moneys in the 1974 Sinking Fund, including the 1974 Reserve Account, in the Reserve Maintenance Fund and in the Self-insurance Fund are insufficient for such purpose. (1974 Agreement, Section 512B).

#### *Subordinate Obligations Fund*

Moneys in the Subordinate Obligations Fund shall be paid out or pledged by the Authority as necessary to enable the Authority to meet its Subordinate Obligations. Subordinate Obligations may be incurred or issued by the Authority for any proper corporate purpose of the Authority.

The Authority may covenant with the holders of any Subordinate Obligations to limit the deposits to the Reserve Maintenance Fund as authorized by paragraph 4 above and to add to the conditions, limitations and restrictions under which Power Revenue Bonds may be issued under the provisions of 1974 Agreement.

Subordinate Obligations shall be payable out of and may be secured by a pledge of (i) available amounts in the Subordinate Obligations Fund and (ii) any other available funds of the Authority. Any such payment or pledge shall be expressly subordinate and junior in all respects to the lien and charge of the Power Revenue Bonds upon the Revenues.

Before incurring any Subordinate Obligations the proceeds of which shall be applied to acquire or construct any works or properties by the Authority in connection with the production, distribution or sale of electric energy, the Authority shall specify by resolution whether or not such works or properties are to be included as part of the System. (1974 Agreement, Section 516).

### *1974 Construction Fund*

A special fund is created by the 1974 Agreement and designated the “Puerto Rico Electric Power Authority Power System Construction Fund” (the “1974 Construction Fund”). The proceeds of any Power Revenue Bonds issued for the purpose of paying the cost of acquiring or constructing Improvements, together with the moneys received from any other source for such purpose, except proceeds which are (i) applied to the repayment of advances, (ii) deposited in the 1974 Reserve Account, (iii) deposited in the Bond Service Account as capitalized interest or (iv) used for the payment of financing expenses, shall be deposited in the 1974 Construction Fund and held by the Authority in trust. (1974 Agreement, Sections 208 and 401). Payments from the 1974 Construction Fund are made by the Executive Director or by any officer or employee of the Authority designated by him for such purpose. (1974 Agreement, Section 402).

### **Rate Covenant**

The Authority covenants that it will at all times fix, charge and collect reasonable rates and charges for the use of the services and facilities furnished by the System so that the Revenues will be at all times sufficient to pay the Current Expenses of the System and to provide an amount at least equal to 120% of the aggregate Principal and Interest Requirements for the next fiscal year on account of all outstanding Power Revenue Bonds, reduced by any amount deposited in the Bond Service Account from the proceeds of bonds to pay interest to accrue thereon in such fiscal year.

The Authority further covenants that if at any time the Revenues shall not be sufficient to satisfy the foregoing covenant as to rates, it will revise the rates and charges for the services and facilities furnished by the System and, if necessary, it will revise its regulations in relation to the collection of bills for such services and facilities, so that such deficiency will be made up before the end of the next ensuing fiscal year. Should any deficiency not be made up in such next ensuing fiscal year, the requirement therefor, shall be cumulative and the Authority shall continue to revise such rates until such deficiency shall have been completely made up. (1974 Agreement, Section 502).

### **Investment of Funds**

The 1974 Agreement provides for the following types of investments:

(a) Government Obligations, which are (i) direct obligations of, or obligations the principal of and interest on which are unconditionally guaranteed by, the United States Government, including securities evidencing ownership interests in such obligations or in specified portions thereof (which may consist of specific portions of the principal of or interest on such obligations), (ii) bonds, debentures or notes issued by any of the following federal agencies: Banks for Cooperatives, Federal Intermediate Credit Banks, Federal Home Loan Banks, Export-Import Bank of the United States, Government National Mortgage Association, Federal Land Banks, or the Federal National Mortgage Association (including participation certificates issued by such Association) and (iii) all other obligations issued or unconditionally guaranteed as to

principal and interest by any agency or person controlled or supervised by and acting as an instrumentality of the United States Government pursuant to authority granted by the Congress;

(b) Investment Obligations, which are (i) Government Obligations, (ii) obligations of any state or territory of the United States or political subdivision thereof (other than obligations rated lower than the three highest grades by a nationally recognized rating agency), (iii) repurchase agreements with commercial banks fully secured by Government Obligations and (iv) any other investment obligations permitted for governmental instrumentalities under the laws of the Commonwealth which are rated in any of the three highest grades by a nationally recognized rating agency or which are collateralized by Investment Obligations; and

(c) Time Deposits, which are time deposits, certificates of deposit or similar arrangements with the 1974 Trustee, Government Development Bank for Puerto Rico or any bank or trust company which is a member of the Federal Deposit Insurance Corporation having a combined capital and surplus aggregating not less than \$100,000,000. (1974 Agreement, Section 101).

Moneys in the Bond Service Account, the Redemption Account and the 1974 Revenue Fund shall be invested by the 1974 Trustee or by the Authority, as the case may be, in Government Obligations which shall mature, or which shall be subject to redemption by the holder thereof at the option of such holder, not later than the respective dates when such moneys will be required for the purposes intended, or in Time Deposits; provided, that each such Time Deposit shall permit the moneys so placed to be available for use when required for the purposes intended.

Any moneys in the 1974 Construction Fund, the Reserve Maintenance Fund, the Self-insurance Fund, the Capital Improvement Fund and the 1974 Reserve Account shall be invested by the 1974 Trustee or the Authority, as the case may be, in Investment Obligations which shall mature, or which shall be subject to redemption by the holder thereof at the option of such holder, in the case of the 1974 Construction Fund, the Self-insurance Fund, the Capital Improvement Fund and the Reserve Maintenance Fund, not later than the respective dates when the moneys invested will be required for the purposes intended, and in the case of the 1974 Reserve Account, as to approximately 50% of such moneys, not later than five years after the date of such investment, and as to the balance of such moneys, as directed by order of the Executive Director or other authorized officer of the Authority. In lieu of such investments, moneys in the 1974 Construction Fund, the Reserve Maintenance Fund, the Self-insurance Fund, the Capital Improvement Fund and the 1974 Reserve Account may be invested in Time Deposits which shall permit the moneys so placed to be available for use at the times provided for investments in Investment Obligations. (1974 Agreement, Section 602).

Any moneys in the Self-insurance Fund may also be invested by the Authority in any investments authorized by law for the Retirement System of the Employees of the Government for Puerto Rico and its Instrumentalities, but the Authority shall invest not less than the lesser of \$25,000,000 and the entire balance in such Fund in Investment Obligations with an average weighted maturity of not more than three years.

Prior to investing any moneys in the Self-insurance Fund in other than Investment Obligations, the Authority shall obtain an Independent Consultant's report recommending what portion of moneys held in the Self-insurance Fund the Authority shall maintain invested in Investment Obligations and shall, after duly considering the report, formally adopt, subject to the consent of Government Development Bank for Puerto Rico, and maintain an investment policy first determining the minimum portion of the moneys held for the credit of the Self-insurance Fund to remain invested in Investment Obligations and then setting forth prudent investment principles, considerations and goals, including liquidity, diversification of assets, safety and rate or rates of return, that will govern the investment strategies and goals for the balance of the Self-insurance Fund and shall advise the 1974 Trustee in writing of those investments other than Investment Obligations that are authorized by said investment policy. (1974 Agreement, Section 602).

### **Accounting**

The Authority covenants that it will keep accurate records and accounts, according to standard practices for public utility systems similar to the properties and business of the Authority and applicable in such circumstances, of all items of cost and expenditures relating to the System, the Revenues collected and the application of the Revenues. The Authority further covenants that in the first month of each fiscal year it will cause an audit for the preceding fiscal year to be made of its books and accounts pertaining to the System by an independent firm of certified public accountants widely known in the United States and approved by the 1974 Trustee. (1974 Agreement, Section 710). The Authority records Revenues and Current Expenses on the accrual basis.

### **Release of Property**

The Authority covenants that so long as any Power Revenue Bonds shall be outstanding it will not sell, lease or otherwise dispose of or encumber the System or any part thereof and will not create or permit to be created any charge or lien on the Revenues ranking equally with or prior to the charge or lien on the Revenues of the Power Revenue Bonds. The Authority may, however, from time to time, sell machinery, fixtures, tools or other movable property or materials if the Authority shall determine that such articles are no longer needed or useful in connection with the construction or operation and maintenance of the System. Any such moneys received may be applied to replace any such properties sold or disposed of or shall be deposited in the Redemption Account or the 1974 Construction Fund. Other property forming part of the System, not needed or serving no useful purpose in connection with the System, may be sold, leased or transferred provided the proceeds of which shall be deposited in the Redemption Account or the 1974 Construction Fund and the rentals be deposited in the 1974 Revenue Fund.

Notwithstanding the previous paragraph, the Authority may abandon, sell, lease or transfer any property forming a part of the System, if, among other things, the Net Revenues for any 12 consecutive calendar months out of the 18 calendar months next preceding the date of such abandonment, sale, lease or transfer, adjusted to give effect to such abandonment, sale, lease or transfer and any replacement and to reflect the rate schedule then in effect, are not less than 120% of the maximum aggregate Principal and Interest Requirements for any fiscal year thereafter on account of all outstanding Power Revenue Bonds and if the 1974 Reserve Account

is fully funded. Any transferee of said property may be considered in lieu of or in addition to the Authority for purposes of such coverage if the transferee agrees to assume the Authority's obligations under the 1974 Agreement. Said coverage test need not be met if the transferee is a public corporation or other governmental entity provided the coverage is not reduced due to such transfer. The proceeds of such sale shall be deposited in the Redemption Account or in the 1974 Construction Fund, at the option of the Authority, or shall be applied to the replacement of the property so sold. The rentals under any such lease shall be deposited in the 1974 Revenue Fund.

In addition, the Authority may lease portions of the System or make contracts or other arrangements or grant licenses or easements with respect to the operation or use of the System, if certain reports and certificates of the Consulting Engineers are provided that confirm, among other things, that operational covenants will be binding on the lessee or other contracting entity and that the lease, contract, license, easement or other arrangement provides for rent or other payments that are projected to be sufficient with other projected Net Revenues of the System to make all payments of the Principal and Interest Requirements for all Power Revenue Bonds. Rents received under any such lease, contract, license, easement or other management shall be included as Revenues. (1974 Agreement, Section 712).

### **Insurance**

The Authority covenants that it will at all times carry insurance, in a responsible insurance company or companies authorized and qualified under the laws of Puerto Rico to assume the risk thereof, covering such properties belonging to the System as are customarily insured, and against loss or damage from such causes as are customarily insured against, by companies engaged in similar business.

The Authority covenants that, immediately after any loss or damage, it will cause to be prepared plans and specifications for repairing, replacing or reconstructing the damaged property, and will forthwith proceed with the repair, replacement or reconstruction of the damaged or destroyed property unless it shall determine that the repair, replacement or reconstruction of such property is not essential to the efficient operation of the System. Any proceeds of any insurance not applied within 18 months after receipt by the Treasurer to repairing, replacing or reconstructing damaged or destroyed property shall be deposited in the Redemption Account or the 1974 Construction Fund, at the option of the Authority, unless the Authority shall be prevented from doing so by conditions beyond its control or unless the holders of 51% in aggregate principal amount of the Power Revenue Bonds then outstanding shall otherwise direct. (1974 Agreement, Section 707).

### **Consulting Engineers and Independent Consultant**

The Authority covenants that so long as any of the Power Revenue Bonds are outstanding it will employ as Consulting Engineers an independent engineer or engineering firm having a wide and favorable repute in the United States for skill and experience in the construction and operation of electric systems. It shall be the duty of the Consulting Engineers to prepare an annual report setting forth their recommendations as to revisions of rates and charges. It shall be the duty of the Consulting Engineers to include in such report their recommendations as to the

amount to be deposited in the Reserve Maintenance Fund, the Capital Improvement Fund and the Self-insurance Fund. (1974 Agreement, Section 706).

The Authority covenants that so long as any Power Revenue Bonds are outstanding it will employ as Independent Consultant one or more independent firms having a wide and favorable repute in the United States for expertise in risk management and other insurance matters related to the construction and operation of electric systems. It shall be the duty of the Independent Consultant to prepare at least biennially a report setting forth its recommendations, based on a review of the insurance then maintained by the Authority in accordance with the 1974 Agreement and the status of the Self-insurance Fund, of any changes in coverage, including its recommendations of policy limits and deductibles and self-insurance, and investment strategies for the Self-insurance Fund. (1974 Agreement, Sections 706 and 707).

### **Modifications**

The Authority and the 1974 Trustee may, without the consent of the holders of the Power Revenue Bonds, enter into such supplemental agreements as shall not be inconsistent with the 1974 Agreement, to cure any ambiguity, to correct or supplement any provision in the 1974 Agreement which may be inconsistent with any other provision therein, to make any other provisions which shall not be inconsistent with the provisions of the 1974 Agreement, provided such action shall not adversely affect the interest of the bondholders, or to grant to or confer upon the 1974 Trustee for the benefit of the bondholders any additional rights, remedies, powers, authority or security that may lawfully be granted to or conferred upon the bondholders or the 1974 Trustee, or to add to the conditions, limitations and restrictions on the issuance of bonds under the provisions of the 1974 Agreement other conditions, limitations and restrictions thereafter to be observed, or to add to the covenants and agreements of the Authority in the 1974 Agreement other covenants and agreements thereafter to be observed by the Authority or to surrender any right or power reserved to or conferred upon the Authority by the 1974 Agreement. (1974 Agreement, Section 1101).

The holders of not less than 60% in aggregate principal amount of the Power Revenue Bonds at the time outstanding shall have the right, from time to time (anything contained in the 1974 Agreement to the contrary notwithstanding), to consent to and approve the execution by the Authority and the 1974 Trustee of such agreement or agreements supplemental thereto as shall be deemed necessary or desirable by the Authority for the purpose of modifying, altering, amending, adding to, repealing or rescinding, in any particular, any of the terms or provisions contained in the 1974 Agreement or in any supplemental agreement; provided, however, that nothing contained in the 1974 Agreement shall permit, or be construed as permitting, (a) an extension of the maturity of any Power Revenue Bond, or (b) a reduction in the principal amount of any Power Revenue Bond or the redemption premium or the rate of interest thereon, or (c) the creation of a lien upon or a pledge of the Revenues other than the lien and pledge created by the 1974 Agreement, or (d) a preference or priority of any Power Revenue Bond or Bonds over any other Power Revenue Bond or Bonds, or (e) a reduction in the aggregate principal amount of the Power Revenue Bonds required for consent to such supplemental agreement. (1974 Agreement, Section 1102).

## Remedies of Bondholders

Among the events described in the 1974 Agreement as “events of default” are the following:

- (a) payment of the principal of and redemption premium, if any, on any of the Power Revenue Bonds shall not be made when the same shall become due and payable, or
- (b) payment of any installment of interest shall not be made when the same shall become due and payable, or
- (c) the Authority shall for any reason be rendered incapable of fulfilling its obligations under the 1974 Agreement, or
- (d) default in meeting any Amortization Requirement, with the specified period of grace, or
- (e) if notice has been received by the 1974 Trustee and the Authority from the bank or other institution providing a credit or liquidity facility or other entity guaranteeing or securing bonds that an event of default has occurred under the agreement underlying said facility or if the issuer of a credit or liquidity facility or other entity has failed to make the facility available or to reinstate the interest component of the facility in accordance with its terms (but only to the extent provided for in the resolution authorizing the issuance of the Power Revenue Bonds secured by the credit or liquidity facility). (1974 Agreement, Section 802).

In the event of any such default the 1974 Trustee may, and upon the written request of the holders of not less than 20% in aggregate principal amount of all Power Revenue Bonds then outstanding shall, declare the principal of the Power Revenue Bonds then outstanding to be due and payable, and, providing it shall be indemnified to its satisfaction, the 1974 Trustee may, and upon the written request of the holders of not less than 10% in aggregate principal amount of the Power Revenue Bonds then outstanding shall, proceed to protect and enforce its rights and the rights of the bondholders under the 1974 Agreement by such suits, actions or special proceedings in equity or at law, or by such proceedings in the office of any board or officer having jurisdiction, either for the appointment of a receiver of the System as authorized by the Act or for the specific performance of any covenant or agreement or for the enforcement of any proper legal or equitable remedy, as the 1974 Trustee shall deem most effectual to protect and enforce the rights aforesaid; provided, however, that the 1974 Trustee shall not be required to proceed for the appointment of a receiver unless it shall have received the written request of the holders of not less than 25% in aggregate principal amount of such bonds then outstanding. (1974 Agreement, Sections 803, 804 and 902).

It is the intent of the 1974 Agreement that all proceedings shall be instituted and maintained for the benefit of all holders of outstanding Power Revenue Bonds. (1974 Agreement, Sections 808 and 809).



## **Defeasance**

The 1974 Agreement provides that if, when the Power Revenue Bonds shall have become due and payable or shall have been duly called for redemption or irrevocable instructions to call said bonds for redemption or payment shall have been given by the Authority to the 1974 Trustee, the whole amount of the principal and the interest and the premium, if any, so due and payable upon all of the Power Revenue Bonds then outstanding shall be paid or sufficient moneys, or Government Obligations or Prerefunded Municipals or Time Deposits secured in the manner set forth in Section 601 of the 1974 Agreement, the principal of and the interest on which when due will provide sufficient moneys, shall be held by the 1974 Trustee or the paying agents for such purpose under the provisions of the 1974 Agreement, and provision shall be made for paying all other sums payable by the Authority, then and in that case the right, title and interest of the 1974 Trustee thereunder shall cease, determine and become void, and the 1974 Trustee in such case, on demand of the Authority, shall release the 1974 Agreement. For purposes of determining whether sufficient amounts have been deposited for defeasance, the interest to become due on Variable Rate Bonds shall be calculated at the maximum rate permitted by the terms thereof, and the principal, premium and interest to become due on Put Bonds and Extendible Maturity Bonds shall mean the maximum amount payable upon the exercise of put options by holders of said bonds or extensions of maturity by the holders of said bonds or the Authority. (1974 Agreement, Section 1201).

## **Bonds Not Deemed Outstanding**

The Power Revenue Bonds and portions of Power Revenue Bonds which have been duly called for redemption under the provisions of Article III of the 1974 Agreement, or with respect to which irrevocable instructions to call for redemption or payment at or prior to maturity have been given to the 1974 Trustee in form satisfactory to it, and for the payment of principal or the redemption price and the accrued interest of which sufficient moneys, or Government Obligations or Prerefunded Municipals or Time Deposits secured in the manner set forth in Section 601 of the 1974 Agreement, shall be held in separate accounts by the 1974 Trustee or by the paying agents in trust for the holders of the bonds or portions thereof to be paid or redeemed, all as provided in the 1974 Agreement, shall not thereafter be deemed to be outstanding under the provisions of the 1974 Agreement. (1974 Agreement, Section 307)

## **SUMMARY OF CERTAIN PROVISIONS OF PROPOSED SUPPLEMENTAL AGREEMENT**

The following is a summary of certain provisions of the proposed Supplemental Agreement. The summary does not purport to be complete and reference is made to the proposed Supplemental Agreement, copies of which are available in substantially final form for examination at the principal corporate trust office of the 1974 Trustee.

### **Third Supplemental Agreement**

The 1974 Agreement will be supplemented to provide that the Authority may grant a lien on Revenues on a parity with the lien of the holders of Power Revenue Bonds to providers of credit or liquidity facilities securing such bonds.

**APPENDIX II**

FINANCIAL STATEMENTS AND SUPPLEMENTAL INFORMATION

**Puerto Rico Electric Power Authority**

*Years Ended June 30, 2004 and 2003*

Puerto Rico Electric Power Authority  
Financial Statements and Supplemental Information  
Years Ended June 30, 2004 and 2003

**Contents**

Report of Independent Auditors .....	1	
Management's Discussion and Analysis .....	3	
Audited Financial Statements		
Balance Sheets .....	10	
Statements of Revenues, Expenses and Changes in Net Assets .....	12	
Statements of Cash Flows .....	13	
Notes to Audited Financial Statements.....	15	
Report on Compliance and on Internal Control over Financial Reporting based on an Audit of the Financial Statements Performed in Accordance with Government Auditing Standards .....		45
Supplemental Information		
Schedule I – Supplementary Information Schedule of Funding Progress .....	47	
Notes to Schedules II-VII – Information Required by the 1974 Agreement.....	48	
Schedules II – Source and Disposition of Net Revenues Under the Provisions of the 1974 Agreement.....	49	
Schedules III – Supplemental Schedule of Sources and Disposition of Net Revenues Under the Provisions of the 1974 Agreement .....	50	
Schedules IV – Supplemental Schedule of Funds Under the Provisions of the 1974 Agreement.....	51	
Schedules V – Supplemental Schedule of Changes in Cash and Investments by Funds .....	52	
Schedules VI – Supplemental Schedule of Changes in Long-Term Debt and Current Portion of Long-Term Debt .....	56	

## Report of Independent Auditors

To the Governing Board of the  
Puerto Rico Electric Power Authority

We have audited the accompanying balance sheets of the Puerto Rico Electric Power Authority (the Authority), a component unit of the Commonwealth of Puerto Rico, as of June 30, 2004 and 2003, and the related statements of revenues, expenses and changes in net assets, and cash flows for the years then ended. These financial statements and supplemental information are the responsibility of the Authority's management. Our responsibility is to express an opinion on these financial statements based on our audits.

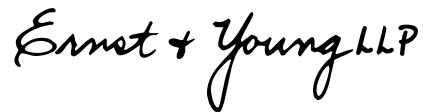
We conducted our audits in accordance with auditing standards generally accepted in the United States and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Authority's internal control over financial reporting. Accordingly, we express no such opinion. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, and assessing the accounting principles used and significant estimates made by management, evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements and supplemental information referred to above present fairly, in all material respects, the financial position of the Authority as of June 30, 2004 and 2003, and its changes in net assets and its cash flows for the years then ended, in conformity with accounting principles generally accepted in the United States.

In accordance with *Government Auditing Standards*, we have also issued our report, dated October 22, 2004, on our consideration of the Authority's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts and grants 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 the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be read in conjunction with this report in considering the results of our audits.

Our audits were conducted primarily for the purpose of expressing an opinion on the financial statements of the Authority taken as a whole. The Management's Discussion and Analysis on pages 3 through 9 is not a required part of the basic financial statements, but is supplementary information required by the Governmental Accounting Standards Board. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the required supplementary information. However, we did not audit the information and express no opinion on it.

Our audits were conducted for the purpose of forming an opinion on the financial statements of the Puerto Rico Electric Power Authority taken as a whole. The supplemental information included in Schedules II - VII is presented for purposes of additional analysis and is not a required part of the financial statements. Such information has been subjected to the auditing procedures applied in the audit of the financial statements and, in our opinion, is fairly stated in all material respects in relation to the financial statements taken as a whole, and are prepared in accordance with the terms of the 1974 Agreement (described herein).



October 22, 2004, except for the  
second paragraph of Note 19, as  
to which the date is March 4, 2005

Stamp No. 2004098  
affixed to  
original of  
this report.

# Puerto Rico Electric Power Authority

## MANAGEMENT'S DISCUSSION AND ANALYSIS

This section of the financial report of Puerto Rico Electric Power Authority (the Authority) presents the analysis of the Authority's financial performance during the fiscal years ended June 30, 2004 and 2003. As management of the Authority, we offer readers of the financial statements this narrative overview and analysis of the financial activities. We encourage readers to consider the information presented here in conjunction with the financial statements that follow this section.

### FINANCIAL HIGHLIGHTS

- The Authority's net assets decreased by \$24.3 (or 4.5 percent) and increased by \$52.4 million (or 10.6 percent) as a result of operations during fiscal years ended June 30, 2004 and 2003.
- Operating income was \$371.8 and \$411.5 million for the fiscal years ended June 30, 2004 and 2003, representing a 9.7 percent decrease and a 11.9 percent increase when compared to fiscal years 2002-2003 and 2001-2002, respectively.
- Ratios of fuel and purchased power adjustment revenues to total operating revenues were 56.0 percent for 2003-2004, 54.7 percent for 2002-2003 and 48.9 percent for 2001-2002.
- Operating expenses increased \$131.5 and \$303.7 million for the fiscal years ended June 30, 2004 and 2003, representing a 6.3 and 16.9 percent increase, when compared to previous fiscal years.
- Ratios of fuel oil and purchased power expenses to total operating expenses (excluding depreciation expenses) were 65.6 percent for 2003-2004, 65.4 percent for 2002-2003 and 60.3 percent for 2001-2002.
- The decrease in the fuel adjustment revenues and fuel expense of \$23.4 and \$21.7 million, respectively, was mainly due to a decrease in fuel oil price per barrel of \$0.63 (or 2.1 percent) for 2003-2004. In addition, the increase in the fuel adjustment revenues and fuel expense of \$187.6 and \$166.1 million, respectively, was mainly due to an increase in fuel oil price per barrel of \$7.32 (or 32.0 percent) for 2002-2003.
- The increase in the purchased power adjustment revenues and expense of \$109.4 and \$97.7 million, respectively, was mainly due to an increase of 86,775 thousand Kwh on two cogeneration facilities and an increase of .069 cents per Kwh in average price of purchased power.

# Puerto Rico Electric Power Authority

## MANAGEMENT'S DISCUSSION AND ANALYSIS (continued)

- The Authority's Net Utility Plant increased by \$241.0 and \$204.1 million or 5.3 and 4.7 percent and Total Assets increased by \$353.1 and \$13.4 million or 5.7 and .21 percent for the fiscal years ended June 30, 2004 and 2003.
- For the fiscal year ended June 30, 2004 as compared to the fiscal year ended June 30, 2003, accounts receivable increased from \$502.6 million on June 30, 2003 to \$535.9 million on June 30, 2004, representing a 6.6 percent increase. Accounts receivable from the governmental sector increased from \$103.6 million on June 30, 2003 to \$158.9 million on June 30, 2004, representing a 53.3 percent increase.
- For the fiscal year ended June 30, 2003 as compared to the fiscal year ended June 30, 2002, accounts receivable increased from \$438.7 million on June 30, 2002 to \$502.6 million on June 30, 2003, representing a 14.6 percent increase. Accounts receivable from the governmental sector decreased from \$108.4 million on June 30, 2002 to \$103.6 million on June 30, 2003, representing a 4.4 percent decrease.

## OVERVIEW OF FINANCIAL REPORT

Management's Discussion and Analysis (MD&A) of operating results serves as an introduction to the basic financial statements and supplementary information. Summary financial statement data, key financial and operational indicators used in the Authority's strategic plan, projected capital improvement program, operational budget and other management tools were used for this analysis.

During the 2002 fiscal year, the Authority adopted Government Accounting Standards Board (GASB) Statement No. 34 and related pronouncements. The implementation of these pronouncements had an effect on the Authority's basic financial statements such as the classification of net assets, modifications to certain note disclosures, and the inclusion of a Management's Discussion and Analysis (MD&A) section as required supplementary information. In addition, the statements of cash flows are now presented using the direct method.

## REQUIRED FINANCIAL STATEMENTS

The financial statements of the Authority consolidate the financial position and operations of Puerto Rico Electric Power Authority and Puerto Rico Irrigation Systems, which include a Balance Sheet, Statement of Revenues, Expenses and Changes in Net Assets, Statement of Cash Flow and the notes to financial statements.

The Balance Sheet presents the financial position of the Authority and provides information about the nature and amount of resources and obligations at year-end.

The Statement of Revenues, Expenses and Changes in Net Assets presents the results of the business activities over the course of the fiscal year and information as to how the net assets changed during the fiscal year.

# Puerto Rico Electric Power Authority

## MANAGEMENT'S DISCUSSION AND ANALYSIS (continued)

The Statement of Cash Flows shows changes in cash and cash equivalents, resulting from operational, financing and investing activities, which include cash receipts and cash disbursement information, without consideration of the depreciation of capital assets.

The notes to the financial statements provide information required and necessary to the understanding of material information of the Authority's financial statements. The notes present information about the Authority's significant accounting policies, significant account balances and activities, risk management, obligations, commitments and contingencies, and subsequent events.

The financial statements were prepared by the Authority's management from the detail accounting books and records.

### FINANCIAL ANALYSIS

The Authority's net assets decreased by \$24.3 and increased by \$52.4 million for the fiscal years ended June 30, 2004 and 2003. Our analysis below focuses on the Authority's net assets and changes in net assets during the year.

#### Authority's Net Assets (In Thousands)

	2004	2003	2002
Current, non-current and other assets	<b>\$1,758,573</b>	\$1,645,846	\$1,836,558
Capital assets	<b>4,804,535</b>	4,563,533	4,359,399
Total assets	<b>\$6,563,108</b>	\$6,209,379	\$6,197,957
Long-term debt outstanding	<b>\$4,909,527</b>	\$4,511,718	\$4,632,928
Other liabilities	<b>1,133,074</b>	1,152,882	1,070,684
Total liabilities	<b>\$6,042,601</b>	\$5,664,600	\$5,703,612
Net assets:			
Invested in capital assets, net of related debt	<b>\$ 115,983</b>	\$ 175,301	\$ 113,475
Restricted	<b>389,724</b>	366,809	377,632
Unrestricted	<b>14,800</b>	2,669	1,238
Total net assets	<b>\$ 520,507</b>	\$ 544,779	\$ 492,345



## Puerto Rico Electric Power Authority

### MANAGEMENT'S DISCUSSION AND ANALYSIS (continued)

The largest portion of the Authority's net assets (75 percent for 2003-2004, 67 percent for 2002-2003 and 77 percent for 2001-2002) is restricted and represents resources that are subject to external restrictions on how they may be used. An additional portion of the Authority's net assets (22 percent for 2003-2004, 32 percent for 2002-2003 and 23 percent for 2001-2002) reflects its investments in capital assets, less any related debt used to acquire those assets that is still outstanding.

Changes in the Authority's net assets can be determined by reviewing the following condensed Statement of Revenue, Expenses and Changes in Net Assets.

#### **Authority's Changes in Net Assets** *(In Thousands)*

	<b>2004</b>	<b>2003</b>	<b>2002</b>
Operating revenues	<b>\$2,605,764</b>	\$2,513,963	\$2,166,632
Other income	<b>15,932</b>	30,625	42,323
Total revenues	<b>2,621,696</b>	2,544,588	2,208,955
Operating expenses	<b>2,233,993</b>	2,102,461	1,798,788
Interest expense, net	<b>270,012</b>	256,931	253,590
Total expenses	<b>2,504,005</b>	2,359,392	2,052,378
Income before contribution in lieu of taxes and other	<b>117,691</b>	185,196	156,577
Contribution in lieu of taxes and other	<b>(180,820)</b>	(175,737)	(128,787)
(Loss) income before contributed capital	<b>(63,129)</b>	9,459	27,790
Contributed capital	<b>38,857</b>	42,975	-
Change in net assets	<b>(24,272)</b>	52,434	27,790
Net assets, beginning of year	<b>544,779</b>	492,345	464,555
Net assets, end of year	<b>\$ 520,507</b>	\$ 544,779	\$ 492,345

For the fiscal year ended June 30, 2004, as compared to June 30, 2003, operating revenues and expenses increased by \$91.8 million (or 3.7%) and \$131.5 million (or 6.3%), respectively, resulting in a decrease of net assets of \$24.3 million. The increase in operating revenues and expenses was mainly due to an increase of \$0.007 per Kwh (or 10.8%) in the average price of purchased power and an increase of 860.8 Mwh (or 16.2%) in purchased power..

For the fiscal year ended June 30, 2003, as compared to June 30, 2002, operating revenues and expenses increased by \$347.3 million (or 16.0%) and \$303.7 million (or 16.9%), respectively, resulting in an increase of net assets of \$52.4 million. The increase in operating revenues and expenses was mainly due to an increase in fuel oil price per barrel of \$7.32.

# Puerto Rico Electric Power Authority

## MANAGEMENT'S DISCUSSION AND ANALYSIS (continued)

### CAPITAL ASSET AND DEBT ADMINISTRATION

#### Capital Assets

The Authority's investment in capital assets as of June 30, 2004 and 2003, amounts to approximately \$4,805 and \$4,564 million (net of accumulated depreciation), respectively. This investment in capital assets includes land, generation, transmission and distribution systems, buildings, fixed equipment, furniture, fixtures and equipment. The total increase in the Authority's investment in capital assets (net of accumulated depreciation) were 5.3 and 5.0 percent for 2003-2004 and 2002-2003.

A substantial portion of the capital expenditures for production plant in fiscal year ended June 30, 2004 and 2003, was spent on the rehabilitation and life extension of generating plant in order to achieve and maintain higher levels of availability, reliability and efficiency.

Major capital asset events during fiscal year 2003-2004 included the following:

- The Authority is constructing new 230 kV transmission lines to complete the transmission loop on the eastern part of the island. The eastern loop will connect major switching and load centers on the eastern part of the island and boost electric system capacity in Puerto Rico's eastern region. The eastern loop is expected to be operating during fiscal year 2005.
- The Authority is also constructing a new 50-mile long 230 kV transmission line between its South Coast steam plant and the transmission center at Aguas Buenas. This new transmission line is expected to be operating in fiscal year 2007. Once in operation, this major infrastructure project will enhance the reliability of the transmission system, and will permit the increase of power transfers from the south coast of Puerto Rico to the northern and central regions.
- An aggressive program to improve the 38 kV sub-transmission system is in effect which includes construction of underground 38 kV lines in Mayagüez, Vega Baja, Viaducto and San Fernando in San Juan. In addition, most 38 kV lines in the central part of the island are being replaced. These projects will improve the reliability of the sub-transmission system.
- The Authority is constructing an underground 115 kV transmission circuit line around the San Juan metropolitan area in order to reduce the incidents of loss of power in the aftermath of hurricanes and other major storms which strike Puerto Rico from time to time. This circuit line is expected to be completed in fiscal year 2006. The Federal Emergency Management Agency has committed to provide \$75 million in grants. Other related projects related to the load growth forecast of the San Juan metropolitan area are the new gas insulated 115/38 kV transmission centers of Martín Peña and Isla Grande. In addition, three new 115/38 kV transmission centers under construction in the municipalities of Comerío, Juana Díaz and Hatillo will increase the load flow capability and improve the voltage regulation of the 38 kV system under emergency conditions.

# Puerto Rico Electric Power Authority

## MANAGEMENT'S DISCUSSION AND ANALYSIS (continued)

- The Authority is also currently designing and building major underground systems located in high-density metropolitan areas. These underground systems will permit the replacement of overhead sub-transmission and distribution lines, thereby improving reliability and assisting municipalities undertaking urban renewal projects by removing unsightly poles, lines and transformers.
- The Authority is designing two new 115 kV capacitor banks in the transmission center of Dorado and Sabana Llana to improve the system power factor and to reduce the reactive power losses at transmission level. These capacitor banks are expected to be constructed in fiscal year 2004-2005.

These projects are funded from cash reserves, excess-operating revenues, grants, and debt issued for such purpose.

Additional information on the Authority's capital assets can be found in Note 6 of this report.

### Long-Term Debt

At the end of the fiscal year 2004, 2003 and 2002, the Authority had total long-term debt outstanding of \$4,909.5, \$4,511.7 and \$4,632.9 million, respectively, comprised of revenue bonds and other borrowings.

#### **Authority Outstanding Debt** (In Thousands)

	<b>2004</b>	<b>2003</b>	<b>2002</b>
Power revenue bonds, net	<b>\$4,904,527</b>	\$4,506,718	\$4,627,928
Note payable	<b>5,000</b>	5,000	5,000
	<b>4,909,527</b>	4,511,718	4,632,928
Current portion	<b>(331,806)</b>	(285,407)	(280,070)
Long-term debt excluding current portion	<b>\$4,577,721</b>	\$4,226,311	\$4,352,858

The Authority maintains ratings of "A3" by Moody's and "A-" by S&P for its bonds.

Additional information on the Authority's long-term debt can be found in Notes 5, 8 and 11.

# Puerto Rico Electric Power Authority

## MANAGEMENT'S DISCUSSION AND ANALYSIS (continued)

### ECONOMIC FACTORS AND NEW YEAR'S BUDGETS AND RATES

The economy of Puerto Rico must be analyzed as a region within the U.S. economy, since it is part of the U.S. monetary and banking system, as well as within its territorial boundaries. The main drive of the Puerto Rico economy is a huge external sector closely tied to the flow of merchandise, tourists, and capital between Puerto Rico and the Mainland. Thus, historically, the real growth rates of the Puerto Rico economy have closely followed those of the U.S. economy. In fiscal year 2004 Puerto Rico experienced the consequences of the slowdown in the U.S. economy, since the U.S. Real GDP increased by only 0.8%.

The economy of Puerto Rico is expected to resume growing in fiscal year 2005, advancing at rates between 2% and 3% in real terms, according to the latest forecast prepared by Interamerican University of Puerto Rico. The Authority expects this turnaround in economic performance to contribute to achieving the conservative income projections of the Authority for fiscal year 2005.

The Authority adopted the 2005 fiscal year budget on June 22, 2004. The electric revenues for fiscal year 2005 are projected to approximately \$2,741.6 million. This budget includes approximately \$434.5 million for representing a decrease of about 2.7% from fiscal year 2004.

### REQUEST FOR INFORMATION

This financial report is designed to provide a general overview of the Authority's finances. Questions concerning any of the information provided in this report or requests for additional financial information should be addressed to the Chief Financial Officer. The executive offices of the Authority are located at 1110 Ponce de León Avenue, San Juan, Puerto Rico 00907.

Puerto Rico Electric Power Authority  
Balance Sheets

	<b>June 30</b>	
	<b>2004</b>	<b>2003</b>
	<i>(In Thousands)</i>	
<b>Assets</b>		
Current assets:		
Cash and cash equivalents	\$ 17,606	\$ 50,451
Receivables, net	535,938	502,609
Fuel oil, at average cost	66,160	53,465
Materials and supplies, at average cost	135,110	130,844
Prepayments and other assets	31,878	20,808
Total current assets	<u>786,692</u>	<u>758,177</u>
Other non-current receivables	68,530	42,069
Restricted assets:		
Cash and cash equivalents held by trustee for payment of principal and interest on bonds	302,638	275,765
Investments held by trustee	324,027	321,649
Construction fund and other special funds	149,464	133,332
Total restricted assets	<u>776,129</u>	<u>730,746</u>
Utility plant:		
Plant in service	6,592,174	6,331,267
Accumulated depreciation	(3,373,571)	(3,210,237)
	<u>3,218,603</u>	<u>3,121,030</u>
Construction in progress	1,585,932	1,442,503
Total utility plant, net	<u>4,804,535</u>	<u>4,563,533</u>
Other properties	38,867	39,751
Deferred expenses:		
Unamortized debt issue cost	49,831	39,218
Other	38,524	35,885
Total deferred expenses	<u>88,355</u>	<u>75,103</u>
Total assets	<u><u>\$6,563,108</u></u>	<u><u>\$6,209,379</u></u>

*(Continue)*

Puerto Rico Electric Power Authority  
Balance Sheets (continued)

	<b>June 30</b>	
	<b>2004</b>	<b>2003</b>
	<i>(In Thousands)</i>	
<b>Liabilities and net assets</b>		
Current liabilities:		
Notes payable to banks	\$ 186,452	\$ 185,000
Accounts payable and accrued liabilities	530,835	545,002
Customers' deposits	150,643	141,863
Total current liabilities	867,930	871,865
Current liabilities payable from restricted assets:		
Current portion of long-term debt and notes payable	331,806	285,407
Accrued interest	132,517	121,942
Total current liabilities payable from restricted assets	464,323	407,349
Noncurrent liabilities:		
Long-term debt, excluding current portion payable from restricted assets	4,577,721	4,226,311
Deferred credit for purchase of power payable from restricted assets	3,673	29,160
Sick leave benefits to be liquidated after one year	128,954	128,912
Supplemental spouse survivor benefits	-	1,003
Total noncurrent liabilities	4,710,348	4,385,386
Total liabilities	6,042,601	5,664,600
Net assets:		
Invested in utility plant, net of related debt	115,983	175,301
Restricted for capital activity and debt service	389,724	366,809
Unrestricted	14,800	2,669
Total net assets	520,507	544,779
Total liabilities and net assets	\$6,563,108	\$6,209,379

*See accompanying notes.*

Puerto Rico Electric Power Authority  
Statements of Revenues, Expenses and Changes in Net Assets

	<b>Years Ended June 30</b>	
	<b>2004</b>	<b>2003</b>
	<i>(In Thousands)</i>	
Operating revenues	<b>\$2,605,764</b>	\$2,513,963
Operating expenses:		
Operations:		
Fuel	<b>864,700</b>	886,425
Purchased power	<b>436,762</b>	339,082
Other production	<b>50,079</b>	45,366
Transmission and distribution	<b>138,102</b>	120,631
Customer accounting and collection	<b>92,032</b>	90,299
Administrative and general	<b>165,425</b>	164,915
Maintenance	<b>236,109</b>	228,167
Depreciation	<b>250,784</b>	227,576
Total operating expenses	<b>2,233,993</b>	2,102,461
Operating income	<b>371,771</b>	411,502
Interest income	<b>9,875</b>	20,296
Other income	<b>6,057</b>	10,329
Income before interest charges and contribution in lieu of taxes	<b>387,703</b>	442,127
Interest charges:		
Interest on bonds	<b>264,219</b>	249,779
Interest on other long-term debt	<b>1,979</b>	-
Other interest	<b>3,622</b>	3,403
Amortization of debt discount, issuance costs and refunding loss	<b>20,471</b>	20,544
Allowance for funds used during construction	<b>(20,279)</b>	(16,795)
Total interest charges, net	<b>270,012</b>	256,931
Income before contribution in lieu of taxes and contributed capital	<b>117,691</b>	185,196
Contribution in lieu of taxes and other	<b>(180,820)</b>	(175,737)
(Loss) income before contributed capital	<b>(63,129)</b>	9,459
Contributed capital	<b>38,857</b>	42,975
Changes in net assets	<b>(24,272)</b>	52,434
Net assets, beginning balance	<b>544,779</b>	492,345
Net assets, ending balance	<b>\$ 520,507</b>	\$ 544,779

*See accompanying notes.*

Puerto Rico Electric Power Authority

Statements of Cash Flows

	<b>Years Ended June 30</b>	
	<b>2004</b>	<b>2003</b>
	<i>(In Thousands)</i>	
<b>Cash flows from operating activities</b>		
Cash received from customers	\$ 2,549,180	\$ 2,286,108
Cash paid to suppliers and employees	(2,248,995)	(1,863,829)
Net cash flows provided by operating activities	<u>300,185</u>	<u>422,279</u>
<b>Cash flows from noncapital financing activities</b>		
Proceeds from notes payable	61,412	–
Other special funds, net	19,659	3,885
Principal paid on fuel line of credit	(905,000)	(980,000)
Proceeds from fuel line of credit	905,000	980,000
Interest paid on fuel line of credit	(1,323)	(2,287)
Net cash flows provided by noncapital financing activities	<u>79,748</u>	<u>1,598</u>
<b>Cash flows from capital and related financing activities</b>		
Construction expenditures	(468,699)	(422,758)
Allowance for funds used during construction	20,279	16,795
Net increase in construction funds	24,670	17,212
Power revenue bonds:		
Proceeds from issuance of bonds, net of original issue discount	514,755	98,125
Principal paid on revenue bonds	(137,369)	(155,163)
Interest paid on revenue bonds	(250,509)	(245,090)
Proceeds from issuance of refunding bonds, net of original issue discount	–	556,346
Defeased bonds, net of original issue discount or premium	–	(644,443)
Payment of bond anticipation notes	(90,000)	–
Proceeds from bond anticipation notes	30,000	60,000
Interest paid on bond anticipation notes	94	–
Net cash flows used in capital and related financing activities	<u>(356,779)</u>	<u>(718,976)</u>
<b>Cash flows from investing activities</b>		
Purchases of investment securities	(1,763,991)	(2,800,788)
Proceeds from sale and maturities of investment securities	1,744,578	2,967,103
Interest on investments	14,955	33,215
Net cash flows (used in) provided by investing activities	<u>(4,458)</u>	<u>199,530</u>
Net increase (decrease) in cash and cash equivalents	<u>18,698</u>	<u>(95,569)</u>
Cash and cash equivalents at beginning of year	<u>372,740</u>	<u>468,309</u>
Cash and cash equivalents at end of year	<u>\$ 391,438</u>	<u>\$ 372,740</u>

*(Continue)*



Puerto Rico Electric Power Authority  
Statements of Cash Flows (continued)

	<b>Years Ended June 30</b>	
	<b>2004</b>	<b>2003</b>
	<i>(In Thousands)</i>	
<b>Cash and cash equivalents</b>		
Unrestricted	\$ 17,606	\$ 50,451
Restricted:		
Cash and cash equivalents held by trustee for payment of principal and interest on outstanding bonds	302,638	275,765
Cash and cash equivalents held in construction and other special funds	71,194	46,524
	<b>\$ 391,438</b>	<b>\$ 372,740</b>
 <b>Reconciliation of net operating income to net cash (used in) provided by operating activities</b>		
Operating income	\$ 371,771	\$ 411,502
Adjustments to reconcile operating income to net cash provided by operating activities:		
Depreciation	250,784	227,576
Amortization of other assets	11,941	17,610
Contribution in lieu of taxes	(180,820)	(175,737)
Changes in assets and liabilities:		
Receivables	(62,218)	(69,690)
Fuel oil	(11,372)	4,219
Materials and supplies	(3,196)	5,159
Prepayments and other assets	(11,070)	(388)
Deferred debits	(23,482)	(10,189)
Noncurrent liabilities, excluding note payable to GDB	(25,445)	(31,943)
Accounts payable and accrued liabilities	(25,488)	35,808
Customers' deposits	8,780	8,352
Total adjustments	<b>(71,586)</b>	<b>10,777</b>
 Net cash flows provided by operating activities	<b>\$ 300,185</b>	<b>\$ 422,279</b>

*See accompanying notes.*

Puerto Rico Electric Power Authority  
Notes to Audited Financial Statements

June 30, 2004 and 2003

**1. Reporting Entity**

Puerto Rico Electric Power Authority (the Authority) is a public corporation and governmental instrumentality of the Commonwealth of Puerto Rico (the Commonwealth) created on May 2, 1941, pursuant to Act No. 83, as amended, re-enacted, and supplemented, of the Legislature of Puerto Rico (the Act) for the purpose of conserving, developing and utilizing the water and power resources of Puerto Rico in order to promote the general welfare of the Commonwealth. Under the entity concept, the Authority is a component unit of the Commonwealth. The Authority produces, transmits, and distributes substantially all of the electric power consumed in Puerto Rico.

The Authority has broad powers including, among others, to issue bonds for any of its corporate purposes. The Authority is required under the terms of a Trust Agreement, dated as of January 1, 1974, as amended (the 1974 Agreement), and the Act to determine and collect reasonable rates for electric service in order to produce revenues sufficient to cover all operating and financial obligations, as defined.

On August 18, 2003, the Commonwealth of Puerto Rico approved Act No. 189, which authorizes the Authority to create, acquire and maintain corporations, partnerships or subsidiary corporations, profit or non-profit entities.

**Basis of Presentation – Blended Component Unit**

The financial statements of the Authority include the financial position and operations of the Puerto Rico Irrigation Systems (Irrigation Systems). The Irrigation Systems operate pursuant to the provisions of the Act, and Acts No. 83 and 84, approved on June 20, 1955, regarding the Puerto Rico Irrigation Service, South Coast, and Isabela Irrigation Service, respectively, and the Lajas Valley Public Irrigation Law, approved on June 10, 1953, as amended.

The Irrigations Systems conform to the requirements of Governmental Accounting Standards Board (GASB) No. 39, *Determining Whether Certain Organizations are Component Units*, on its stand-alone financial statements. GASB No. 39 establishes standards for defining and reporting on the financial reporting entity. It also establishes standards for reporting participation in joint ventures. It applies to financial reporting by primary governments, and other stand-alone governments; and it applies to the separately issued financial statements of governmental component units. In addition, this Statement should be applied to governmental and nongovernmental component units when they are included in a governmental financial reporting entity.

Puerto Rico Electric Power Authority  
Notes to Audited Financial Statements (continued)

**1. Reporting Entity (continued)**

**Basis of Presentation – Blended Component Unit (continued)**

Condensed financial information as of June 30, 2004 and 2003, and for the year then ended for the Irrigation Systems is as follows:

	<b>2004</b>	<b>2003</b>
	<i>(In Thousands)</i>	
Balance sheets:		
Assets:		
Receivables, net	\$ <b>7,638</b>	\$ 6,157
Prepayments and other assets	<b>2,178</b>	2,172
Utility Plant, net of depreciation	<b>19,990</b>	19,496
Total assets	<b>29,806</b>	27,825
Liabilities:		
Accounts payable, net	<b>905</b>	872
Statement of revenues, expenditures and changes in net assets		
Operating revenues	<b>5,496</b>	5,205
Operating expenses	<b>(3,548)</b>	(6,240)
	<b>1,948</b>	(1,035)
Net assets, beginning balance	<b>26,953</b>	27,988
Net assets, ending balance	<b>\$28,901</b>	\$26,953

**2. Summary of Significant Accounting Policies**

The following is a summary of the most significant accounting policies followed by the Authority in preparing its financial statements:

**Basis of Accounting**

The accounting and reporting policies of the Authority conform with the accounting rules prescribed by the Governmental Accounting Standards Board (GASB). As such, it functions as an enterprise fund. The Authority maintains its accounting records on the accrual method of accounting in conformity with accounting principles generally accepted in the United States. Although the Authority is not subject to all Federal Energy Regulatory Commission (FERC) regulations, the Authority has adopted the uniform system of accounts prescribed by FERC.

Puerto Rico Electric Power Authority  
Notes to Audited Financial Statements (continued)

**2. Summary of Significant Accounting Policies (continued)**

**Basis of Accounting (continued)**

The Authority follows the provisions of GASB Statement No. 20, *Accounting and Financial Reporting for Proprietary Funds and Other Governmental Entities that Use Proprietary Fund Accounting*, as amended by GASB Statement No. 34, which requires proprietary activities to apply all applicable GASB pronouncements as well as all Financial Accounting Standards Board (FASB) Statements and Interpretations, and Accounting Principles Board Opinions and Accounting Research Bulletins issued on or before November 30, 1989, unless the pronouncements conflict or contradict GASB pronouncements.

This pronouncement permits the adoption of all FASB Statements and Interpretations issued after November 30, 1989, except for those that conflict or contradict GASB pronouncements. The Authority, as allowed by GASB, decided not to implement any FASB Statement or Interpretation issued after November 30, 1989.

**Use of Estimates in the Preparation of Financial Statements**

The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the reported amount of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Because of uncertainties inherent in the estimation process, it is possible that actual results could differ from those estimates.

**GASB Statement Nos. 34, 37 and 38**

During the 2002 fiscal year the Authority adopted the provisions of GASB Statement No. 34, *Basic Financial Statements—and Management’s Discussion and Analysis—for State and Local Governments* (Statement 34); GASB Statement No. 37, *Basic Financial Statements – and Management’s Discussion and Analysis – for State and Local Governments: Omnibus* (Statement 37); and GASB Statement No. 38, *Certain Financial Statement Disclosures* (Statement 38). Statements 34, 37 and 38 established standards for external financial reporting and disclosure for all state and local government entities, which for the Authority includes a statement of net assets, a statement of revenues, expenses and changes in net assets and a statement of cash flows. The most significant change related to the implementation of Statement 34 for Authority is the requirement that net assets be classified into three components – invested in capital assets, net of related debt; restricted; and unrestricted, on a retroactive basis. Previously, Authority net assets were reported as fund equity, as either retained earnings or contributions in aid of construction. These classifications are defined as follows:

Puerto Rico Electric Power Authority  
Notes to Audited Financial Statements (continued)

**2. Summary of Significant Accounting Policies (continued)**

**GASB Statement Nos. 34, 37 and 38 (continued)**

- Invested in capital assets, net of related debt – This component of net assets consists of capital assets, net of accumulated depreciation and reduced by the outstanding balances of any bonds, or other long-term borrowings that are attributable to the acquisition, construction, or improvement of those assets. If there are significant unspent related debt proceeds at year-end, the portion of the debt attributable to the unspent proceeds is not included in the calculation of invested in capital assets, net of related debt. Rather, that portion of the debt is included in the same net assets component as the unspent proceeds.
- Restricted – This component of net assets consists of net assets subject to external constraints on their use imposed by creditors (such as through debt covenants), contributors, or laws or regulations of other governments or constraints imposed by law through constitutional provisions or enabling legislation.
- Unrestricted net assets – This component of net assets consists of net assets that do not meet the definition of “restricted” or “invested in capital assets, net of related debt.”

**Cash and Cash Equivalents**

For purposes of the statements of cash flows, the Authority considers all highly liquid debt instruments with maturities of three months or less when purchased to be cash equivalents. Cash and cash equivalents included in the restricted funds are considered cash equivalents for purposes of the statements of cash flows.

**Receivables**

Receivables are stated net of estimated allowances for uncollectible accounts, which are determined, based upon past collection experience and current economic conditions.

**Materials and Supplies**

Materials and supplies inventories are carried at average cost and are stated at the lower of cost or market.

**Investments**

The Authority follows the provisions of GASB Statement No. 31, *Accounting and Financial Reporting for Certain Investments and for External Investment Pools*, which require the reporting of investments at fair value in the balance sheet and the recording of changes in fair value in the statement of revenues, expenses and changes in net assets. The fair value is based on quoted market prices.

Puerto Rico Electric Power Authority  
Notes to Audited Financial Statements (continued)

**2. Summary of Significant Accounting Policies (continued)**

**Investments (continued)**

The funds under the 1974 Agreement may be invested in:

- Government obligations, which are direct obligations of, or obligations whose principal and interest is guaranteed by the U.S. Government, or obligations of certain of its agencies or instrumentalities.
- Investment obligations of any of the states or territories of the United States or political subdivisions thereof (other than obligations rated lower than the three highest grades by a nationally recognized rating agency) and repurchase agreements with commercial banks fully secured by U.S. Government obligations.
- Time deposits with Government Development Bank for Puerto Rico (GDB) or the Authority's Trustee under the 1974 Agreement or any bank or trust company member of the Federal Deposit Insurance Corporation having a combined capital and surplus of not less than \$100 million.

Effective April 1999, the 1974 Agreement was amended to provide that permitted investments of moneys to the credit of the Self-insurance Fund be expanded (subject to the Authority's adoption of an investment policy with the consent of GDB) to coincide with the investments permitted for the pension fund for employees of the Commonwealth of Puerto Rico and its instrumentalities. Such investments include various debt instruments, such as mortgage loans and leases, common and preferred stock, real property and various other financial instruments.

**Utility Plant**

Utility plant is carried at cost, which includes labor, materials, overhead, and an allowance for the cost of funds used during construction (AFUDC). AFUDC represents the cost of borrowed funds used to finance construction work in progress. AFUDC is capitalized as an additional cost of property and as a reduction of interest expense. Capitalized interest expense is reduced by interest income earned on related investments acquired with proceeds of tax-exempt borrowings. Such costs are recovered from customers as a cost of service through depreciation charges in future periods. Capitalized interest during the years ended June 30, 2004 and 2003 amounted to \$20.3 million and \$16.8 million, respectively. These amounts are net of interest income earned on investments amounting to \$3.1 million and \$3.1 thousand, respectively.

Maintenance, repairs, and the cost of renewals of minor items of property units are charged to operating expenses. Replacements of major items of property are charged to the plant accounts. The cost of retired property, together with removal cost less salvage, is charged to accumulated depreciation with no gain or loss recognized.

Puerto Rico Electric Power Authority  
Notes to Audited Financial Statements (continued)

**2. Summary of Significant Accounting Policies (continued)**

**Depreciation**

Depreciation is computed on the straight-line method at rates considered adequate to allocate the cost of the various classes of property over their estimated service lives. The annual composite rate of depreciation, determined by the Authority's consulting engineers, was approximately 4.25% for 2004 and 2003.

**Unamortized Debt Expense**

Debt issuance expenses and discounts incurred in the issuance of bonds are deferred and amortized using the straight-line method, which approximates the interest method, over the term of the related debt.

For refunding debt, the excess of reacquisition cost over the carrying value of long-term debt is deferred and amortized to operating expenses using the straight-line method over the remaining life of the original debt or the life of the new debt, whichever is shorter.

**Asbestos Containment Deferred Costs**

Maintenance costs incurred in the containment of asbestos are deferred and included in other deferred expenses. Such costs are amortized as recovered over an estimated life of 12 years.

**Pension Plan**

Pension expense is equal to the statutory required contribution to the employees' retirement system. A pension liability or asset is reported equal to the cumulative difference between annual required contributions and actual contributions.

**Accounting for Compensated Absences**

Accumulated unpaid vacation and sick leave pay are accrued when earned and an additional amount is accrued as a liability for the employer salary-related benefits associated with compensated absences using salary rates in effect at the balance sheet date.

The cost of compensated absences expected to be paid in the next twelve months is classified as accounts payable and accrued liabilities while amounts expected to be paid after twelve months are classified as noncurrent liabilities.

**Revenue Recognition, Fuel Costs and Purchase Power**

Clients are billed monthly, except for rural clients who are billed bi-monthly. Revenues are recorded based on services rendered during each accounting period, including an estimate for unbilled services. Revenues include amounts resulting from a fuel and purchased power cost recovery clause (Fuel Adjustment Clause), which is designed to permit full recovery through customer billings of fuel costs and purchased power. Fuel costs and purchased power are reflected in operating expenses as the fuel and purchased power are consumed.

Puerto Rico Electric Power Authority  
Notes to Audited Financial Statements (continued)

**2. Summary of Significant Accounting Policies (continued)**

**Contributions in Lieu of Taxes and Governmental Subsidies**

The Act exempts the Authority from all taxes that otherwise would be levied on its properties and revenues by the Commonwealth and its Municipalities, except as follows:

**Municipalities**

To the extent net revenues, as defined, are available, the Authority is required under the Act to make a contribution in lieu of taxes of 11% to the Commonwealth and the Municipalities of gross electric sales (with certain exemptions) computed on the basis of an annual average fuel oil price of up to a maximum of \$30 per barrel.

The Authority is required under the Act to make a contribution in lieu of taxes of the greater of:

1. Twenty percent of the Authority's Adjusted Net Revenues (Net Revenues, as defined in the 1974 Agreement, less the cost of government rate subsidies);
2. The cost collectively of the actual electric power consumption of the municipalities;  
or
3. The prior five-year moving average of the contributions in lieu of taxes paid to the municipalities collectively.

If the Authority does not have sufficient funds available in any year to pay the contributions in lieu of taxes then difference will be accrued and carried forward for a maximum of three years. The contribution in lieu of taxes to Municipalities can be used to offset accounts receivable balance owed by the Municipalities to the Authority as permitted by law.

**Commonwealth of Puerto Rico**

To the extent net revenues are available, the Authority is also required under the Act to set aside the remainder of contribution in lieu of taxes of gross electric sales for the purpose of (i) financing capital improvements, (ii) offsetting other subsidies (other than cost of fuel adjustments to certain residential clients) of the Commonwealth, and (iii) any other lawful corporate purpose. Amounts assigned to (ii) above, are classified as a contribution in lieu of taxes in the accompanying statements of revenues, expenses and changes in net assets and reduce the related accounts receivable in the balance sheets.

**Contributed Capital**

The Authority records contributed capital as income in the year earned. The Authority receives contributed capital in the form of cash and property from residential projects developed during recent years.



Puerto Rico Electric Power Authority  
Notes to Audited Financial Statements (continued)

**3. Cash and Cash Equivalents**

The 1974 Agreement established the General Fund, the Revenue Fund, and certain other funds (see Note 5). All revenues (other than income from investments and construction funds obtained from financing) are deposited in these funds. The monies held in these funds are presented as unrestricted cash and cash equivalents in the balance sheets.

At June 30, 2004, the carrying amount and bank balance of cash deposits held by the Authority and restricted cash deposits held by the Trustee under the 1974 Agreement are as follows (in thousands):

	<b>2004</b>		<b>2003</b>	
	<b>Carrying Amount</b>	<b>Bank Balance</b>	<b>Carrying Amount</b>	<b>Bank Balance</b>
Unrestricted	\$ 17,606	\$ 18,764	\$ 50,451	\$ 45,142
Restricted:				
Held by the Trustee	302,638	302,638	275,765	275,765
Held by the Authority	71,194	71,194	46,524	46,524
	<b>\$391,438</b>	<b>\$392,596</b>	\$372,740	\$367,431

Cash deposits, except for minor amounts, are covered by the Federal Deposit Insurance Corporation, or collateral held on behalf of the Authority by the Secretary of the Treasury of the Commonwealth of Puerto Rico (the Secretary) or its agent in the name of the Secretary.

Puerto Rico Electric Power Authority  
Notes to Audited Financial Statements (continued)

**4. Accounts Receivable**

At June 30, receivables consist of (in thousands):

	<b>2004</b>	<b>2003</b>
Electric and related services:		
Government agencies and municipalities	<b>\$158,902</b>	\$103,629
Residential, industrial, and commercial	<b>289,978</b>	289,587
Recoveries under fuel adjustment clause under (over) billed	<b>4,210</b>	(756)
Unbilled services	<b>142,086</b>	145,715
Commonwealth subsidy (fuel adjustment clause) for certain residential clients	<b>31,598</b>	31,598
Miscellaneous accounts and others	<b>12,216</b>	10,603
	<b>638,990</b>	580,376
Allowance for uncollectible accounts	<b>(36,751)</b>	(36,951)
	<b>602,239</b>	543,425
Accrued interest on investments	<b>2,229</b>	1,253
Less other non-current receivables, mostly related to Commonwealth	<b>(68,530)</b>	(42,069)
	<b>\$535,938</b>	\$502,609

On October 29, 1991, the Authority entered into an agreement with the Commonwealth for the payment of the outstanding fuel adjustment subsidy receivable amounting to approximately \$94 million. Under this agreement, the Commonwealth was paying that amount over a fifteen-year period in installments of approximately \$6.3 million per year, without interest. As of June 30, 2004 and 2003, the outstanding fuel adjustment subsidy receivable amounted to approximately \$31.6 million. In June 2004, the Legislature of the Commonwealth of Puerto Rico superseded the 1991 agreement with a revised agreement containing an eight-year payment schedule that totals \$55.7 million. The amount owed to the Authority under the 2004 agreement includes an allocation for past due government account receivables in addition to the unpaid balance of the fuel adjustment subsidy.

In addition, the Authority has other subsidies and reimbursable costs receivable from the Commonwealth, which are reduced by means of charges (accounted for as a contribution in lieu of taxes and to the extent net revenues, as defined, are available) against a portion of the 5% of gross electric sales it is required to set aside under the Act. The portion of such receivables and other governmental receivables not expected to be collected during the next fiscal year are reflected in the accompanying balance sheets as other noncurrent receivables.

Puerto Rico Electric Power Authority  
Notes to Audited Financial Statements (continued)

**5. Restricted Assets**

At June 30, 2004 and 2003, certain investments and cash deposits of the Authority were restricted to comply with long-term principal and interest debt service requirements (sinking funds) as well as for self-insurance. These restricted assets are held by the Trustee under the 1974 Agreement (see Note 3) in the following funds:

*1974 Reserve Account* - Reserve for payment of principal of and interest on Power Revenue Bonds in the event moneys in Bond Service Account or Redemption Account are insufficient for such purpose.

*1974 Self-insurance Fund* - Fund to pay the cost of repairing, replacing or reconstructing any property damaged or destroyed from, or extraordinary expenses incurred as a result of a cause, which is not covered by insurance required under the 1974 Agreement. The 1974 Self-insurance Fund also serves as an additional reserve for the payment of the principal of and interest on the Power Revenue Bonds, and meeting the amortization requirements to the extent that moneys in the Bond Service Account, the Redemption Account and the 1974 Reserve Account are insufficient for such purpose.

*Bond Service Account and Redemption Account (1974 Sinking Fund)* - Current year requirements for principal of and interest on Power Revenue Bonds. As of June 30, 2004, cash and cash equivalents in this account amounted to \$302.6 million (2003 - \$275.8 million).

At June 30, investments held by the Trustee consist of (in thousands):

	<b>2004</b>	<b>2003</b>
1974 Reserve Account	<b>\$243,260</b>	\$241,409
1974 Self-insurance Fund	<b>80,767</b>	80,240
	<b>\$324,027</b>	\$321,649

Investments held by Trustee under the 1974 Agreement are invested exclusively in securities of the U.S. Government and its agencies.

The Authority also has cash and investment securities held by the trust department of a commercial bank restricted for the following purposes:

*1974 Construction Fund* - Special fund created by the 1974 Agreement. The proceeds of any Power Revenue Bonds issued for the purpose of paying the cost of acquiring or constructing improvements, together with the money received from any other source for such purpose, except proceeds which are (i) applied to the repayment of advances, (ii) deposited in the 1974 Reserve Account, (iii) deposited in the Bond Service Account as capitalized interest or (iv) used for the payment of financing expenses, shall be deposited in the 1974 Construction Fund and held by the Authority in trust.

Puerto Rico Electric Power Authority  
Notes to Audited Financial Statements (continued)

**5. Restricted Assets (continued)**

*Reserve Maintenance Fund* - Fund to pay the cost of unusual or extraordinary maintenance or repairs, not recurring annually, and renewals and replacements, including major items of equipment. The Reserve Maintenance Fund also serves as an additional reserve for the payment of principal of and interest on the Power Revenue Bonds and meeting the amortization requirements to the extent that moneys in the 1974 Sinking Fund, including money in the 1974 Reserve Account, are insufficient for such purpose.

*Cogeneration Fund* - Fund created on December 15, 1997 pursuant to an agreement between the Authority and EcoEléctrica L.P., a joint venture of private companies, for the purpose of enabling the Authority to pay certain expenses in connection with the Authority's activities concerning cogeneration planning and implementation.

*Other Fund* - During fiscal year 1999, one of the partners of EcoEléctrica, L.P. (EcoEléctrica) sold its interest in the partnership to a utility company. Pursuant to the agreement between the Authority and EcoEléctrica, the Authority received \$29.6 million as a waiver of certain contractual provisions. During fiscal year 2000, the Authority received \$18 million from AES Puerto Rico, L.P. (AES) as a waiver of certain contractual provisions of its co-generation contract. The Authority will use the proceeds received from EcoEléctrica and AES to reduce the cost of power to be purchased under the respective agreements thus reducing its customers' invoices.

At June 30, the 1974 Construction Fund and other special funds consist of (in thousands):

	2004		2003	
	Cash and Cash Equivalents	Investments	Cash and Cash Equivalents	Investments
1974 Construction Fund	\$69,324	\$ 921	\$35,844	\$ 921
Reserve Maintenance Fund	-	53,821	-	42,701
Other Funds	1,870	23,528	10,680	43,186
	<b>\$71,194</b>	<b>\$78,270</b>	\$46,524	\$86,808

Following is the composition of the investments in the 1974 Construction Fund and other special funds (in thousands):

	2004	2003
U.S. Government obligations	\$65,372	\$58,470
Corporate bonds	2,363	5,225
Equity securities	10,535	23,113
	<b>\$78,270</b>	<b>\$86,808</b>

Puerto Rico Electric Power Authority  
Notes to Audited Financial Statements (continued)

**6. Utility Plant**

As of June 30, utility plant consists of:

	<b>2004</b>	<b>2003</b>
	<i>(In Thousands)</i>	
Distribution	<b>\$ 2,129,764</b>	\$ 2,039,383
Transmission	<b>1,000,449</b>	995,842
Production	<b>1,697,895</b>	1,573,700
Other production	<b>543,084</b>	566,293
Hydroelectric	<b>86,566</b>	85,705
General	<b>1,103,783</b>	1,039,711
Irrigation systems	<b>30,633</b>	30,633
	<b>6,592,174</b>	6,331,267
Less accumulated depreciation	<b>(3,373,571)</b>	(3,210,237)
	<b>3,218,603</b>	3,121,030
Construction in progress	<b>1,585,932</b>	1,442,503
	<b>\$ 4,804,535</b>	\$ 4,563,533

Utility plant activity for the year ended June 30, 2004, was as follows:

	<b>Beginning Balance</b>	<b>Increases</b>	<b>Decreases</b>	<b>Transfers</b>	<b>Ending Balance</b>
Utility plant	\$ 6,331,267	\$ –	\$(87,450)	\$ 348,357	\$ 6,592,174
Construction work in progress	1,442,503	491,786	–	(348,357)	1,585,932
Total utility plant	7,773,770	491,786	(87,450)	–	8,178,106
Less:					
Accumulated depreciation	(3,210,237)	(250,784)	87,450	–	(3,373,571)
Total utility plant, net	\$ 4,563,533	\$ 241,002	\$ –	\$ –	\$ 4,804,535

Construction work-in-progress at June 30, 2004, consists principally of expansions and upgrades to the electric generation, distribution and transmission systems.

Puerto Rico Electric Power Authority  
Notes to Audited Financial Statements (continued)

**7. Other Property – Optical Fiber Network (OFN)**

On September 2000, the Authority entered into two agreements with Puerto Rico Information Network, Inc. (PRIN). The first agreement (Development and Management Agreement) establishes that PRIN would design and develop an OFN that will form part of the Authority's internal communications system. The second agreement (Initial Installment Purchase Agreement) establishes that upon the completion of the OFN, PRIN would transfer to the Authority title to the network.

On October 10, 2002, the Authority paid \$36.8 million to acquire the OFN.

In addition, the Authority is currently negotiated the cancellation of both agreements with PRIN.

On April 5, 2004, Puerto Rico Fiber Networks, Corp. was incorporated to develop strategies for commercializing the surplus capacity of the installed fiber, adding flexibility and diversification to its operations, which are expected to be in operation during the last semester of fiscal year 2004-2005.

**8. Defeasance of Debt**

In prior years, the Authority has refunded in advance certain Power Revenue Bonds and other obligations by placing the proceeds of new debt in an irrevocable trust to provide for future debt service payments on such bonds. Accordingly, the trust accounts, assets, and liabilities for the defeased bonds are not included in the Authority's financial statements. At June 30, 2004 and 2003, \$614.4 million, of Power Revenue Bonds series B, N, O, P, Q, R, T, V, X, and HH, REA-A, B, C, E, F, G, H, which remain outstanding are considered defeased.

**9. Notes Payable to Banks**

On July 3, 1999, the Authority, GDB, and certain banks entered into an agreement for a revolving line of credit to be used for financing fuel purchases. Under the agreement, the Authority borrowed \$125 million. The average effective interest rate during each year and at year-end was 1.23% and 1.36%, respectively, for 2004; and 1.09% and 1.32%, respectively, for 2003.

On July 2, 2003, the Authority and GDB entered into another agreement for a line of credit of \$68 million to fund made under a settlement agreement relating to a certain litigation with the municipalities of Puerto Rico. As of June 30, 2004, the Authority had drawn \$61.4 million under this line of credit. In connection with same litigation, GDB approved a second line of credit amounting to \$57 million for electric infrastructure projects in the Municipalities. No moneys have been drawn on this second line of credit as of June 30, 2004.

Puerto Rico Electric Power Authority  
Notes to Audited Financial Statements (continued)

**9. Notes Payable to Banks (continued)**

On March 26, 2004, the Authority and GDB entered into an agreement for a line of credit of \$25.3 million to be used for financing the improvements to Isabela irrigation system. The Authority expects that this line of credit will be paid by the Commonwealth of Puerto Rico from the proceeds of future bond issues. No moneys have been drawn on this line of credit as of June 30, 2004.

**10. Accounts Payable and Accrued Liabilities**

	<b>2004</b>	<b>2003</b>
	<i>(In Thousands)</i>	
Accounts payable, accruals, and withholdings in process of payment	<b>\$315,545</b>	\$279,797
Additional accruals and withholdings:		
Injuries and damages and other	<b>18,383</b>	28,295
Accrued vacation and payroll benefits	<b>48,314</b>	54,058
Accrued sick leave and payroll benefits - exclusive of benefits to be liquidated after one year of approximately \$128.9 million in 2004 and 2003	<b>14,425</b>	15,695
Accrued compensation	<b>28,322</b>	26,309
Accrued pension plan contribution and withholding from employees:		
Employees' Retirement System	<b>25,845</b>	12,275
Supplemental unfunded benefit obligation spouse-survivor benefit	-	14,818
Supplemental unfunded pension obligation exchanged for forfeited sick leave benefits - exclusive of benefits to be liquidated after one year of approximately \$0 million and \$1.0 million in 2004 and 2003, respectively	<b>1,349</b>	4,634
Employees health plan	<b>11,975</b>	16,498
Contract retainage	<b>26,464</b>	23,561
Contribution in lieu of taxes	<b>6,451</b>	38,576
Other accrued liabilities	<b>33,762</b>	30,486
	<b>\$530,835</b>	\$545,002

Puerto Rico Electric Power Authority  
Notes to Audited Financial Statements (continued)

**11. Long-Term Debt**

At June 30, long-term debt consists of:

	<u>2004</u>	<u>2003</u>
	<i>(In Thousands)</i>	
Power Revenue Bonds payable:		
Publicly offered at various dates from 1988 to 2004, interest rates ranging from 3.8% to 7.0%, maturing to 2031	<b>\$5,032,510</b>	\$4,647,960
RUS issues - interest rate of 5%, maturing to 2028	<b>30,224</b>	31,703
	<u><b>5,062,734</b></u>	<u>4,679,663</u>
Less unamortized discount and debt reacquisition costs	<u><b>(158,207)</b></u>	<u>(172,945)</u>
Revenue bonds payable, net	<b>4,904,527</b>	4,506,718
Note payable	<u><b>5,000</b></u>	<u>5,000</u>
	<b>4,909,527</b>	4,511,718
Less current portion of long-term debt	<u><b>(331,806)</b></u>	<u>(285,407)</u>
	<u><b>\$4,577,721</b></u>	<u>\$4,226,311</u>

Long-term debt activity for the years ended June 30, 2004 and 2003, was as follows:

	<u>2004</u>	<u>2003</u>
	<i>(In Thousands)</i>	
Long-term debt excluding current portion	<b>\$4,511,718</b>	\$4,632,928
New issues:		
Power revenue bonds	<b>517,305</b>	98,125
Power revenue refunding bonds	-	506,840
Debt discount on new bond issues – net	<b>(2,550)</b>	49,506
Defeasance of bonds	-	(614,435)
Debt discount and excess reacquisition costs on cancelled bonds – net	-	(30,008)
Accretion of capital appreciation bonds	<b>3,135</b>	5,930
	<u><b>5,029,608</b></u>	<u>4,648,886</u>
Payment to bondholders:		
Power revenue – July 1	<b>(136,621)</b>	(154,455)
Power revenue – January 1	<b>(748)</b>	(708)
Total payments	<u><b>(137,369)</b></u>	<u>(155,163)</u>
Amortization of debt discount and excess reacquisition costs	<u><b>17,288</b></u>	<u>17,995</u>
Balance at end of year	<u><b>\$4,909,527</b></u>	<u>\$4,511,718</u>
Current portion of long-term debt	<u><b>\$ 331,806</b></u>	<u>\$ 285,407</u>



Puerto Rico Electric Power Authority  
Notes to Audited Financial Statements (continued)

**11. Long-Term Debt (continued)**

**Power Revenue Bonds Payable**

The Authority has issued Power Revenue Bonds pursuant to the 1974 Agreement principally for the purpose of financing the cost of Improvements, as such term is defined in the 1974 Agreement, and subject to the conditions and limitations set forth therein.

In the 1974 Agreement, the Authority covenants to fix, charge, and collect rates so that revenues will be sufficient to pay current expenses and to provide the greater of (i) the required deposits or transfers under the Sinking Fund, the 1974 Self-insurance Fund and the Reserve Maintenance Fund or (ii) 120% of the aggregate principal and interest requirements for the next fiscal year on account of all outstanding Power Revenue Bonds.

Gross revenues, exclusive of income on certain investments, less current expenses as defined in the Agreement have been pledged to repay Power Revenue Bonds principal and interest (see Note 5).

During fiscal year 2004, the Authority issued its Power Revenue Bonds, Series NN.

The Authority issued the Power Revenue Bonds, Series NN for the purpose of paying a portion of the cost of its CIP.

A summary of the net proceeds of the Power Revenue Bonds, Series NN and application of the proceeds follows:

Principal amount of bonds	\$517,305,000
Plus:	
Net original issue premium	1,069,071
Proceeds	<u>\$518,374,071</u>
Application of net proceeds:	
Deposit to 1974 Construction Fund	\$410,913,000
Repayment of Government Development Bank line of credit	90,000,000
Underwriting discount, municipal bond issuance premium and estimated legal, printing and other financing expenses	17,461,071
Costs of Issuance	<u>\$518,374,071</u>

Maturities of the Power Revenue Refunding Bonds Series NN issued during fiscal year 2004 range from July 1, 2005 to July 1, 2016. Interest on the Series NN Bonds is payable on each January 1 and July 1.

Puerto Rico Electric Power Authority  
Notes to Audited Financial Statements (continued)

**11. Long-Term Debt (continued)**

**Power Revenue Bonds Payable (continued)**

During fiscal year 2003, the Authority issued its Power Revenue Bonds, Series KK, LL and MM. In addition, the Authority issued the Series KK and MM Bonds pursuant to Section 210 of the 1974 Agreement to refund blocks of the following previous bond issues summarized below:

Series	Principal Amount Refunded
Series B	\$115,101,500
Series O	140,025,561
Series P	9,230,000
Series Q	9,295,000
Series R	5,285,000
Series T	179,770,000
Series V	4,240,000
Series X	26,550,000
Series HH	10,435,000
Rea A	3,842,000
Rea B	13,120,000
Rea C	10,582,000
Rea D	14,910,000
Rea E	10,523,000
Rea F	7,525,000
Rea G	32,101,000
Rea H	21,900,000
Total refunded	\$614,435,061

The refunding permitted the Authority to realize savings on its debt service requirements on bonds outstanding under the 1974 agreement. Reduction of the total debt service payments over the next 21 years is approximately \$7,000,000. This will generate an economic gain (difference between present value of the old and new debt service payments) of approximately \$6,900,000. The Authority deposited the net proceeds of the Series KK and MM Power Revenue Refunding Bonds with the 1974 trustee, as escrow agent. The net proceeds were invested in Government Obligations, the principal of and interest on which when due, will provide moneys sufficient to pay the redemption price of the Refunded Power Revenue Bonds on and the interest coming due on the Refunded Power Revenue Bonds through their respective dates of redemption. See Note 8.

Upon the deposit with the 1974 Trustee referred to above, the Refunded Power Revenue Bonds will, in the opinion of the Bond Counsel, no longer be outstanding under the provisions of the 1974 Agreement and the Refunded Power Revenue Bonds will thereupon be defeased.

Puerto Rico Electric Power Authority  
Notes to Audited Financial Statements (continued)

**11. Long-Term Debt (continued)**

**Power Revenue Bonds Payable (continued)**

The Authority issued the Power Revenue Bonds, Series LL for the purpose of paying a portion of the cost of its CIP.

A summary of the net proceeds of the Power Revenue Bonds, Series KK, Series LL, Series MM, and application of the proceeds follows:

Principal amount of Series KK Refunding Bonds	\$401,785,000
Principal amount of Series LL Bonds	98,125,000
Principal amount of Series MM Refunding Bonds	105,055,000
Plus:	
Net original issue premium	52,999,882
Other available moneys	1,483,484
Proceeds	<u>\$659,448,366</u>
Application of net proceeds:	
Deposit to Escrow Fund for Refunded Power Revenue Bonds	\$646,092,216
Deposit to 1974 Construction Fund	13,356,150
Costs of Issuance	<u>\$659,448,366</u>

Maturities of the Power Revenue Refunding Bonds Series KK issued during fiscal year 2003 range from July 1, 2005 to July 1, 2016. The Series KK Bonds bear fixed interest rates ranging from 4.00% to 5.50%. Interest on the Series KK Bonds is payable on each January 1 and July 1.

Maturities of the Power Revenue Bonds Series LL issued during fiscal year 2003 range from July 1, 2016 to July 1, 2019. The Series MM Bonds bear a fixed interest rate of 5.50%. Interest on the Series LL Bonds is payable on each January 1 and July 1.

Maturities of the Power Revenue Refunding Bonds Series MM issued during fiscal year 2003 range from July 1, 2004 to July 1, 2023. The Series MM Bonds bear fixed interest rates ranging from 3.00% to 5.00%. Interest on the Series MM Bonds is payable on each January 1 and July 1.

**Note Payable**

On December 15, 1997, the Authority borrowed \$5,000,000 from EcoEléctrica (the Note) for the purpose of enabling the Authority to pay certain expenses in connection with Authority's activities concerning cogeneration planning and implementation. The Note bears interest at a rate per annum equal to LIBOR minus three percent (3%) and will be paid at the earliest of various events described in the Note agreement. As of June 30, 2004 and 2003, the interest rate was 0%. The note is due October 30, 2004.

Puerto Rico Electric Power Authority  
Notes to Audited Financial Statements (continued)

**11. Long-Term Debt (continued)**

**Scheduled Maturities of Long-Term Debt**

The scheduled maturities of long-term debt with interest thereon at June 30, 2004, including sinking fund debt service requirements, are as follows:

<b>Fiscal Year Ending June 30</b>	<b>Principal</b>	<b>Interest</b>	<b>Total</b>
	<i>(In thousands)</i>		
2005	\$ 351,832	\$ 387,347	\$ 739,179
2006	193,824	248,576	442,400
2007	195,765	237,390	433,155
2008	176,812	225,840	402,652
2009	187,130	216,630	403,760
2010-2014	928,297	941,897	1,870,194
2015-2019	989,278	678,177	1,667,455
2020-2024	979,076	426,160	1,405,236
2025-2029	765,615	188,691	954,306
2030-2032	300,105	30,624	330,729
Total	<u>5,067,734</u>	<u>3,581,332</u>	<u>8,649,066</u>
Less:			
Unamortized discount	7,034	-	7,034
Excess reacquisition costs	(165,241)	-	(165,241)
Interest	-	(3,581,332)	(3,581,332)
Total long-term debt	<u>4,909,527</u>	<u>-</u>	<u>4,909,527</u>
Current portion, net of discount and excess reacquisition costs	<u>(331,806)</u>	<u>-</u>	<u>(331,806)</u>
Long-term debt, excluding current portion	<u><u>\$4,577,721</u></u>	<u><u>\$ -</u></u>	<u><u>\$ 4,577,721</u></u>

**12. Employees' Retirement Benefits**

**Pension Plan**

Plan Description

All of the Authority's permanent full-time employees are eligible to participate in the Authority's Pension Plan, a single employer defined benefit pension plan (the Plan) administered by the Employees' Retirement System of the Puerto Rico Electric Power Authority (the System). The System issues a publicly available financial report that includes financial statements and required supplementary information for the Plan. That report may be obtained by writing to the Retirement System of the Puerto Rico Electric Power Authority, PO Box 13978, San Juan, Puerto Rico 00908-3978.

Puerto Rico Electric Power Authority  
Notes to Audited Financial Statements (continued)

**12. Employees' Retirement Benefits (continued)**

**Pension Plan (continued)**

Plan Description (continued)

Benefits include maximum retirement benefits of 75% of average basic salary (based on the three highest annual basic salaries) for employees with 30 years of service; also, reduced benefits are available upon early retirement. The Plan was amended on February 9, 1993 to provide revised benefits to new employees limiting the maximum retirement basic salary to \$50,000. The plan was further amended in January 1, 2000 to provide improved retirement benefits to employees with 25 years or more of credited service. Disability and death benefits are also provided. Separation benefits fully vest upon reaching 10 years of credited service.

If a member's employment is terminated before he becomes eligible for any other benefits under this Plan, he shall receive a refund of his member contribution plus interest compounded annually. The Plan is not subject to the requirements of the Employees Retirement Income Security Act of 1974 (ERISA).

Funding Policy and Annual Pension Cost

The contribution requirements of plan members and the Authority are established and may be amended by the Authority. The Annual Pension Cost (APC) and the Annual Required Contribution (ARC) were computed as part of an actuarial valuation performed as of June 30, 2003 and projected to June 30, 2004 based on current year demographic data.

**Supplemental Benefits not Funded Through the System**

Supplemental benefits were unfunded and such benefits were reimbursed to the System when paid up to December 31, 1999. Effective January 1, 2000, the Board of Trustees of the System approved the transfer of the obligation for supplemental benefits provided by the Authority and not funded through the System (supplemental pension obligations exchanged for forfeited sick leave benefits and the supplemental spousal survivor benefits) to the Retirement System. Also, the Board of Trustees of the System accepted an amortization period for the Plan of 40 years, which commenced on June 30, 1996.

Supplemental Pension Obligations Exchanged for Forfeited Sick Leave Benefits

The Authority's employees with over 20 years of service are entitled to exchange accrued sick leave for supplemental pension benefits and/or be paid in cash the value of such sick leave upon separation from employment.

An accrued liability of \$1.3 million and \$5.6 million exists as of June 30, 2004 and 2003, respectively, including the current and non-current portions.

Puerto Rico Electric Power Authority  
Notes to Audited Financial Statements (continued)

**12. Employees' Retirement Benefits (continued)**

**Supplemental Benefits not Funded Through the System (continued)**

Supplemental Pension Obligations Exchanged for Forfeited Sick Leave Benefits (continued)

The Authority's annual pension cost for the year ended June 30, 2004 and related information for the Plan and supplemental benefits follows:

	<u>Pension Plan</u>
Contribution rates:	
Authority	16.93%
Plan members	10.70%
Annual pension cost (thousands)	\$64,967
Contributions made and accruals (thousands)	\$52,657
Actuarial valuation date	6/30/2003
Actuarial cost method	Entry age
Amortization method	Level percentage of pay, closed (4% payroll increases per year)
Remaining amortization period	33 years
Asset valuation method	3-year smoothed market
Actuarial assumptions:	
Investment rate of return (net of administrative expenses)*	8.5%
Projected salary increases*	5.0%
*Includes inflation at	3%
Cost-of-living adjustments	From 8% per year for yearly pension up to \$3,600 and 4% per year for yearly pension between \$3,600 and \$7,200, 2% per year for yearly pension in excess of \$7,200. The minimum adjustment is \$300 per year. The maximum is \$600 per year.

Puerto Rico Electric Power Authority  
Notes to Audited Financial Statements (continued)

**12. Employees' Retirement Benefits (continued)**

**Supplemental Benefits not Funded Through the System (continued)**

Fiscal Year Ending	Three-Year Trend Information (In Millions)		
	Annual Pension Cost (APC)	Percentage of APC Contributed	Net Pension Obligation
Pension Plan			
06/30/98	\$29.20	100%	\$ —
06/30/99	28.80	100%	\$ —
06/30/00	39.80	100%	\$ —
06/30/01	35.00	100%	\$ —
06/30/02	43.00	100%	\$ —
06/30/03	50.60	100%	\$ —
06/30/04	65.00	81%	\$12.3

The annual required contribution amounted to \$65.0 million in 2004 and \$50.6 million in 2003.

**Post Retirement Health Benefits**

The Authority also provides certain health care benefits for retired employees and spouses. Substantially all of the Authority's employees may become eligible for those benefits if they reach normal retirement while working for the Authority.

Costs of benefits provided by the Authority are based on a cost-plus plan. Such costs include claims received from the plan administrators, a charge for an administration fee and an accrual for incurred but not reported claims. The costs of health care benefits to retirees amounted to approximately \$51.0 million in 2004 and \$47.0 million in 2003. Currently, 9,421 retirees meet eligibility requirements.

**13. Revenues from Major Clients and Related Parties**

Electric operating revenues from major clients and related parties are as follows:

	<u>2004</u>	<u>2003</u>
	<i>(In Thousands)</i>	
Governmental sector, principally instrumentalities, agencies and corporations of the Commonwealth of Puerto Rico	<b>\$306,166</b>	\$268,286
Municipalities	<b>114,826</b>	112,276
	<u><b>\$420,992</b></u>	<u>\$380,562</u>

Puerto Rico Electric Power Authority  
Notes to Audited Financial Statements (continued)

**14. Net Assets**

Restricted assets at June 30, 2004 and 2003 include \$389.7 million and \$366.8 million, respectively, which have been appropriated principally to comply with long-term principal and interest debt services requirements and a reserve for damaged or destroyed property of the Authority not fully covered by insurance as required by the 1974 Agreement. Funds set aside for self-insurance purposes are deposited in the Self-Insurance Fund held by the Trustee (see Note 5).

**15. Contribution in Lieu of Taxes (See Note 2)**

	<b>2004</b>	<b>2003</b>
	<i>(In Thousands)</i>	
Municipalities	<b>\$156,772</b>	\$152,925
Commonwealth:		
Hotels	<b>3,714</b>	3,623
Fuel adjustment subsidy	<b>19,743</b>	18,485
Other subsidies (offset against outstanding accounts receivable and reimbursable costs)	<b>591</b>	704
	<b>\$180,820</b>	\$175,737

**16. Commitments and Contingencies**

**Environmental Matters**

Facilities and operations of the Authority are subject to regulations under numerous Federal and Commonwealth environmental laws, including the Clean Air Act, Clean Water Act, and the National Pollutant Discharge Elimination System (NPDES). In February 1992, the Environmental Protection Agency (EPA) performed an inspection of various facilities of the Authority and became aware of deficiencies in different areas, principally air opacity; water quality; spill prevention control and countermeasures; and underground storage tanks. As a result, the Authority and undertake Supplemental Environmental Projects (SEPs).

On June 20, 2002, the Government of the United States (the Federal Government) and the Authority executed a Settlement Agreement to resolve litigation over the proposed extension of the Authority's term of probation arising from certain alleged environmental violations. The Settlement Agreements provides that the Authority will burn fuel oil with a sulfur content not to exceed 0.5% by weight at the Authority's Palo Seco and San Juan power plants for a period of not less than two years. On May 2003, the Court selected a Visible Emissions Compliance Auditor as part of Settlement Agreements.



Puerto Rico Electric Power Authority  
Notes to Audited Financial Statements (continued)

**16. Commitments and Contingencies (continued)**

**Environmental Matters (continued)**

The Authority continues in its efforts to reduce visible emissions at the Aguirre and Costa Sur power plants. While current operating permits allow the use of No. 6 fuel oil with up to 1.5% sulfur content, the Authority continues voluntarily to burn No. 6 fuel oil with 1.0% content. Also, as part of the probation extension agreement discussed above, the Authority keeps burning No. 6 fuel oil with sulfur content equal to or less than 0.5% at its Palo Seco and San Juan power plants and will switch to use No. 6 fuel oil sulfur content equal to or less than .75% at Aguirre and Costa Sur power plants under the provision of recent agreements.

In April 2003, the Authority agreed to join six other countries as potentially responsible parties (PRPs) in an Administrative Order on Consent for Remedial Investigation and Feasibility Study for Soil at the Vega Baja Solid Waste Disposal Superfund Site, with the understanding that such agreement did not constitute an acceptance of responsibility.

**Commitments to Purchase Power**

In October 1994, the Authority signed a contract with AES Puerto Rico, L.P. (AES) to purchase power of approximately 454 megawatts generated from a coal fluidized bed combustion facility. The term of the agreement is for twenty-five (25) years. This project commenced operations in November 2002.

In March 1995, the Authority also signed a contract with EcoEléctrica, L.P. (EcoEléctrica) to purchase power of approximately 507 megawatts from a gas-fired combined cycle power plant. The term of the agreement is for twenty-two (22) years. This project has been in operation since 2000.

Under both agreements, the cost of the purchased power will be based on the quantity of energy delivered and dependable capacity available, as more fully explained in the contracts. The Authority also has the option to purchase the generating facilities if certain conditions, as defined in the contracts, are met. However, in no event will the exercise price of each of the purchase options be below fair value. The Authority is not responsible for and does not guarantee the debt or operations of AES or EcoEléctrica. Both contracts obligate the Authority to purchase power only if generated by the plants.

**Risk Management**

The Authority is exposed to various risks of losses related to torts; thefts of, damage to, and destruction of assets; errors and omissions; injuries to employees; and natural disasters. The Authority obtains insurance policies covering all-risk property (excluding transmission and distribution lines), boiler and machinery and public liability. The all-risk property and boiler and machinery policies have a combined coverage of \$650 million per occurrence. The policies' self-retention in case of earthquake and windstorm losses is \$25 million, \$2 million for all other covered risks, except boiler and machinery losses, which carry \$2 million retention. The public general liability policy covers property damage and bodily injury to third parties with a \$75 million aggregate limit in excess of the self-retention limit of \$1 million per occurrence.

Puerto Rico Electric Power Authority  
Notes to Audited Financial Statements (continued)

**16. Commitments and Contingencies (continued)**

**Risk Management (continued)**

The Authority considers its Self-insurance Fund sufficient to provide for its self-insurance risk (see Note 5). Claims expenditures and liabilities are recorded when it is probable that a loss has occurred and the amount of that loss can be reasonably estimated.

The Authority has a cost plus health insurance program covering substantially all employees. The Authority contracted an administrator for the processing, approval and payment of claims plus an administrative fee. The accrual for employees' health plan includes the liability for claims processed and an estimate for claims incurred but not reported.

The State Insurance Fund Corporation (SIF) provides workers' compensation to the Authority. In addition, the Authority is self-insured to pay the difference between the SIF payment and (i) 100% of the employee salary during the first 104 weeks and (ii) 80% of the employee salary for 52 additional weeks.

In addition, the Authority is self insured for its transmission and distribution lines. Transmission and distribution lines amounted to approximately \$3.1 and \$3.0 billion at June 30, 2004 and 2003, respectively.

The net assets and restricted assets set aside in the Self-insurance Fund for self-insurance amounted to approximately \$80.8 million at June 30, 2004 and \$80.2 million at June 30, 2003.

Changes in the balances of the health insurance program and other self-insurance risks during fiscal years 2004 and 2003 were as follows:

	<b>Liability Beginning Balance</b>	<b>Expenses</b>	<b>Payments</b>	<b>Liability Ending Balance</b>
	<i>(In Thousands)</i>			
2004	\$50,891	\$ 92,822	\$112,073	\$31,640
2003	\$38,768	\$116,545	\$104,422	\$50,891

**Contingencies**

The Authority is a defendant or codefendant in several lawsuits incidental to its business, some involving substantial amounts. In those instances that management and legal counsel believe that the outcome of the litigation will be unfavorable to the Authority, a provision has been made to cover the estimated liability. Management, based on discussions with legal counsel, believes that the additional liability, if any, resulting from the ultimate resolution of these matters will not have a material effect on the Authority's financial position or results of operations.

Puerto Rico Electric Power Authority  
Notes to Audited Financial Statements (continued)

**16. Commitments and Contingencies (continued)**

**Contingencies (continued)**

On May 18, 2000, Abengoa, Puerto Rico, S.E. (Abengoa), the Authority's contractor for the repowering of San Juan steam plant units 5 and 6, unilaterally declared a termination of the contract with the Authority and filed a complaint for breach of contract. The Authority has moved for time to answer the complaint and has filed a counter claim for the cost of the project and for all damages caused to the Authority by the alleged illegal contract termination. The Authority believes that the actions by the contractor will not materially affect the ability of the Authority to provide service nor will there be a material difference in the quality of service provided by the Authority.

In May 1998, the Municipality of Ponce filed a complaint against the Authority in the San Juan Superior Court requesting the payment by the Authority of the full contributions in lieu of taxes and electric energy sales set aside for prior fiscal years. The complaint challenges the application of the Net Revenues by the Authority in making deposits to certain funds under the 1974 Agreement and under a prior trust indenture (now terminated) for the purposes of paying costs of capital improvements and seeks a payment by the Authority in the amount by which the amount available to pay contributions in lieu of taxes and electric energy sales set aside to the Municipality of Ponce has been reduced as a result of such application. The Authority understands that because the Act provides that the contributions in lieu of taxes and electric energy sales set aside are only payable after complying with the Authority's deposit obligations under the 1974 Agreement and the prior indenture and shortfalls do not carry forward as future liabilities of the Authority as described above, it is legally entitled to make such deposits even if the effect is to reduce such contributions and set aside available to municipalities.

On April 14, 2003, the Authority made a settlement offer consisting of a payment in cash of \$68 million and \$57 million for electric infrastructure projects in the municipalities. As part of the settlement agreement, the municipalities supported an amendment to the Act that was proposed by the Authority, that the amount payable to municipalities is calculated based on a percentage of the net revenues defined on the 1974 Agreement.

During fiscal year ended June 30, 2003, 37 municipalities accepted this settlement, receiving an amount of \$26.1 million. During fiscal year ended June 30, 2004, 38 additional municipalities accepted the settlement as well, receiving \$37.5 million. Two municipalities have not accepted the settlement offer at June 30, 2004.

The settlement provided for the Authority to changes its legislation on CILT calculation, which the Authority did. The new law signed in August 2004 included a transitory clause regarding the \$68 million payment, stating that this amount was a special CILT that the accepting municipalities would received, with monies provided by Government Development Bank for Puerto Rico (GDB), while the Authority would repay to GDB and guarantee with monies to be allocated as special CILT in an 8-year term. The settlement was retroactive starting in 2003.

Puerto Rico Electric Power Authority  
Notes to Audited Financial Statements (continued)

**16. Commitments and Contingencies (continued)**

**Contingencies (continued)**

In June 2004, the Office of the Comptroller of the Commonwealth of Puerto Rico (the Comptroller) issued a report stating that the Authority overcharged its clients by approximately \$49.8 million, and should reimburse this amount to such clients. After this report was made public, two lawsuits were filed by clients of the Authority against the Authority demanding the reimbursement of such alleged overcharges. On June 17, 2004, the President of the Governing Board of the Authority sent a written response to the Comptroller and issued a press release in which the Authority denies that any overcharges have been made. The Authority's position is that the Comptroller incorrectly based his conclusion on data that is not relevant to the calculation of the Authority's rates, and that the Authority's rates were properly established in the year 2000 in accordance with applicable laws and regulations. In particular, the Authority notes that its rates properly take into consideration the cost of the fuel used by the Authority's generating facilities and the cost of the electricity purchased from the two co-generating facilities that sell power to the Authority.

**Construction and Other Commitments**

As of June 30, 2004, the Authority has commitments of approximately \$212.2 million on active construction, maintenance, and engineering services contracts.

**17. Supplemental Disclosures of Noncash Capital and Financing Information**

The accreted value of capital appreciation bonds equals the original principal amount of such capital appreciation bonds plus interest accrued from its date of issuance. During the years ended June 30, 2004 and 2003, the accrued interest on capital appreciation bonds amounted to \$3.1 million and \$5.9 million, respectively.

**18. Significant New Accounting Pronouncement**

In March 2003, the GASB issued Statement No. 40, *Deposit and Investment Risk Disclosures - an amendment of GASB Statement No. 3*. This Statement results from the Board's formal reviews of its existing standards. These reviews—part of the Board's strategic plan—are designed to evaluate the continuing usefulness of current requirements. The reduction of existing custodial credit risk disclosures follows from federal banking reforms adopted since the release of Statement 3. This statement will be effective for the University for fiscal year ended June 30, 2005.

In November 2003 the GASB issued Statement No. 42, *Accounting and Financial Reporting for Impairment of Capital Assets and for Insurance Recoveries*. This Statement establishes accounting and financial reporting standards for impairment of capital assets. A capital asset is considered impaired when its service utility has declined significantly and unexpectedly. This Statement also clarifies and establishes accounting requirements for insurance recoveries. This statement will be effective for the University for fiscal year ended June 30, 2006.

Puerto Rico Electric Power Authority  
Notes to Audited Financial Statements (continued)

**18. Significant New Accounting Pronouncement (continued)**

In April 2004 the GASB issued Statement No. 43, *Financial Reporting for Postemployment Benefit Plans Other Than Pension Plans*. This Statement establishes uniform financial reporting standards for OPEB plans and supersedes the interim guidance included in Statement No. 26, *Financial Reporting for Postemployment Healthcare Plans Administered by Defined Benefit Pension Plans*. The approach followed in this Statement generally is consistent with the approach adopted in Statement No. 25, *Financial Reporting for Defined Benefit Pension Plans and Note Disclosures for Defined Contribution Plans*, with modifications to reflect differences between pension plans and OPEB plans. This statement will be effective as follows:

The requirements of this Statement for OPEB plan reporting are effective one year prior to the effective date of Statement 45 for the employer (single-employer plan) or for the largest participating employer in the plan (multiple-employer plan). The requirements of this Statement are effective in three phases based on a government's total annual revenues in the first fiscal year ending after June 15, 1999:

- Plans in which the sole or largest employer is a phase 1 government—with annual revenues of \$100 million or more—are required to implement this Statement in financial statements for periods beginning after December 15, 2005.
- Plans in which the sole or largest employer is a phase 2 government—with total annual revenues of \$10 million or more but less than \$100 million—are required to implement this Statement in financial statements for periods beginning after December 15, 2006.
- Plans in which the sole or largest employer is a phase 3 government—with total annual revenues of less than \$10 million—are required to implement this Statement in financial statements for periods beginning after December 15, 2007.

If comparative financial statements are presented, restatement of prior-period financial statements is required. Early implementation is encouraged.

In May 2004, the GASB issued Statement No. 44, *Economic Condition Reporting: The Statistical Section - An Amendment of NCGA Statement 1*. This Statement amends the portions of NCGA Statement 1, *Governmental Accounting and Financial Reporting Principles*, that guide the preparation of the statistical section. The statistical section presents detailed information, typically in ten-year trends, that assists users in utilizing the basic financial statements, notes to basic financial statements, and required supplementary information to assess the economic condition of a government. This statement is effective for Statistical sections prepared for periods beginning after June 15, 2005.

## Puerto Rico Electric Power Authority

### Notes to Audited Financial Statements (continued)

#### 18. Significant New Accounting Pronouncement (continued)

In July 2004 the GASB issued Statement No. 45, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions*. This Statement improves the relevance and usefulness of financial reporting by (a)requiring systematic, accrual-basis measurement and recognition of OPEB cost (expense) over a period that approximates employees' years of service and (b)providing information about actuarial accrued liabilities associated with OPEB and whether and to what extent progress is being made in funding the plan. This statement will be effective as follows:

The requirements of this Statement are effective in three phases based on a government's total annual revenues in the first fiscal year ending after June 15, 1999:

- Governments that were phase 1 governments for the purpose of implementation of Statement 34—those with annual revenues of \$100 million or more—are required to implement this Statement in financial statements for periods beginning after December 15, 2006.
- Governments that were phase 2 governments for the purpose of implementation of Statement 34—those with total annual revenues of \$10 million or more but less than \$100 million—are required to implement this Statement in financial statements for periods beginning after December 15, 2007.
- Governments that were phase 3 governments for the purpose of implementation of Statement 34—those with total annual revenues of less than \$10 million—are required to implement this Statement in financial statements for periods beginning after December 15, 2008.

Earlier application of this Statement is encouraged. All component units should implement the requirements of this Statement no later than the same year as their primary government.

In December 2004, the GASB issued Statement No. 46, *Net Assets Restricted by Legislation - An Amendment of GASB Statement No. 34*. This Statement clarifies that a legally enforceable enabling legislation restriction is one that a party external to a government—such as citizens, public interest groups, or the judiciary—can compel a government to honor. The Statement states that the legal enforceability of an enabling legislation restriction should be reevaluated if any of the resources raised by the enabling legislation are used for a purpose not specified by the enabling legislation or if a government has other cause for reconsideration. Although the determination that a particular restriction is not legally enforceable may cause a government to review the enforceability of other restrictions, it should not necessarily lead a government to the same conclusion for all enabling legislation restrictions. This statement is effective for periods beginning after June 15, 2005. Earlier application is encouraged.

Puerto Rico Electric Power Authority  
Notes to Audited Financial Statements (continued)

**19. Subsequent Events**

**Bond Issuance**

On August 12, 2004, the Authority issued \$319,970,000 Power Revenue Refunding Bonds, Series OO, PP and QQ, to Refunded Power Revenue Bonds. The refunding will permit the Authority to realize savings on its debt service requirements on bonds outstanding under the 1974 Agreement.

On March 4, 2005, the Authority started the process of issuing approximately \$500,000,000 Power Revenue Bonds, Series RR and \$475,000,000 Power Refunding Bonds, Series SS. The expected issuance date is April 4, 2005.

Ernst & Young LLP  
1000 Scotiabank Plaza  
273 Ponce de Leon Avenue  
Hato Rey, Puerto Rico 00917-1989

Phone: (787) 759-8213  
Fax: (787) 753-0808  
Fax: (787) 753-0813  
[www.ey.com](http://www.ey.com)

## Report of Independent Auditors on Compliance and Internal Control Over Financial Reporting in Accordance with Government Auditing Standards

To the Board of Directors  
Puerto Rico Electric Power Authority

We have audited the financial statements of Puerto Rico Electric Power Authority (the Authority) as of and for the year ended June 30, 2004 and 2003, and have issued our report thereon dated October 22, 2004. We conducted our audit in accordance with auditing standards generally accepted in the United States and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

### Internal Control Over Financial Reporting

In planning and performing our audit, we considered the Authority's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide assurance on the internal control over financial reporting. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control over financial reporting that might be material weaknesses. A material weakness is a reportable condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements caused by error or fraud in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. We noted no matters involving the internal control over financial reporting and its operation that we consider to be material weaknesses. However, we noted other matters involving the internal control over financial reporting that we have reported to management of the Authority in a separate letter dated October 22, 2004.

### Compliance and Other Matters

As part of obtaining reasonable assurance about whether the Authority's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts and grants, 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 no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*.



This report is intended solely for the information and use of the Authority's management, and pass-through entities and is not intended to be and should not be used by anyone other than these specified parties.

*Ernst + Young LLP*

October 22, 2004

Stamp No. 2004099  
affixed to  
original of  
this report.

## Puerto Rico Electric Power Authority

Supplementary Information  
Schedule of Funding Progress

(In Millions)

June 30, 2004

<b>Actuarial Valuation Date</b>	<b>Actuarial Value of Assets (a) Note 1</b>	<b>Actuarial Liability (AAL) (b)</b>	<b>Unfunded AAL (UAAL) (b) - (a)</b>	<b>Funded Ratio (a)/(b)</b>	<b>Covered Payroll (c)</b>	<b>UAAL Percentage Of Covered Payroll [(b) - (a)]/(c)</b>
<b>Pension Plan</b>						
6/30/96	\$1,000	\$1,256	\$256	80%	\$261	98%
6/30/97	1,084	1,333	249	81%	271	92%
6/30/98*	1,268	1,495	227	85%	274	83%
6/30/99**	1,443	1,538	95	94%	277	34%
6/30/00	1,550	1,799	250	86%	278	90%
6/30/01	1,547	1,964	417	79%	290	144%
6/30/02	1,441	2,012	572	72%	298	192%
6/30/03	1,337	2,137	799	63%	306	262%

Note 1: The system, as permitted by the GASB, reflects its investments at an average fair market value of the last three years to determine its actuarial funding.

\* Estimated valuation, projected from actual 6/30/97 valuation.

\*\* Estimated valuation, projected from actual 6/30/98 valuation. Does not reflect benefit improvements effective January 1, 2000.

Puerto Rico Electric Power Authority

Note to Schedules II-VII - Information Required by the 1974 Agreement

As of June 30, 2004 and 2003 and the Years then Ended

Schedules II - VII present certain information which is required by the 1974 Agreement. The Net Revenues data, as defined in the 1974 Agreement (Net Revenues), presented in Schedules II and III differ in some important respects from generally accepted accounting principles (GAAP). Such differences are explained below; Schedule II also presents a reconciliation of Net Revenues with GAAP.

The most significant differences between Net Revenues and GAAP are the following:

- 1) Revenues do not include investment income on investments in the construction fund (see Note 5 to the financial statements);
- 2) Depreciation and interest expense on bonds covered by the 1974 Agreement are not included as deductions in calculating Net Revenues;
- 3) Amortization of debt discount and issuance costs and the allowance for funds used during construction are not considered in the computation in calculating Net Revenues;
- 4) Contribution in lieu of taxes is not considered a deduction for purposes of Net Revenues;
- 5) Net Revenues do not include revenues or expenses of the Irrigation Systems (see Note 1 to the financial statements).

For further details and information on the definition of Net Revenues, please refer to the 1974 Agreement.

**Schedule II**

Puerto Rico Electric Power Authority  
Sources and Disposition of Net Revenues  
Under the Provisions of the 1974 Agreement for the Years Ended June 30, 2004 and 2003  
Statements of Income (GAAP) and Reconciliation of Net Income  
(In Thousands)

	2004			2003		
	1974 Agreement	Statement of Income (GAAP)	Reconciliation of Net Income	1974 Agreement	Statement of Income (GAAP)	Reconciliation of Net Income
Reconciliation of components of net income:						
Revenues:						
Operating revenues	\$2,600,268	\$2,605,764	\$ 5,496	\$2,508,758	\$2,513,963	\$ 5,205
Revenues from Commonwealth for rural electrification	591	591	-	704	704	-
Other operating revenues	8,565	8,565	-	9,625	9,625	-
Other	3,581	3,581	-	17,163	17,163	-
1974 Agreement construction fund investment income and gain sale of other properties	-	42,052	42,052	-	46,107	46,107
	<u>2,613,005</u>	<u>2,660,553</u>		<u>2,536,250</u>	<u>2,587,562</u>	
Current expenses:						
As shown	1,979,755	1,983,209		1,871,476	1,874,885	
Other interest	-	3,622		-	3,403	
Total as defined	<u>1,979,755</u>	<u>1,986,831</u>	(7,076)	<u>1,871,476</u>	<u>1,878,288</u>	(6,812)
Net revenues, as defined	<u>\$ 633,250</u>			<u>\$ 664,774</u>		
Depreciation	\$ -	<u>250,784</u>	(250,784)	\$ -	<u>227,576</u>	(227,576)
Disposition of Revenues: (not classified in order of payment):						
Interest on debt	\$ 266,198	266,198		249,779	249,779	
Amortization debt discount and financing expenses	-	1,308		-	473	
Amortization of bond defeasance	-	19,163		-	20,070	
Allowance for funds used during construction	-	(20,279)		-	(16,795)	
Net interest on long-term debt	<u>266,198</u>	<u>266,390</u>	(192)	<u>249,779</u>	<u>253,527</u>	(3,748)
Power revenue bonds:						
Principal	166,004	-	166,004	137,329	-	137,329
Reserve	-	-	-	(30,000)	-	(30,000)
Internal Funds	43,144	-	43,144	144,537	-	144,537
Reserve Maintenance Fund	7,000	-	7,000	7,000	-	7,000
Contribution in lieu of taxes	150,904	180,820	(29,916)	156,129	175,737	(19,608)
Total expenses (GAAP)		<u>2,684,825</u>			<u>2,535,128</u>	
Net revenues, as defined	<u>\$ 633,250</u>			<u>\$ 664,774</u>		
Net income		<u>\$ (24,272)</u>	<u>\$ (24,272)</u>		<u>\$ 52,434</u>	<u>\$ 52,434</u>

See accompanying Notes.

## Puerto Rico Electric Power Authority

Supplemental Schedule of Sources and Disposition  
of Net Revenues under the Provisions of the 1974 Agreement  
for the Years Ended June 30, 2004 and 2003  
(In Thousands)

	2004	2003
<b>Sources of Net Revenues:</b>		
Revenues:		
Electric revenues	\$2,600,268	\$2,508,758
Revenues from the Commonwealth for rural electrification	591	704
Other operating revenues	8,565	9,625
Other (principally interest)	3,581	17,163
	2,613,005	2,536,250
<b>Current Expenses:</b>		
Operations:		
Fuel	864,700	886,425
Purchased Power – Eco-Eléctrica	260,572	220,295
Purchased Power – AES	176,191	118,787
Other production	48,787	44,990
Transmission and distribution	136,509	119,408
Customer accounting and collection	91,763	89,710
Administrative and general	163,049	163,517
Maintenance	234,563	224,941
Interest (Other than long term debt)	3,621	3,403
	1,979,755	1,871,476
Net revenues, as defined	\$ 633,250	\$ 664,774
<b>Disposition of Net Revenues:</b>		
<b>Revenue fund:</b>		
Power revenue bonds - sinking fund requirements:		
Interest	\$ 264,219	\$ 249,779
Principal	166,004	137,329
Reserve	-	(30,000)
Reserve maintenance fund	7,000	7,000
Balance available for capital improvements and other needs	43,144	144,537
	480,367	508,645
<b>General obligation notes:</b>		
Interest	1,979	-
Principal	-	-
	1,979	-
Contribution in lieu of taxes and other:	150,904	156,129
Net revenues, as defined	\$ 633,250	\$ 664,774

*See accompanying Notes.*

**Schedule IV**

Puerto Rico Electric Power Authority  
Supplemental Schedule of Funds Under the Provisions of the 1974 Agreement  
(In Thousands)

	For the Years Ended June 30							
	2004		2003		2004		2003	
	Total	Held by Authority Other Assets	Restricted Deposits with Trustee Other Assets	Non-Current Assets	Total	Held by Authority Other Assets	Restricted Deposits with Trustee Other Assets	Non-Current Assets
<b>By Account</b>								
1974 Agreement (restricted):								
Sinking Fund – principal and interest	\$ 302,293	\$ –	\$302,293	\$ –	\$275,765	\$ –	\$275,765	\$ –
Reserve account	243,605	–	–	243,605	241,409	–	–	241,409
Self Insurance Fund	80,767	–	–	80,767	80,240	–	–	80,240
Reserve Maintenance Fund	53,821	53,821	–	–	42,701	42,701	–	–
Construction Fund	–	–	–	–	–	–	–	–
Rural Utilities Service (RUS)	1,543	622	921	–	1,486	565	921	–
Other	68,702	68,702	–	–	35,280	35,280	–	–
Cogeneration Fund	–	–	–	–	–	–	–	–
PREPA Client Fund	25,398	25,398	–	–	52,366	52,366	–	–
Financing Fuel Fund	–	–	–	–	1,500	1,500	–	–
General purpose (unrestricted):								
General	15,311	15,311	–	–	47,894	47,894	–	–
Working funds	2,295	2,295	–	–	2,558	2,558	–	–
<b>Total</b>	<b>\$ 793,735</b>	<b>\$166,149</b>	<b>\$303,214</b>	<b>\$324,372</b>	<b>\$781,199</b>	<b>\$182,864</b>	<b>\$276,686</b>	<b>\$321,649</b>
<b>By type of assets held</b>								
Working funds	\$ 2,295	\$ 2,295	\$ –	\$ –	\$ 2,558	\$ 2,558	\$ –	\$ –
Cogeneration Fund	–	–	–	–	–	–	–	–
PREPA Client Fund	–	–	–	–	–	–	–	–
Cash in bank and time deposits (by depository institutions):								
Government Development Bank for Puerto Rico	1	1	–	–	1	1	–	–
Banco Popular de Puerto Rico	12,114	12,114	–	–	9,566	9,566	–	–
Citibank, N. A.	522	522	–	–	20,838	20,838	–	–
State Street Bank and Trust Co., N.A.	302,293	–	302,293	–	275,765	–	275,765	–
Banco Bilbao Vizcaya	17	17	–	–	38	38	–	–
Banco Bilbao Vizcaya, Mayagüez, PR	332	332	–	–	356	356	–	–
First Bank, San Juan, Puerto Rico	357	357	–	–	472	472	–	–
Banco Santander, Santurce, Puerto Rico	1,065	1,065	–	–	15,680	15,680	–	–
Roig Comercial Bank, Humacao, PR	33	33	–	–	133	133	–	–
Western Bank, Mayagüez, Puerto Rico	870	870	–	–	810	810	–	–
Economic Development Bank	–	–	–	–	–	–	–	–
Other institutions	–	–	–	–	–	–	–	–
	319,899	17,606	302,293	–	326,217	50,452	275,765	–
Investment Securities	473,836	148,543	921	324,372	454,981	132,411	921	321,649
<b>Total</b>	<b>\$ 793,735</b>	<b>\$ 166,149</b>	<b>\$303,214</b>	<b>\$324,372</b>	<b>\$781,198</b>	<b>\$182,863</b>	<b>\$276,686</b>	<b>\$321,649</b>

See accompanying notes.

Schedule V

Puerto Rico Electric Power Authority

Supplement Schedule of Changes in Cash and Investments by Funds

Year Ended June 30, 2004

(In Thousands)

	General Purposes Funds				General Obligations Notes Fund
	Total	General Fund	Revenue Fund	Working Fund	
<b>Balances at June 30, 2003</b>	\$ 781,197	\$ 47,775	\$ 118	\$2,558	\$ -
Operations:					
Net revenues	-	(633,250)	150,904	-	-
Funds provided from internal operations	407,359	407,359	-	-	-
1974 Agreement investment income	-	(3,193)	-	-	-
Offset of current year's contribution in lieu of taxes against certain government accounts receivable	-	120,489	(120,489)	-	-
Offset of current year's 5% contribution in lieu of taxes against Commonwealth of Puerto Rico debt and transfers to General Obligations Notes Fund	-	30,415	(30,415)	-	-
Funds used for construction	467,576	-	-	-	-
Funds used for restoration of plant	-	-	-	-	-
Proceeds from penalties to AES	-	-	-	-	-
Financing:					
Proceeds from new bond issues-net of original issue discounts	514,755	-	-	-	-
Proceeds from line of credit-municipalities settlement agreement	61,806	61,806	-	-	-
Defeased bonds-net of original issue discounts	-	-	-	-	-
Accretion of capital appreciation bonds	3,135	3,135	-	-	-
Amortization of debt discount and excess reacquisition costs	20,471	20,471	-	-	-
Sinking Funds and account transfers	-	-	-	-	-
Notes issued for construction	30,000	-	-	-	-
Notes issued for fuel purchases	905,000	905,000	-	-	-
Payment of notes	(995,000)	(905,000)	-	-	-
Payment of interest	(250,415)	-	-	-	-
Payment of current maturities of long-term debt	(137,369)	-	-	-	-
Changes in assets and liabilities:					
Working funds	-	263	-	(263)	-
Accounts receivable (includes non-current)	(60,737)	(60,737)	-	-	-
Fuel oil	(11,372)	(11,372)	-	-	-
Materials and supplies	(3,196)	(3,196)	-	-	-
Prepayments and other	(11,070)	(11,070)	-	-	-
Deferred debits	23,488	23,488	-	-	-
Accounts payable and accrued liabilities (includes non-current)	(25,521)	(25,521)	-	-	-
Customer deposits	8,780	8,780	-	-	-
Interfund transfers, etc.	-	30,686	(103)	-	-
Total before interfund accounts	793,735	6,328	15	2,295	-
Add (deduct) interfund accounts	-	8,968	-	-	-
<b>Balances at June 30, 2004</b>	<b>\$ 793,735</b>	<b>\$ 15,296</b>	<b>\$ 15</b>	<b>\$2,295</b>	<b>\$ -</b>

See accompanying notes.

Sinking Fund				Other Funds			
Interest 1974 Agreement	Principal 1974 Agreement	Reserve 1974 Agreement	Self Insurance Fund	Construction 1974 Agreement	Reserve Maintenance Fund	Cogeneration Fund	Clients Fund
\$ 136,499	\$ 139,266	\$241,409	\$80,240	\$ 36,765	\$42,701	\$ -	\$53,866
-	-	-	-	-	-	-	-
-	-	-	-	-	-	-	-
266,198	166,004	-	-	43,144	7,000	-	-
-	-	-	-	-	-	-	-
-	-	-	-	3,193	-	-	-
-	-	-	-	-	-	-	-
-	-	-	-	-	-	-	-
-	-	-	-	(467,576)	-	-	-
-	-	-	-	-	-	-	-
-	-	-	-	-	-	-	-
-	-	-	-	-	-	-	-
-	-	-	-	-	-	-	-
-	-	-	-	-	-	-	-
-	-	-	-	514,755	-	-	-
-	-	-	-	-	-	-	-
-	-	-	-	-	-	-	-
-	-	-	-	30,000	-	-	-
-	-	-	-	-	-	-	-
-	-	-	-	(90,000)	-	-	-
(250,509)	-	-	-	94	-	-	-
-	(137,369)	-	-	-	-	-	-
-	-	-	-	-	-	-	-
-	-	-	-	-	-	-	-
-	-	-	-	-	-	-	-
-	-	-	-	-	-	-	-
-	-	-	-	-	-	-	-
-	-	-	-	-	-	-	-
-	-	-	-	-	-	-	-
-	-	-	-	-	-	-	-
-	-	-	-	-	-	-	-
-	-	-	-	-	-	-	-
(15,693)	(1,758)	1,851	527	8,838	4,120	-	(28,468)
136,495	166,143	243,260	80,767	79,213	53,821	-	25,398
-	-	-	-	-	-	-	-
-	-	-	-	(8,968)	-	-	-
\$136,495	\$166,143	\$243,260	\$80,767	\$ 70,245	\$53,821	\$ -	\$ 25,398



Schedule V

Puerto Rico Electric Power Authority

Supplement Schedule of Changes in Cash and Investments by Funds

Year Ended June 30, 2003

(In Thousands)

	General Purposes Funds				
	Total	General Fund	Revenue Fund	Working Fund	General Obligations Notes Fund
<b>Balances at June 30, 2002</b>	\$1,072,040	\$ 162,601	\$ 118	\$2,536	\$ -
Operations:					
Net revenues	-	(664,774)	156,129	-	-
Funds provided from internal operations	491,065	491,065	-	-	-
1974 Agreement investment income	-	(3,133)	-	-	-
Offset of current year's contribution in lieu of taxes against certain government accounts receivable	-	133,317	(133,317)	-	-
Offset of current year's 5% contribution in lieu of taxes against Commonwealth of Puerto Rico debt and transfers to General Obligations Notes Fund	-	22,812	(22,812)	-	-
Funds used for construction	(421,337)	-	-	-	-
Funds used for restoration of plant	-	-	-	-	-
Proceeds from penalties to AES	-	-	-	-	-
Financing:					
Proceeds from new bond issues-net of original issue discounts	654,471	-	-	-	-
Defeased bonds-net of original issue discounts	(644,443)	-	-	-	-
Accretion of capital appreciation bonds	5,930	5,930	-	-	-
Amortization of debt discount and excess reacquisition costs	20,544	20,544	-	-	-
Sinking Funds and account transfers	-	-	-	-	-
Notes issued for construction	60,000	-	-	-	-
Notes issued for fuel purchases	980,000	980,000	-	-	-
Payment of notes	(980,000)	(980,000)	-	-	-
Payment of interest	(245,090)	-	-	-	-
Payment of current maturities of long-term debt	(155,163)	-	-	-	-
Changes in assets and liabilities:					
Working funds	-	(22)	-	22	-
Accounts receivable (includes non-current)	(67,904)	(67,904)	-	-	-
Fuel oil	4,219	4,219	-	-	-
Materials and supplies	5,159	5,159	-	-	-
Prepayments and other	(355)	(355)	-	-	-
Deferred debits	(10,189)	(10,189)	-	-	-
Accounts payable and accrued liabilities (includes non-current)	3,898	3,898	-	-	-
Customer deposits	8,352	8,352	-	-	-
Interfund transfers, etc.	-	(75,707)	-	-	-
Total before interfund accounts	781,197	35,813	118	2,558	-
Add (deduct) interfund accounts	-	11,962	-	-	-
<b>Balances at June 30, 2003</b>	\$ 781,197	\$ 47,775	\$ 118	\$2,558	\$ -

See accompanying notes.

Sinking Fund				Other Funds			
Interest 1974 Agreement	Principal 1974 Agreement	Reserve 1974 Agreement	Self Insurance Fund	Construction 1974 Agreement	Reserve Maintenance Fund	Cogeneration Fund	Clients Fund
\$ 130,835	\$ 156,040	\$260,193	\$77,353	\$ 192,115	\$41,476	\$ -	\$48,773
219,779	137,329	-	-	144,537	7,000	-	-
-	-	-	-	-	-	-	-
-	-	-	-	3,133	-	-	-
-	-	-	-	-	-	-	-
-	-	-	-	-	-	-	-
-	-	-	-	-	-	-	-
-	-	-	-	(421,337)	-	-	-
-	-	-	-	-	-	-	-
-	-	-	-	-	-	-	-
-	-	-	-	-	-	-	-
-	-	-	-	654,471	-	-	-
30,000	-	(30,000)	-	(644,443)	-	-	-
-	-	-	-	-	-	-	-
-	-	-	-	-	-	-	-
-	-	-	-	60,000	-	-	-
-	-	-	-	-	-	-	-
(245,090)	-	-	-	-	-	-	-
-	(155,163)	-	-	-	-	-	-
-	-	-	-	-	-	-	-
-	-	-	-	-	-	-	-
-	-	-	-	-	-	-	-
-	-	-	-	-	-	-	-
-	-	-	-	-	-	-	-
-	-	-	-	-	-	-	-
-	-	-	-	-	-	-	-
975	1,060	11,216	2,887	60,251	(5,775)	-	5,093
136,499	139,266	241,409	80,240	48,727	42,701	-	53,866
-	-	-	-	(11,962)	-	-	-
\$ 136,499	\$ 139,266	\$241,409	\$80,240	\$ 36,765	\$42,701	\$ -	\$53,866

Puerto Rico Electric Power Authority  
Supplemental Schedule of Changes in Long-Term  
Debt and Current Portion of Long-Term Debt

Years Ended June 30, 2004 and 2003  
(In Thousands)

	2004	2003
Long-term debt excluding current portion:		
Balance at the beginning of year	<b>\$4,226,311</b>	\$4,352,858
Transfers to current liabilities:		
Power revenue bonds	<b>(166,480)</b>	(142,505)
General obligation notes	-	-
Total transfers	<b>(166,480)</b>	(142,505)
Remainder	<b>4,059,831</b>	4,210,353
New issues:		
Power revenue bonds	<b>517,305</b>	98,125
Power revenue refunding bonds	-	506,840
Note payable to EcoElectrica	-	-
Debt discount on new bond issues - net	<b>(2,550)</b>	49,506
Defeasance of bonds	-	(614,435)
Debt discount and excess reacquisition costs on cancelled bonds - net	-	(30,008)
Accretion of capital appreciation bonds	<b>3,135</b>	5,930
Balance at the end of year	<b>\$4,577,721</b>	\$4,226,311
Current portion of long-term debt:		
Balance at beginning of year	<b>\$ 285,407</b>	\$ 280,070
Transfer from long-term debt	<b>166,480</b>	142,505
Payments to bondholders:		
Power revenue - July 1	<b>(136,621)</b>	(154,455)
Power revenue - January 1	<b>(748)</b>	(708)
Obligations under capital lease	-	-
General obligation notes	-	-
Total payments	<b>(137,369)</b>	(155,163)
Amortization of debt discount and excess reacquisition costs	<b>17,288</b>	17,995
Balance at end of year	<b>\$ 331,806</b>	\$ 285,407

See accompanying notes.

March 24, 2005

Puerto Rico Electric Power Authority  
San Juan, Puerto Rico

Dear Sirs:

Washington Group International, Inc. (“Washington Group”) serves as the Consulting Engineers under the provisions of the Trust Agreement, dated as of January 1, 1974, as amended, by and between Puerto Rico Electric Power Authority (the “Authority”) and U.S. Bank Trust National Association, in the Borough of Manhattan, City and State of New York, successor trustee. Such Trust Agreement is referred to herein as the “Agreement”, and the trustee under the Agreement is referred to herein as the “Trustee”. The Agreement requires the Consulting Engineers annually to prepare and file with the Authority and the Trustee a report with their recommendations as to any necessary or advisable revisions of rates and charges and such other advices and recommendations as they may deem desirable. In addition, the report will include the amount that should be deposited monthly during the next fiscal year to the credit of the Reserve Maintenance Fund; the amount, if any, to be deposited to the Self-insurance Fund in the next fiscal year; and, the amount to be deposited to the Capital Improvement Fund in the next fiscal year. The most recent such recommendations and report provided to the Authority and the Trustee was dated as of June 2004.

In preparing this letter and in reaching the conclusions and opinions contained herein and referred to in the Official Statement to which this letter is appended, Washington Group has relied upon inquiries, observations and analyses made and conducted by it in the performance of its duties under the Agreement and upon its professional experience. Washington Group also has relied upon various financial, economic, political and other information and projections provided to it by the Authority and other sources, some of such information and projections having been accepted by Washington Group without it having conducted an independent investigation thereof. In addition, Washington Group has made assumptions which it believes to be reasonable to make including, but not limited to, the following:

1. that the Authority will adhere to its proposed schedule of programmed regular maintenance;
2. that the Authority will continue to maintain the effective availability of its generating units;
3. that the Authority’s current capacity expansion plan will be realized as to increases in capacity and approximate timing;
4. that the Authority’s forecasts of costs and availability of fuels are reasonable;

5. that financing will be available to the Authority at reasonable rates, in adequate amounts and at appropriate times;

6. that the Authority will not be adversely affected by labor disputes and will have adequate levels of labor productivity;

7. that there will be no material changes in the requirements of regulatory authorities, the Legislature of Puerto Rico will not enact any legislation that will adversely affect the Authority, nor will there be unforeseen technological developments;

8. that the demographic, statistical, economic and other information regarding Puerto Rico obtained by Washington Group from publicly available sources is reliable;

9. that the Authority will not be unduly affected by natural disasters; and

10. that the Authority will not experience unforeseeable or extraordinary conditions not included in usual estimates and opinions of engineers.

Based upon and subject to the foregoing which should be read in conjunction with and as part of the following conclusions, it is our considered opinion with respect to the Authority that:

1. The Authority's production, transmission and distribution plant is in good repair and sound operating condition;

2. The Authority's generating capacity expansion plan is adequate and should allow the Authority to meet targeted electric reliability criteria;

3. The Authority's projections of future load growth and estimates of peak load referred to in the Official Statement, to which this letter is appended, under the caption "Adequacy of Capacity" are reasonable for base planning purposes;

4. The Authority's revenue and base capacity planning forecasts (and the methodologies and assumptions on which they are based) are reasonable for planning purposes and are generally consistent with electric utility industry practices;

5. The Authority's current projected capital improvement program is reasonable and the estimated expenditures are consistent with the Authority's future needs;

6. The Authority's estimates of future growth form a reasonable basis for its projected operating results;

7. The Authority's electric rates and charges should generate sufficient revenues to pay its current expenses and debt service and to finance that portion of its capital improvement program that is currently anticipated to be financed with current operating revenues; and

8. The 961 MW of capacity presently being provided by the two cogenerators described in the Official Statement to which this letter is appended, and their role in the Authority's capacity expansion program should not cause the Authority to experience a meaningful reduction in control over its revenue producing capability as a result of the purchase rather than self-generation of electricity. The methodology used by the Authority in determining its avoided cost of generating or otherwise obtaining an equivalent amount of energy, pursuant to the Public Utilities Regulatory Policies Act of 1978, as amended (which requires the Authority to pay an amount based upon such avoided cost for power generated and made available to the Authority), is reasonable.

Very truly yours,

WASHINGTON GROUP INTERNATIONAL, INC.

A handwritten signature in cursive script, reading "George W. Romano, Jr.", written in black ink.

George W. Romano, Jr.  
Manager,  
Utility Management  
Services Department

**PROPOSED FORM OF BOND COUNSEL OPINION**

*Upon delivery of the Series RR Bonds and the Series SS Bonds, Squire, Sanders & Dempsey L.L.P. is prepared to render its final opinion with respect to the Series RR Bonds and the Series SS Bonds in substantially the following form:*

April 4, 2005

Puerto Rico Electric Power Authority  
San Juan, Puerto Rico

Re: \$509,520,000 Puerto Rico Electric Power Authority Power Revenue Bonds, Series RR  
and \$483,930,000 Puerto Rico Electric Power Authority Power Revenue Refunding  
Bonds, Series SS

Gentlemen:

We have served as bond counsel in connection with the issuance by the Puerto Rico Electric Power Authority (the "Authority"), a governmental instrumentality of the Commonwealth of Puerto Rico, of its \$509,520,000 aggregate principal amount of Power Revenue Bonds, Series RR (the "Series RR Bonds") and \$483,930,000 aggregate principal amount of Power Revenue Refunding Bonds, Series SS (the "Series SS Bonds" and, together with the Series RR Bonds, the "Bonds"). The Bonds are dated, mature on July 1 of the years and in such principal amounts, bear interest at the rates and are subject to redemption, all as set forth or provided for in the Resolution referred to hereinbelow. The Bonds are issuable as fully registered bonds without coupons, in authorized denominations of \$5,000 or any multiple thereof, in the manner and in accordance with the terms and conditions of the Resolution.

In our capacity as bond counsel, we have examined the transcript of the proceedings (the "Transcript") of the Authority relating to the issuance of the Bonds, including, without limitation, Act No. 83 of the Legislature of Puerto Rico, approved May 2, 1941, as amended and re-enacted by Act No. 19, approved April 8, 1942, as amended, creating the Authority (formerly called Puerto Rico Water Resources Authority) and Act No. 111, approved May 6, 1941, as amended by Act No. 153, approved May 14, 1943 (said Acts No. 83, No. 19, No. 111 and No. 153, as amended, being herein collectively referred to as the "Authority Act"); the Trust Agreement, dated as of January 1, 1974, as amended (the "Trust Agreement"), by and between the Authority and U.S. Bank Trust National Association, as successor trustee; Resolution No. 3255, duly adopted by the Authority on March 8, 2005 (the "Resolution"); and such other documents as we have deemed necessary to render this opinion. Capitalized words used herein without definitions have the meanings ascribed thereto in the Trust Agreement or the Resolution, as applicable.

We have also examined a copy of each of the Series RR Bonds and the Series SS Bonds, as executed and authenticated. We assume that all other such Bonds have been similarly executed and authenticated.

From such examination, we are of the opinion that:

1. The Authority Act is valid.
2. Said proceedings have been validly and legally taken.
3. The Series RR Bonds have been duly authorized and issued to provide funds to pay all or a portion of the cost of certain Improvements (as defined in the Trust Agreement) included in the Authority's capital improvement program for fiscal years 2005 and 2006.
4. The Series SS Bonds have been duly authorized and issued to provide funds to refund certain of the Authority's outstanding bonds, which bonds are more particularly described in the Delegates' Certificate executed and delivered by the Delegates as required by the Resolution.
5. The Trust Agreement provides for the issuance of additional bonds, from time to time, under the conditions, limitations and restrictions therein set forth.
6. The Bonds are valid and binding special obligations of the Authority, payable solely from the Puerto Rico Electric Power Authority Power Revenue Bonds Interest and Sinking Fund established under the Trust Agreement, to the credit of which Fund the Authority has covenanted to deposit a sufficient amount of the revenues of the System, over and above the expenses of repair, maintenance and operation, to pay the principal of and the interest on all bonds issued under the provisions of the Trust Agreement as the same become due and payable and to create a reserve for such purpose, which Fund is pledged to and charged with the payment of the principal of and the interest on all bonds issued under the provisions of the Trust Agreement.
7. The Trust Agreement provides for the fixing and collecting by the Authority of rates and charges for the use of the services and facilities of the System sufficient for the payment of the expenses of the Authority incurred in the repair, maintenance and operation of the System and for the payment of the principal of and the interest on all bonds issued under the provisions of the Trust Agreement as the same become due and payable, including reserves for such purposes.
8. The bonds issued under the provisions of the Trust Agreement, including the Bonds, do not constitute a debt of the Commonwealth of Puerto Rico or of any of its municipalities or other political subdivisions, and neither the Commonwealth of Puerto Rico nor any such municipality or other political subdivision is liable thereon, and such bonds, including the Bonds, are payable only out of the revenues of the System, to the extent provided in the Trust Agreement.
9. The interest on the Bonds is excluded from gross income for federal income tax purposes under Section 103 of the Internal Revenue Code of 1986, as amended (the "Code"), and is not an item of tax preference for purposes of the federal alternative minimum tax imposed on individuals and corporations. The Bonds and the interest thereon are exempt from state,



Commonwealth of Puerto Rico and local income taxation. We express no opinion as to any other tax consequences regarding the Bonds.

Under the Code, a portion of the interest on the Bonds earned by certain corporations may be subject to a corporate alternative minimum tax and interest on the Bonds may be subject to a branch profits tax imposed on certain foreign corporations doing business in the United States and to a tax imposed on excess net passive income of certain S corporations.

In giving the opinion set forth in numbered paragraph 9. hereof, we have relied upon and assumed continuing compliance with the Authority's covenants and the accuracy, which we have not independently verified, of the representations and certifications of the Authority contained in the Transcript. The accuracy of those representations and certifications, and the Authority's continuing compliance with those covenants, may be necessary for the interest on the Bonds to be and to remain excluded from gross income for federal income tax purposes. Failure to comply with certain of those covenants subsequent to issuance of the Bonds may cause interest on the Bonds to be included in gross income for federal income tax purposes retroactively to the date of issuance of the Bonds. The Authority has covenanted to comply with the requirements of the Code to the extent permitted by the Constitution and laws of the Commonwealth. We are not aware of any provisions of the Constitution or laws of the Commonwealth of Puerto Rico that would prevent the Authority from complying with the requirements of the Code.

In rendering the opinions set forth herein, we have assumed the accuracy and truthfulness of all public records and of all certifications, documents and other proceedings examined by us that have been executed or certified by public officials acting within the scope of their official capacities and have not verified the accuracy or truthfulness thereof. We have also assumed the genuineness of the signatures appearing upon such public records, certifications, documents and proceedings. As to questions of fact material to our opinion, we have relied on representations of the Authority furnished to us, without undertaking to verify such representations by independent investigation.

It is to be understood that the rights of the holders of the Bonds and the enforceability of the Bonds may be subject to judicial discretion and valid bankruptcy, insolvency, reorganization, moratorium and other laws affecting creditors' rights generally, and subject to general principles of equity (regardless of whether considered in a proceeding in equity or at law).

Respectfully submitted,

[To be signed "Squire, Sanders & Dempsey L.L.P."]



CDC IXIS Financial Guaranty North America, Inc.
825 Third Avenue, Sixth Floor
New York, NY 10022
For information, contact (212) 909-3939
Toll-free (866) 243-4212

FINANCIAL GUARANTY INSURANCE POLICY

ISSUER: \_\_\_\_\_

Policy No.: CIFG NA-##

CUSIP: \_\_\_\_\_

Effective Date: \_\_\_\_\_, 200\_

OBLIGATIONS: \_\_\_\_\_

CDC IXIS FINANCIAL GUARANTY NORTH AMERICA, INC. ("CIFG NA"), for consideration received, hereby UNCONDITIONALLY AND IRREVOCABLY GUARANTEES to each Policyholder, subject only to the terms and conditions of this Policy (which includes each endorsement hereto), the full and complete payment by or on behalf of the Issuer of Regular Payments of principal of and interest on the Obligations.

For the further protection of each Policyholder, CIFG NA irrevocably and unconditionally guarantees:

- (1) payment of any amount required to be paid under this Policy by CIFG NA following CIFG NA's receipt of notice and instruments of assignment as described in Endorsement No. 1 hereto and
(2) payment of the amount of any distribution of principal of and interest on the Obligations made during the Term of this Policy to such Policyholder that is subsequently avoided in whole or in part as a preference payment under applicable law, all as described in Endorsement No. 1 hereto.

CIFG NA shall be subrogated to the rights of each Policyholder to receive payments under the Obligations to the extent of any payment by CIFG NA hereunder. Upon disbursement in respect of an Obligation, CIFG NA shall become the owner of the Obligation, appurtenant coupon, if any, and all rights to payment of principal thereof or interest thereon.

The following terms shall have the meanings specified below, subject to and including any modifications set forth in any endorsement hereto, for all purposes of this Policy. "Effective Date," "Issuer" and "Obligations" mean, respectively, the Effective Date, Issuer and Obligations referenced above. "Policyholder" means, if the Obligations are in book-entry form, the registered owner of any Obligation as indicated on the registration books maintained by or on behalf of the Issuer for such purpose or, if the Obligations are in bearer form, the holder of any Obligation; provided, however, that any trustee acting on behalf of and for the benefit of such registered owner or holder shall be deemed to be the Policyholder to the extent of such trustee's authority. "Regular Payments" means payments of interest and principal which are agreed to be made during the Term of this Policy in accordance with the original terms of the Obligations when issued and without regard to any amendment or modification of such Obligations thereafter; payments which become due on an accelerated basis as a result of (a) a default by the Issuer or any other person, (b) an election by the Issuer to pay principal or other amounts on an accelerated basis or (c) any other cause, shall not constitute "Regular Payments" unless CIFG NA shall elect, in its sole discretion, to pay such principal due upon such acceleration together with any accrued interest to the date of acceleration. "Term of this Policy" has the meaning set forth in Endorsement No. 1 hereto.

This Policy sets forth in full the undertaking of CIFG NA, and shall not be modified, altered or affected by any other agreement or instrument, including any modification or amendment thereto or to the Obligations (except a contemporaneous or subsequent agreement or instrument given by CIFG NA or to which CIFG NA has given its written consent) or by the merger, consolidation or dissolution of the Issuer. The premiums paid in respect of this Policy are nonrefundable for any reason whatsoever, including payment, or provision being made for payment, of the Obligations prior to maturity. This Policy may not be cancelled or revoked during the Term of this Policy, including for nonpayment of premium due to CIFG NA. Payments under this Policy may not be accelerated except at the sole option of CIFG NA.

In witness whereof, CDC IXIS FINANCIAL GUARANTY NORTH AMERICA, INC. has caused this Policy to be executed on its behalf by its Authorized Officer.

CDC IXIS FINANCIAL GUARANTY NORTH AMERICA, INC.

By \_\_\_\_\_
Authorized Officer



Financial Guaranty Insurance Company  
 125 Park Avenue  
 New York, NY 10017  
 T 212-312-3000  
 T 800-352-0001

## Municipal Bond New Issue Insurance Policy

<b>Issuer:</b>	<b>Policy Number:</b>
	<b>Control Number:</b> 0010001
<b>Bonds:</b>	<b>Premium:</b>

Financial Guaranty Insurance Company ("Financial Guaranty"), a New York stock insurance company, in consideration of the payment of the premium and subject to the terms of this Policy, hereby unconditionally and irrevocably agrees to pay to U.S. Bank Trust National Association or its successor, as its agent (the "Fiscal Agent"), for the benefit of Bondholders, that portion of the principal and interest on the above-described debt obligations (the "Bonds") which shall become Due for Payment but shall be unpaid by reason of Nonpayment by the Issuer.

Financial Guaranty will make such payments to the Fiscal Agent on the date such principal or interest becomes Due for Payment or on the Business Day next following the day on which Financial Guaranty shall have received Notice of Nonpayment, whichever is later. The Fiscal Agent will disburse to the Bondholder the face amount of principal and interest which is then Due for Payment but is unpaid by reason of Nonpayment by the Issuer but only upon receipt by the Fiscal Agent, in form reasonably satisfactory to it, of (i) evidence of the Bondholder's right to receive payment of the principal or interest Due for Payment and (ii) evidence, including any appropriate instruments of assignment, that all of the Bondholder's rights to payment of such principal or interest Due for Payment shall thereupon vest in Financial Guaranty. Upon such disbursement, Financial Guaranty shall become the owner of the Bond, appurtenant coupon or right to payment of principal or interest on such Bond and shall be fully subrogated to all of the Bondholder's rights thereunder, including the Bondholder's right to payment thereof.

This Policy is non-cancellable for any reason. The premium on this Policy is not refundable for any reason, including the payment of the Bonds prior to their maturity. This Policy does not insure against loss of any prepayment premium which may at any time be payable with respect to any Bond.

As used herein, the term "Bondholder" means, as to a particular Bond, the person other than the Issuer who, at the time of Nonpayment, is entitled under the terms of such Bond to payment thereof. "Due for Payment" means, when referring to the principal of a Bond, the stated maturity date thereof or the date on which the same shall have been duly called for mandatory sinking fund redemption and does not refer to any earlier date on which payment is due by reason of call for redemption (other than by mandatory sinking fund redemption), acceleration or other advancement of maturity and means, when referring to interest on a Bond, the stated date for payment of interest. "Nonpayment" in respect of a Bond means the failure of the Issuer to have provided sufficient funds to the paying agent for payment in full of all



**Financial Guaranty Insurance Company**  
125 Park Avenue  
New York, NY 10017  
T 212-312-3000  
T 800-352-0001

## **Municipal Bond New Issue Insurance Policy**

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principal and interest Due for Payment on such Bond. "Notice" means telephonic or telegraphic notice, subsequently confirmed in writing, or written notice by registered or certified mail, from a Bondholder or a paying agent for the Bonds to Financial Guaranty. "Business Day" means any day other than a Saturday, Sunday or a day on which the Fiscal Agent is authorized by law to remain closed.

In Witness Whereof, Financial Guaranty has caused this Policy to be affixed with its corporate seal and to be signed by its duly authorized officer in facsimile to become effective and binding upon Financial Guaranty by virtue of the countersignature of its duly authorized representative.

*Frank Bivona*

SPECIMEN

**President**

**Effective Date:**

**Authorized Representative**

U.S. Bank Trust National Association, acknowledges that it has agreed to perform the duties of Fiscal Agent under this Policy.

**Authorized Officer**



Financial Guaranty Insurance Company  
 125 Park Avenue  
 New York, NY 10017  
 T 212-312-3000  
 T 800-352-0001

**Endorsement**  
 To Financial Guaranty Insurance Company  
 Insurance Policy

**Policy Number:**

**Control Number:** 0010001

It is further understood that the term "Nonpayment" in respect of a Bond includes any payment of principal or interest made to a Bondholder by or on behalf of the issuer of such Bond which has been recovered from such Bondholder pursuant to the United States Bankruptcy Code by a trustee in bankruptcy in accordance with a final, nonappealable order of a court having competent jurisdiction.

NOTHING HEREIN SHALL BE CONSTRUED TO WAIVE, ALTER, REDUCE OR AMEND COVERAGE IN ANY OTHER SECTION OF THE POLICY. IF FOUND CONTRARY TO THE POLICY LANGUAGE, THE TERMS OF THIS ENDORSEMENT SUPERSEDE THE POLICY LANGUAGE.

In Witness Whereof, Financial Guaranty has caused this Endorsement to be affixed with its corporate seal and to be signed by its duly authorized officer in facsimile to become effective and binding upon Financial Guaranty by virtue of the countersignature of its duly authorized representative.

**President**

**Effective Date:**

**Authorized Representative**

**Acknowledged as of the Effective Date written above:**

**Authorized Officer**  
**U.S. Bank Trust National Association, as Fiscal Agent**



**FINANCIAL  
SECURITY  
ASSURANCE®**

## MUNICIPAL BOND INSURANCE POLICY

ISSUER:

Policy No.: -N

BONDS:

Effective Date:

Premium:

FINANCIAL SECURITY ASSURANCE INC. ("Financial Security"), for consideration received, hereby UNCONDITIONALLY AND IRREVOCABLY agrees to pay to the trustee (the "Trustee") or paying agent (the "Paying Agent") (as set forth in the documentation providing for the issuance of and securing the Bonds) for the Bonds, for the benefit of the Owners or, at the election of Financial Security, directly to each Owner, subject only to the terms of this Policy (which includes each endorsement hereto), that portion of the principal of and interest on the Bonds that shall become Due for Payment but shall be unpaid by reason of Nonpayment by the Issuer.

On the later of the day on which such principal and interest becomes Due for Payment or the Business Day next following the Business Day on which Financial Security shall have received Notice of Nonpayment, Financial Security will disburse to or for the benefit of each Owner of a Bond the face amount of principal of and interest on the Bond that is then Due for Payment but is then unpaid by reason of Nonpayment by the Issuer, but only upon receipt by Financial Security, in a form reasonably satisfactory to it, of (a) evidence of the Owner's right to receive payment of the principal or interest then Due for Payment and (b) evidence, including any appropriate instruments of assignment, that all of the Owner's rights with respect to payment of such principal or interest that is Due for Payment shall thereupon vest in Financial Security. A Notice of Nonpayment will be deemed received on a given Business Day if it is received prior to 1:00 p.m. (New York time) on such Business Day; otherwise it will be deemed received on the next Business Day. If any Notice of Nonpayment received by Financial Security is incomplete, it shall be deemed not to have been received by Financial Security for purposes of the preceding sentence and Financial Security shall promptly so advise the Trustee, Paying Agent or Owner, as appropriate, who may submit an amended Notice of Nonpayment. Upon disbursement in respect of a Bond, Financial Security shall become the owner of the Bond, any appurtenant coupon to the Bond or right to receipt of payment of principal of or interest on the Bond and shall be fully subrogated to the rights of the Owner, including the Owner's right to receive payments under the Bond, to the extent of any payment by Financial Security hereunder. Payment by Financial Security to the Trustee or Paying Agent for the benefit of the Owners shall, to the extent thereof, discharge the obligation of Financial Security under this Policy.

Except to the extent expressly modified by an endorsement hereto, the following terms shall have the meanings specified for all purposes of this Policy. "Business Day" means any day other than (a) a Saturday or Sunday or (b) a day on which banking institutions in the State of New York or the Insurer's Fiscal Agent are authorized or required by law or executive order to remain closed. "Due for Payment" means (a) when referring to the principal of a Bond, payable on the stated maturity date thereof or the date on which the same shall have been duly called for mandatory sinking fund redemption and does not refer to any earlier date on which payment is due by reason of call for redemption (other than by mandatory sinking fund redemption), acceleration or other advancement of maturity unless Financial Security shall elect, in its sole discretion, to pay such principal due upon such acceleration together with any accrued interest to the date of acceleration and (b) when referring to interest on a Bond, payable on the stated date for payment of interest. "Nonpayment" means, in respect of a Bond, the failure of the Issuer to have provided sufficient funds to the Trustee or, if there is no Trustee, to the Paying Agent for payment in full of all principal and interest that is Due for Payment on such Bond. "Nonpayment" shall also include, in respect of a Bond, any payment of principal or interest that is Due for Payment made to an Owner by or on behalf of the Issuer which has been recovered from such Owner pursuant to the

United States Bankruptcy Code by a trustee in bankruptcy in accordance with a final, nonappealable order of a court having competent jurisdiction. "Notice" means telephonic or telecopied notice, subsequently confirmed in a signed writing, or written notice by registered or certified mail, from an Owner, the Trustee or the Paying Agent to Financial Security which notice shall specify (a) the person or entity making the claim, (b) the Policy Number, (c) the claimed amount and (d) the date such claimed amount became Due for Payment. "Owner" means, in respect of a Bond, the person or entity who, at the time of Nonpayment, is entitled under the terms of such Bond to payment thereof, except that "Owner" shall not include the Issuer or any person or entity whose direct or indirect obligation constitutes the underlying security for the Bonds.

Financial Security may appoint a fiscal agent (the "Insurer's Fiscal Agent") for purposes of this Policy by giving written notice to the Trustee and the Paying Agent specifying the name and notice address of the Insurer's Fiscal Agent. From and after the date of receipt of such notice by the Trustee and the Paying Agent, (a) copies of all notices required to be delivered to Financial Security pursuant to this Policy shall be simultaneously delivered to the Insurer's Fiscal Agent and to Financial Security and shall not be deemed received until received by both and (b) all payments required to be made by Financial Security under this Policy may be made directly by Financial Security or by the Insurer's Fiscal Agent on behalf of Financial Security. The Insurer's Fiscal Agent is the agent of Financial Security only and the Insurer's Fiscal Agent shall in no event be liable to any Owner for any act of the Insurer's Fiscal Agent or any failure of Financial Security to deposit or cause to be deposited sufficient funds to make payments due under this Policy.

To the fullest extent permitted by applicable law, Financial Security agrees not to assert, and hereby waives, only for the benefit of each Owner, all rights (whether by counterclaim, setoff or otherwise) and defenses (including, without limitation, the defense of fraud, whether acquired by subrogation, assignment or otherwise, to the extent that such rights and defenses may be available to Financial Security to avoid payment of its obligations under this Policy in accordance with the express provisions of this Policy.

This Policy sets forth in full the undertaking of Financial Security, and shall not be modified, altered or affected by any other agreement or instrument, including any modification or amendment thereto. Except to the extent expressly modified by an endorsement hereto, (a) any premium paid in respect of this Policy is nonrefundable for any reason whatsoever, including payment, or provision being made for payment, of the Bonds prior to maturity and (b) this Policy may not be canceled or revoked. THIS POLICY IS NOT COVERED BY THE PROPERTY CASUALTY INSURANCE SECURITY FUND SPECIFIED IN ARTICLE 76 OF THE NEW YORK INSURANCE LAW.

In witness whereof, FINANCIAL SECURITY ASSURANCE INC. has caused this Policy to be executed on its behalf by its Authorized Officer.

[Countersignature]

FINANCIAL SECURITY ASSURANCE INC.

By \_\_\_\_\_

By \_\_\_\_\_  
Authorized Officer

A subsidiary of Financial Security Assurance Holdings Ltd.  
350 Park Avenue, New York, N.Y. 10022-6022

(212) 826-0100

Form 500NY (5/90)

**FINANCIAL GUARANTY INSURANCE POLICY**

**MBIA Insurance Corporation  
Armonk, New York 10504**

Policy No. [NUMBER]

MBIA Insurance Corporation (the "Insurer"), in consideration of the payment of the premium and subject to the terms of this policy, hereby unconditionally and irrevocably guarantees to any owner, as hereinafter defined, of the following described obligations, the full and complete payment required to be made by or on behalf of the Issuer to [PAYING AGENT/TRUSTEE] or its successor (the "Paying Agent") of an amount equal to (i) the principal of (either at the stated maturity or by any advancement of maturity pursuant to a mandatory sinking fund payment) and interest on, the Obligations (as that term is defined below) as such payments shall become due but shall not be so paid (except that in the event of any acceleration of the due date of such principal by reason of mandatory or optional redemption or acceleration resulting from default or otherwise, other than any advancement of maturity pursuant to a mandatory sinking fund payment, the payments guaranteed hereby shall be made in such amounts and at such times as such payments of principal would have been due had there not been any such acceleration, unless the Insurer elects, in its sole discretion, to pay in whole or in part any principal due by reason of such acceleration); and (ii) the reimbursement of any such payment which is subsequently recovered from any owner pursuant to a final judgment by a court of competent jurisdiction that such payment constitutes an avoidable preference to such owner within the meaning of any applicable bankruptcy law. The amounts referred to in clauses (i) and (ii) of the preceding sentence shall be referred to herein collectively as the "Insured Amounts." "Obligations" shall mean:

**[PAR]  
[LEGAL NAME OF ISSUE]**

Upon receipt of telephonic or telegraphic notice, such notice subsequently confirmed in writing by registered or certified mail, or upon receipt of written notice by registered or certified mail, by the Insurer from the Paying Agent or any owner of an Obligation the payment of an Insured Amount for which is then due, that such required payment has not been made, the Insurer on the due date of such payment or within one business day after receipt of notice of such nonpayment, whichever is later, will make a deposit of funds, in an account with U.S. Bank Trust National Association, in New York, New York, or its successor, sufficient for the payment of any such Insured Amounts which are then due. Upon presentment and surrender of such Obligations or presentment of such other proof of ownership of the Obligations, together with any appropriate instruments of assignment to evidence the assignment of the Insured Amounts due on the Obligations as are paid by the Insurer, and appropriate instruments to effect the appointment of the Insurer as agent for such owners of the Obligations in any legal proceeding related to payment of Insured Amounts on the Obligations, such instruments being in a form satisfactory to U.S. Bank Trust National Association, U.S. Bank Trust National Association shall disburse to such owners, or the Paying Agent payment of the Insured Amounts due on such Obligations, less any amount held by the Paying Agent for the payment of such Insured Amounts and legally available therefor. This policy does not insure against loss of any prepayment premium which may at any time be payable with respect to any Obligation.

As used herein, the term "owner" shall mean the registered owner of any Obligation as indicated in the books maintained by the Paying Agent, the Issuer, or any designee of the Issuer for such purpose. The term owner shall not include the Issuer or any party whose agreement with the Issuer constitutes the underlying security for the Obligations.

Any service of process on the Insurer may be made to the Insurer at its offices located at 113 King Street, Armonk, New York 10504 and such service of process shall be valid and binding.

This policy is non-cancellable for any reason. The premium on this policy is not refundable for any reason including the payment prior to maturity of the Obligations.

IN WITNESS WHEREOF, the Insurer has caused this policy to be executed in facsimile on its behalf by its duly authorized officers, this [DAY] day of [MONTH, YEAR].

**COUNTERSIGNED:**

\_\_\_\_\_  
Resident Licensed Agent

\_\_\_\_\_  
City, State

STD-RCS-7  
01/05

**MBIA Insurance Corporation**

\_\_\_\_\_  
resident

Attest:

\_\_\_\_\_  
Assistant Secretary



1221 Avenue of the Americas  
New York, New York 10020  
Telephone: (212) 478-3400

## MUNICIPAL BOND INSURANCE POLICY

ISSUER: [            ]

Policy No: [            ]

BONDS: [            ]

Effective Date: [            ]

**XL Capital Assurance Inc. (XLCA)**, a New York stock insurance company, in consideration of the payment of the premium and subject to the terms of this Policy (which includes each endorsement attached hereto), hereby agrees unconditionally and irrevocably to pay to the trustee (the "Trustee") or the paying agent (the "Paying Agent") (as set forth in the documentation providing for the issuance of and securing the Bonds) for the benefit of the Owners of the Bonds or, at the election of XLCA, to each Owner, that portion of the principal and interest on the Bonds that shall become Due for Payment but shall be unpaid by reason of Nonpayment.

XLCA will pay such amounts to or for the benefit of the Owners on the later of the day on which such principal and interest becomes Due for Payment or one (1) Business Day following the Business Day on which XLCA shall have received Notice of Nonpayment (provided that Notice will be deemed received on a given Business Day if it is received prior to 10:00 a.m. New York time on such Business Day; otherwise it will be deemed received on the next Business Day), but only upon receipt by XLCA, in a form reasonably satisfactory to it, of (a) evidence of the Owner's right to receive payment of the principal or interest then Due for Payment and (b) evidence, including any appropriate instruments of assignment, that all of the Owner's rights with respect to payment of such principal or interest that is Due for Payment shall thereupon vest in XLCA. Upon such disbursement, XLCA shall become the owner of the Bond, any appurtenant coupon to the Bond or the right to receipt of payment of principal and interest on the Bond and shall be fully subrogated to the rights of the Owner, including the Owner's right to receive payments under the Bond, to the extent of any payment by XLCA hereunder. Payment by XLCA to the Trustee or Paying Agent for the benefit of the Owners shall, to the extent thereof, discharge the obligation of XLCA under this Policy.

In the event the Trustee or Paying Agent has notice that any payment of principal or interest on a Bond which has become Due for Payment and which is made to an Owner by or on behalf of the Issuer of the Bonds has been recovered from the Owner pursuant to a final judgment by a court of competent jurisdiction that such payment constitutes an avoidable preference to such Owner within the meaning of any applicable bankruptcy law, such Owner will be entitled to payment from XLCA to the extent of such recovery if sufficient funds are not otherwise available.

The following terms shall have the meanings specified for all purposes of this Policy, except to the extent such terms are expressly modified by an endorsement to this Policy. "Business Day" means any day other than (a) a Saturday or Sunday or (b) a day on which banking institutions in the State of New York or the Insurer's Fiscal Agent are authorized or required by law or executive order to remain closed. "Due for Payment", when referring to the principal of Bonds, is when the stated maturity date or a mandatory redemption date for the application of a required sinking fund installment has been reached and does not refer to any earlier date on which payment is due by reason of call for redemption (other than by application of required sinking fund installments), acceleration or other advancement of maturity, unless XLCA shall elect, in its sole discretion, to pay such principal due upon such acceleration; and, when referring to interest on the Bonds, is when the stated date for payment of interest has been reached. "Nonpayment" means the failure of the Issuer to have provided sufficient funds to the Trustee or Paying Agent for payment in full of all principal and interest on the Bonds which are Due for Payment. "Notice" means telephonic or telecopied notice, subsequently confirmed in a signed writing, or written notice by registered or certified mail, from an Owner, the Trustee or the Paying Agent to XLCA which notice shall specify (a) the person or entity making the claim, (b) the Policy Number, (c) the claimed amount and (d) the date such claimed amount became Due for Payment. "Owner" means, in respect of a Bond, the person or entity who, at the time of Nonpayment, is entitled under the terms of such Bond to payment thereof, except that "Owner" shall not include the Issuer or any person or entity whose direct or indirect obligation constitutes the underlying security for the Bonds.

XLCA may, by giving written notice to the Trustee and the Paying Agent, appoint a fiscal agent (the "Insurer's Fiscal Agent") for purposes of this Policy. From and after the date of receipt by the Trustee and the Paying Agent of such notice, which shall specify the name and notice address of the Insurer's Fiscal Agent, (a) copies of all notices required to be delivered to XLCA pursuant to this Policy shall be simultaneously delivered to the Insurer's Fiscal Agent and to XLCA and shall not be deemed received until received by both and (b) all payments required to be made by XLCA under this Policy may be made directly by XLCA or by the Insurer's Fiscal Agent on behalf of XLCA. The Insurer's Fiscal Agent is the agent of XLCA only and the Insurer's Fiscal Agent shall in no event be liable to any Owner for any act of the Insurer's Fiscal Agent or any failure of XLCA to deposit or cause to be deposited sufficient funds to make payments due hereunder.

Except to the extent expressly modified by an endorsement hereto, (a) this Policy is non-cancelable by XLCA, and (b) the Premium on this Policy is not refundable for any reason. This Policy does not insure against loss of any prepayment or other acceleration payment which at any time may become due in respect of any Bond, other than at the sole option of XLCA, nor against any risk other than Nonpayment. This Policy sets forth the full undertaking of XLCA and shall not be modified, altered or affected by any other agreement or instrument, including any modification or amendment thereto.

THIS POLICY IS NOT COVERED BY THE PROPERTY/CASUALTY INSURANCE SECURITY FUND SPECIFIED IN ARTICLE 76 OF THE NEW YORK INSURANCE LAW.

In witness whereof, XLCA has caused this Policy to be executed on its behalf by its duly authorized officers.

\_\_\_\_\_  
Name:  
Title:

\_\_\_\_\_  
Name:  
Title: