

\$557,410,000
PUERTO RICO ELECTRIC POWER AUTHORITY
Power Revenue Refunding Bonds, Series VV

The Power Revenue Refunding Bonds, Series VV (the “Bonds”) of the 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 July 1, 2007 and on each January 1 and July 1 thereafter.
- The Bonds are not subject to redemption prior to their maturity.
- 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 Financial Guaranty Insurance Company, Financial Security Assurance, Inc. or MBIA Insurance Corporation, 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 May 30, 2007.
- The issuance of the Bonds and the purchase of the Bonds by the underwriters of the Bonds (the “Underwriters”) are subject to the approval of legality by Squire, Sanders & Dempsey L.L.P. (“Bond Counsel”), and certain other conditions. Adsuar Muñoz Goyco Seda & Pérez-Ochoa, P.S.C., 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.

UBS Investment Bank
Banc of America Securities LLC
Goldman, Sachs & Co.
Morgan Stanley
Samuel A. Ramírez & Co.

BBVAPR MSD
Lehman Brothers
Popular Securities
Santander Securities

JPMorgan
Citigroup
Merrill Lynch & Co.
RBC Capital Markets
Wachovia Bank, National Association

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Puerto Rico Electric Power Authority

Power Revenue Refunding Bonds, Series VV

<u>Maturity (July 1)</u>	<u>Principal Amount</u>	<u>Interest Rate</u>	<u>Yield</u>
2020	\$19,210,000	5.500%	4.190%
2024 [❖]	27,265,000	5.250	4.150
2025+	28,695,000	5.250	4.180
2026+	30,200,000	5.250	4.190
2027 ^{❖❖}	31,785,000	5.250	4.200
2029+	68,715,000	5.250	4.230
2030 [❖]	72,365,000	5.250	4.240
2031 ^{❖❖}	76,205,000	5.250	4.250
2032 [❖]	80,255,000	5.250	4.260
2033 [❖]	38,780,000	5.250	4.270
2034 [❖]	40,870,000	5.250	4.280
2035 [❖]	43,065,000	5.250	4.280

❖ Insured by FGIC

❖❖ Insured by FSA

+ Insured by MBIA

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 Financial Guaranty Insurance Company ("FGIC"), Financial Security Assurance, Inc. ("FSA") and MBIA Insurance Corporation ("MBIA") contained under the heading "Bond Insurance" of this Official Statement, none of the information in this Official Statement has been supplied or verified by FGIC, FSA or MBIA. FGIC, FSA and MBIA 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.

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INTRODUCTORY STATEMENT

The purpose of this Official Statement of the Puerto Rico Electric Power Authority (the “Authority”) is to furnish information in connection with the issuance and sale by the Authority of its Power Revenue Refunding Bonds, Series VV (the “Bonds”).

This Official Statement includes the Authority’s Official Statement, dated April 19, 2007, relating to the Authority’s \$643,530,000 aggregate principal amount of Power Revenue Bonds, Series TT and \$1,300,035,000 aggregate principal amount of Power Revenue Refunding Bonds, Series UU, which is attached hereto as Appendix A. Any and all information in the Authority’s Official Statement attached as Appendix A which is not specifically updated or changed herein is the most current information available and shall apply fully to 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 Bonds maturing on July 1 of the years 2024, 2030 and 2032 through 2035, inclusive, as shown on the inside cover page of this Official Statement (the “FGIC Insured Bonds”), when due, will be insured by a municipal bond new issue 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 Bonds maturing on July 1 of the years 2027 and 2031, as shown on the inside cover 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 Bonds maturing on July 1 of the years 2025, 2026 and 2029, 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.

RECENT DEVELOPMENTS

On Wednesday, May 23, 2007, the Electrical Industry and Irrigation Workers Union authorized its leadership to declare a strike, if the union leadership determines a strike is in the interest of the union as part of its collective bargaining negotiations. The Authority believes that the approval of an authorization to strike is not necessarily indicative that a strike will occur, as these authorizations are frequently obtained in the context of collective bargaining negotiations. Even if a strike should occur, the Authority believes that its operations and security contingency plans are adequate to maintain service and that a strike will not materially affect its financial performance or ability to pay the Bonds.

PLAN OF FINANCING

Bonds

The Authority is issuing the Bonds pursuant to Section 210 of the 1974 Agreement to provide funds, together with other available moneys, 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, or pay such Refunded Bonds at maturity as follows:

<u>Refunded Bonds</u>	<u>Maturity Date</u>	<u>Principal Amount to be Refunded</u>	<u>Interest Rate</u>	<u>Redemption Date</u>	<u>Redemption Price</u>
Series DD	07/01/2011	\$ 9,050,000 ⁽¹⁾	5.000%	07/01/2008	101.50%
	07/01/2012	9,500,000 ⁽²⁾	5.000	07/01/2008	101.50
	07/01/2020 ⁽³⁾	21,220,000	5.000	07/01/2008	101.50
Series NN	07/01/2024	29,280,000	5.125	07/01/2013	100.00
	07/01/2029 ⁽⁴⁾	134,740,000	5.125	07/01/2013	100.00
	07/01/2032 ⁽⁵⁾	124,570,000	5.000	07/01/2013	100.00
Series RR	07/01/2029	33,430,000	5.000	07/01/2015	100.00
	07/01/2030	35,145,000	5.000	07/01/2015	100.00
	07/01/2035 ⁽⁶⁾	204,680,000	5.000	07/01/2015	100.00

⁽¹⁾ Represents a portion of the \$13,760,000 principal amount maturing July 1, 2011.

⁽²⁾ Represents a portion of the \$14,450,000 principal amount maturing July 1, 2012.

⁽³⁾ Represents the Amortization Requirement due July 1, 2020 of the \$234,000,000 term bond maturing July 1, 2028.

⁽⁴⁾ Represents the Amortization Requirements due July 1 of the years 2025, 2026, 2027 and 2029 of the \$170,495,000 term bond maturing July 1, 2029.

⁽⁵⁾ Represents the Amortization Requirements due July 1 of the years 2030 through 2032, inclusive, of the \$124,570,000 term bond maturing July 1, 2032.

⁽⁶⁾ Represents the Amortization Requirements due July 1 of the years 2031 through 2035, inclusive, of the \$204,680,000 term bond maturing July 1, 2035.

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 Bonds with the 1974 Trustee, as escrow agent, under the terms of an escrow deposit agreement. The net proceeds of the 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, as applicable.

Upon the deposit with the 1974 Trustee referred to above, the Refunded Bonds will, in the opinion of Squire, Sanders & Dempsey L.L.P. (“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 Causey Demgen & Moore, 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

Sources:

Principal amount of the Bonds.....	\$557,410,000.00
Net original issue premium.....	82,016,511.80
Other available moneys ⁽¹⁾	<u>12,619,072.92</u>
Total Sources.....	<u>\$652,045,584.72</u>

Uses:

Deposit to Escrow Fund for the Refunded Bonds.....	\$637,315,730.38
Underwriting discount, municipal bond insurance premiums, and estimated legal, printing and other financing expenses.....	<u>14,729,854.34</u>
Total Uses.....	<u>\$652,045,584.72</u>

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

SECURITY

Reserve Account

As of December 31, 2006, approximately \$267 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 \$261.1 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 refunding of the Refunded Bonds. The Authority will transfer the excess amount to the Bond Service Account of the 1974 Sinking Fund.

Additional Bonds

Under the earnings coverage tests of the 1974 Agreement, Net Revenues for the twelve months ended November 30, 2006 of \$712.7 million were 158% of the maximum aggregate annual Principal and Interest Requirements of \$451.5 million on all outstanding Power Revenue Bonds. Estimated average annual Net Revenues for the five fiscal years ending June 30, 2012 of \$752.7 million would be 167% of the maximum aggregate annual Principal and Interest Requirements of \$451.5 million on all outstanding Power Revenue Bonds (including the Bonds, but excluding the Refunded Bonds).

BOND INSURANCE

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 of the Bonds (the "Underwriters") as to the accuracy or completeness of the information.

Payments Under the Policy

Concurrently with the issuance of the FGIC Insured Bonds, FGIC will issue its Municipal Bond New Issue 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 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 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, nonappealable order of a court having competent jurisdiction.

Once issued, the FGIC Policy is non-cancellable 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. In the event that payment of the FGIC Insured Bonds is accelerated, FGIC will only be obligated to pay principal (or accreted value, if applicable) and interest in the originally scheduled amounts on the originally scheduled 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 accelerated value, if applicable) or interest caused by the insolvency or negligence or any other act or omission of the trustee or paying agent, if any.

As a condition of its commitment to insure FGIC Insured Bonds, FGIC may be granted certain rights under the FGIC Insured Bond documentation. 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 should be 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

FGIC is a New York stock insurance corporation that writes financial guaranty insurance in respect of public finance and structured finance obligations and other financial obligations, including credit default swaps. FGIC is licensed to engage in the financial guaranty insurance business in all 50 states, the District of Columbia, the Commonwealth of Puerto Rico, the U.S. Virgin Islands and the United Kingdom.

FGIC is a direct, wholly owned subsidiary of FGIC Corporation, a Delaware corporation. At March 31, 2007, the principal owners of FGIC Corporation and the approximate percentage of its outstanding common stock owned by each were as follows: The PMI Group, Inc. – 42%; affiliates of the Blackstone Group L.P. – 23%; and affiliates of the Cypress Group L.L.C. – 23%. Neither FGIC Corporation nor any of its stockholders or affiliates 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 FGIC is domiciled, including New York's comprehensive financial guaranty insurance law. That law, among other things, limits the business of each financial guaranty insurer to financial guaranty insurance (and related lines); requires that each financial guaranty insurer maintain a minimum surplus to policyholders; establishes limits on the aggregate net amount of exposure that may be retained in respect of a particular issuer or revenue source (known as single risk limits) and on the aggregate net amount of exposure that may be retained in respect of particular types of risk as compared to the policyholders' surplus (known as aggregate risk limits); and establishes contingency, loss and unearned premium reserve requirements. In addition, FGIC is also subject to the applicable insurance laws and regulations of all other jurisdictions in which it is licensed to transact 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.

At March 31, 2007, FGIC had net admitted assets of approximately \$3.947 billion, total liabilities of approximately \$2.828 billion, and total capital and policyholders' surplus of approximately \$1.119 billion, determined in accordance with statutory accounting practices ("SAP") prescribed or permitted by insurance regulatory authorities.

The unaudited financial statements as of March 31, 2007, and the audited consolidated financial statements of FGIC and subsidiaries, on the basis of U.S. generally accepted accounting principles ("GAAP"), as of December 31, 2006 and December 31, 2005, which have been filed with the Nationally Recognized Municipal Securities Information Repositories ("NRMSIRs"), are hereby included by specific reference in this Official Statement. Any statement contained herein under the heading "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 FGIC with the NRMSIRs subsequent to the date of this Official Statement and prior to the termination of the offering of the FGIC Insured 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.

The New York State Insurance Department recognizes only SAP for determining and reporting the financial condition and results of operations of an insurance company, for determining its solvency under the New York Insurance Law, and for determining whether its financial condition warrants the payment of a dividend to its stockholders. Although FGIC prepares both GAAP and SAP financial statements, no consideration is given by the New York State Insurance Department to financial statements prepared in accordance with GAAP in making such determinations. A discussion of the principal differences between SAP and GAAP is contained in the notes to FGIC's audited SAP financial statements.

Copies of FGIC's most recently published GAAP and SAP financial statements are available upon request to: Financial Guaranty Insurance Company, 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 the heading "BOND INSURANCE." In addition, FGIC makes no representation regarding the Bonds or the advisability of investing in the FGIC Insured Bonds.

The FSA Bond Insurance Policy

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

Concurrently with the issuance of the FSA Insured 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 on the FSA Insured Bonds when due as set forth in the form of the FSA Policy included as an exhibit to this Official Statement.

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 March 31, 2007, FSA's combined policyholders' surplus and contingency reserves were approximately \$2,601,527,000 and its total net unearned premium reserve was approximately \$2,089,989,000 in accordance with statutory accounting principles. At March 31, 2007, FSA's consolidated shareholder's equity was approximately \$2,753,483,000 and its total net unearned premium reserve was approximately \$1,649,524,000 in accordance with generally accepted accounting principles.

The consolidated financial statements of FSA included in, or as exhibits to, the annual and quarterly reports filed after December 31, 2005 by Holdings with the Securities and Exchange Commission are hereby incorporated by reference into this Official Statement. All financial statements of FSA included in, or as exhibits to, documents filed by Holdings pursuant to Section 13(a), 13(c), 14 or 15(d) of the Securities Exchange Act of 1934 after the date of this Official Statement and before the termination of the offering of the FSA Insured Bonds shall be deemed incorporated by reference into this Official Statement. Copies of materials incorporated by reference will be provided upon request to Financial Security Assurance Inc.: 31 West 52nd Street, New York, New York 10019, Attention: Communications Department. FSA's telephone number is (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 the Official Statement, nor has it participated in the preparation thereof, except that FSA has provided to the Authority the information presented under this caption for inclusion in the Official Statement.

The MBIA Bond Insurance Policy

The following information has been furnished by MBIA 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.

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 bond insurance policy for the MBIA Insured Bonds (the "MBIA Policy") and MBIA set forth under the heading "Bond Insurance". Additionally, MBIA makes no representation regarding the MBIA Insured Bonds or the advisability of investing in the MBIA Insured Bonds.

The MBIA 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 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").

MBIA's Policy does not insure against loss of any prepayment premium which may at any time be payable with respect to any MBIA Insured Bonds. MBIA's 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. MBIA's 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 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 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 Insurance Corporation

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, either directly or through subsidiaries, is licensed to do business in the Republic of France, the United Kingdom and the Kingdom of Spain and is subject to regulation under the laws of those jurisdictions.

The principal executive offices of MBIA are located at 113 King Street, Armonk, New York 10504 and the main telephone number at that address is (914) 273-4545.

Regulation

As a financial guaranty insurance company licensed to do business in the State of New York, MBIA is subject to the New York Insurance Law which, among other things, prescribes minimum capital requirements and contingency reserves against liabilities for MBIA, limits the classes and concentrations of investments that are made by MBIA and requires the approval of policy rates and forms that are employed by MBIA. State law also regulates the amount of both the aggregate and individual risks that may be insured by MBIA, the payment of dividends by MBIA, changes in control with respect to MBIA and transactions among MBIA and its affiliates.

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

Financial Strength Ratings of MBIA

Moody's Investors Service, Inc. rates the financial strength of MBIA “Aaa.”

Standard & Poor's, 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.

MBIA Financial Information

As of December 31, 2006, MBIA had admitted assets of \$10.9 billion (audited), total liabilities of \$6.9 billion (audited), and total capital and surplus of \$4.0 billion (audited) determined in accordance with statutory accounting practices prescribed or permitted by insurance regulatory authorities. As of March 31, 2007, MBIA had admitted assets of \$11.2 billion (unaudited), total liabilities of \$7.0 billion (unaudited), and

total capital and surplus of \$4.2 billion (unaudited) determined in accordance with statutory accounting practices prescribed or permitted by insurance regulatory authorities.

For further information concerning MBIA, see the consolidated financial statements of MBIA and its subsidiaries as of December 31, 2006 and December 31, 2005 and for each of the three years in the period ended December 31, 2006, prepared in accordance with generally accepted accounting principles, included in the Annual Report on Form 10-K of the Company for the year ended December 31, 2006 and the consolidated financial statements of MBIA and its subsidiaries as of March 31, 2007 and for the three month period ended March 31, 2007 and March 31, 2006 included in the Quarterly Report on Form 10-Q of the Company for the quarter ended March 31, 2007, which are hereby incorporated by reference into this Official Statement and shall be deemed to be a part hereof.

Copies of the statutory financial statements filed by MBIA with the State of New York Insurance Department are available over the Internet at the Company's web site at <http://www.mbia.com> and at no cost, upon request to MBIA at its principal executive offices.

Incorporation of Certain Documents by Reference

The following documents filed by MBIA with the Securities and Exchange Commission (the "SEC") are incorporated by reference into this Official Statement:

- (1) MBIA's Annual Report on Form 10-K for the year ended December 31, 2006; and
- (2) MBIA's Quarterly Report on Form 10-Q for the quarter ended March 31, 2007.

Any documents, including any financial statements of MBIA and its subsidiaries that are included therein or attached as exhibits thereto, filed by MBIA pursuant to Sections 13(a), 13(c), 14 or 15(d) of the Exchange Act after the date of MBIA's most recent Quarterly Report on Form 10-Q or Annual Report on Form 10-K, and prior to the termination of the offering of MBIA Insured Bonds offered hereby shall be deemed to be incorporated by reference in this Official Statement and to be a part hereof from the respective dates of filing such documents. 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.

MBIA files annual, quarterly and special reports, information statements and other information with the SEC under File No. 1-9583. Copies of MBIA's SEC filings (including (1) MBIA's Annual Report on Form 10-K for the year ended December 31, 2006, and (2) MBIA's Quarterly Report on Form 10-Q for the quarter ended March 31, 2007) 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 MBIA's web site at <http://www.mbia.com>; and (iv) at no cost, upon request to MBIA at its principal executive offices.

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 FGIC, FSA and MBIA concurrently with the delivery of their respective municipal bond insurance policies, as long as FGIC, FSA and MBIA shall not be in default on their respective obligations under the municipal bond insurance policies, FGIC, FSA and MBIA 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 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 to Appendix A, *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 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 July 1 and January 1, commencing on July 1, 2007.

Redemption

The Bonds are not subject to redemption prior to their stated maturity.

THE SYSTEM

Projected Five-Year Capital Improvement and Financing Program

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 and projected financing of the same for the five fiscal years ending June 30, 2011.

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

	Years Ending June 30					Total
	2007	2008	2009	2010	2011	
Capital Improvements						
Production plant.....	\$291,200	\$242,811	\$208,620	\$130,787	\$107,970	\$981,388
Transmission.....	97,749	109,316	95,033	110,958	77,804	490,860
Distribution.....	84,076	81,445	78,030	79,733	78,215	401,499
Other ⁽¹⁾	58,468	52,694	51,860	80,884	70,302	314,208
Total.....	\$531,493	\$486,266	\$433,543	\$402,362	\$334,291	\$2,187,955
Financing Sources						
Internal Funds.....	57,229	134,287	121,235	111,240	96,525	507,516
Borrowed Funds ⁽²⁾	474,264	351,979	312,308	291,122	237,766	1,667,439
Total.....	\$531,493	\$486,266	\$433,543	\$402,362	\$334,291	\$2,187,955

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

(2) For the purpose of this table, it is assumed that of the total \$1.7 billion Power Revenue Bonds expected to be issued in the five-year period ending June 30, 2011, \$875.0 million is expected to be used to repay lines of credit with private banks anticipated to be drawn during this period.

DEBT

The following table sets forth the bonds and notes of the Authority outstanding as of May 3, 2007, and as adjusted for the issuance of the Bonds, and the refunding of the Refunded Bonds as of May 30, 2007.

	<u>Outstanding as of May 3, 2007</u>	<u>As adjusted⁽¹⁾ as of May 30, 2007</u>
Power Revenue Bonds	(in thousands)	
Publicly Offered	\$5,711,470	\$5,667,265
Rural Electrification.....	<u>28,175</u>	<u>28,175</u>
Sub-total.....	5,739,645	5,695,440
Notes.....	729,061	719,061
Government Development		
Bank lines of credit	<u>44,467</u>	<u>44,467</u>
Total.....	<u>\$6,513,173</u>	<u>\$ 6,458,968</u>

(1) As adjusted for the issuance of the Bonds and the refunding of the Refunded Bonds.

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 refunding of the Refunded Bonds. The Amortization Requirements are subject to adjustment as provided in the definition

thereof. See Appendix I to Appendix A, *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 ⁽¹⁾	The Bonds			Total Debt Service Requirements ⁽²⁾
		Maturity and Amortization Requirements	Interest	Total	
2007	\$449,018,649.14		\$ 2,524,093.19	\$ 2,524,093.19	\$ 451,542,742.33
2008	414,317,639.35		29,312,050.00	29,312,050.00	443,629,689.35
2009	405,729,807.28		29,312,050.00	29,312,050.00	435,041,857.28
2010	394,588,476.02		29,312,050.00	29,312,050.00	423,900,526.02
2011	382,147,238.52		29,312,050.00	29,312,050.00	411,459,288.52
2012	385,317,914.76		29,312,050.00	29,312,050.00	414,629,964.76
2013	399,705,642.26		29,312,050.00	29,312,050.00	429,017,692.26
2014	399,362,971.00		29,312,050.00	29,312,050.00	428,675,021.00
2015	384,110,499.76		29,312,050.00	29,312,050.00	413,422,549.76
2016	379,098,899.76		29,312,050.00	29,312,050.00	408,410,949.76
2017	393,716,217.24		29,312,050.00	29,312,050.00	423,028,267.24
2018	345,863,049.96		29,312,050.00	29,312,050.00	375,175,099.96
2019	344,764,889.96		29,312,050.00	29,312,050.00	374,076,939.96
2020	342,259,459.96	\$ 19,210,000.00	29,312,050.00	48,522,050.00	390,781,509.96
2021	364,510,231.76		28,255,500.00	28,255,500.00	392,765,731.76
2022	342,813,793.00		28,255,500.00	28,255,500.00	371,069,293.00
2023	342,552,268.14		28,255,500.00	28,255,500.00	370,807,768.14
2024	293,188,004.14	27,265,000.00	28,255,500.00	55,520,500.00	348,708,504.14
2025	266,814,577.34	28,695,000.00	26,824,087.50	55,519,087.50	322,333,664.84
2026	244,022,609.34	30,200,000.00	25,317,600.00	55,517,600.00	299,540,209.34
2027	244,053,856.90	31,785,000.00	23,732,100.00	55,517,100.00	299,570,956.90
2028	247,689,693.82		22,063,387.50	22,063,387.50	269,753,081.32
2029	143,070,632.50	68,715,000.00	22,063,387.50	90,778,387.50	233,849,020.00
2030	142,966,296.62	72,365,000.00	18,455,850.00	90,820,850.00	233,787,146.62
2031	100,608,841.22	76,205,000.00	14,656,687.50	90,861,687.50	191,470,528.72
2032	52,332,387.50	80,255,000.00	10,655,925.00	90,910,925.00	143,243,312.50
2033	98,075,887.50	38,780,000.00	6,442,537.50	45,222,537.50	143,298,425.00
2034	50,158,000.00	40,870,000.00	4,406,587.50	45,276,587.50	95,434,587.50
2035	50,159,750.00	43,065,000.00	2,260,912.50	45,325,912.50	95,485,662.50
2036	50,158,250.00			0.00	50,158,250.00
2037	<u>50,158,500.00</u>			0.00	<u>50,158,500.00</u>
Total	<u>\$ 8,503,334,934.75</u>	<u>\$557,410,000.00</u>	<u>\$673,481,805.69</u>	<u>\$1,230,891,805.69</u>	<u>\$9,734,226,740.44</u>

- (1) Debt service requirement on all Power Revenue Bonds outstanding on May 30, 2007, including Rural Electrification Bonds, prior to giving effect to the issuance of the Bonds and after giving effect to the refunding of the Refunded Bonds.
- (2) Debt service requirement on all Power Revenue Bonds outstanding on May 30, 2007, including Rural Electrification Bonds, after giving effect to the issuance of the Bonds and to the refunding of the Refunded Bonds.

NET REVENUES AND COVERAGE

Projected Net Revenues

The following table presents the Authority's estimates of Net Revenues for the five fiscal years ending June 30, 2011, 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				
	2007 ⁽¹⁾	2008	2009	2010	2011
Average number of clients	1,455,164	1,472,492	1,482,211	1,491,083	1,501,704
Electric energy sales (in millions of kWh).....	20,749.3	21,113.1	21,645.5	22,202.2	22,796.8
Authority generation (gross)(in millions of KWh)	18,802.0	19,388.5	19,906.5	20,559.7	21,315.6
Purchased generation (gross)(in millions of KWh)	6,138.0	5,994.0	6,116.0	6,132.0	6,091.0
Sources of Net Revenues					
Revenues:					
Sales of electric energy:					
Residential	\$1,306,965	\$1,332,023	\$1,295,130	\$1,251,747	\$1,244,922
Commercial	1,713,602	1,765,622	1,754,359	1,733,165	1,756,159
Industrial.....	659,857	671,090	656,484	637,916	638,240
Other.....	105,701	107,502	104,137	100,771	99,264
	<u>3,786,125</u>	<u>3,876,237</u>	<u>3,810,110</u>	<u>3,723,599</u>	<u>3,738,585</u>
Revenues from Commonwealth for					
Rural Electrification	76	26	19	-	-
Other Operating Revenues	6,323	-	-	-	-
Other (principally interests earned).....	26,350	29,832	31,832	33,832	35,832
	<u>3,818,874</u>	<u>3,906,095</u>	<u>3,841,961</u>	<u>3,757,431</u>	<u>3,774,417</u>
Current Expenses ⁽²⁾ :					
Operations:					
Fuel	1,650,538	1,668,755	1,577,881	1,475,500	1,464,372
Purchased Power	664,220	712,572	717,176	713,655	707,383
Other Production	56,310	54,970	55,896	57,127	58,349
Transmission and Distribution	149,685	141,706	144,092	147,265	150,415
Client accounting and collection.....	107,496	112,079	113,966	116,475	118,967
Administration and general	210,917	211,147	214,703	219,430	224,124
Maintenance	253,894	265,109	269,573	275,508	281,402
Other – Interest Charges.....	3,044	2,292	2,351	2,410	2,410
	<u>3,096,104</u>	<u>3,168,630</u>	<u>3,095,640</u>	<u>3,007,371</u>	<u>3,007,422</u>
Net Revenues.....	<u>\$722,770</u>	<u>\$737,465</u>	<u>\$746,321</u>	<u>\$750,060</u>	<u>\$766,995</u>
Coverage					
Principal and Interest Requirements ⁽³⁾	\$455,022	\$419,568	\$451,343	\$464,004	\$491,850
Ratio of Net Revenues to Principal and Interest Requirements	1.59	1.76	1.65	1.62	1.56

(1) Based on actual results for the six-month period ended December 31, 2006 and an estimate for the last six months of fiscal year 2007.

(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, and (ii) expected Power Revenue Bond issues, all at an assumed interest rate of 6%, of \$567 million in each of fiscal years 2008 and 2010 (no repayments of principal of these issues are assumed until after fiscal year 2009). Debt service requirement based on estimate as of June 2006. Actual principal and interest requirement will vary based on the actual principal and interest on the Bonds.

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, 2011, in accordance with the provisions of the 1974 Agreement.

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

Disposition of Net Revenues	Years Ending June 30				
	2007⁽¹⁾	2008	2009	2010	2011
1974 Sinking Fund:					
Interest.....	\$257,457	\$255,076	\$278,303	\$285,465	\$309,020
Principal	197,565	164,492	173,040	178,539	182,830
Interest on Notes	19,055	-	-	-	-
Capital Improvement Funds	<u>57,229</u>	<u>134,287</u>	<u>121,235</u>	<u>111,240</u>	<u>96,525</u>
Total	531,306	553,855	572,578	575,244	588,375
Contributions in lieu of taxes and other ⁽²⁾	<u>191,464</u>	<u>183,610</u>	<u>173,743</u>	<u>174,816</u>	<u>178,620</u>
Total Net Revenues.....	<u>\$722,770</u>	<u>\$737,465</u>	<u>\$746,321</u>	<u>\$750,060</u>	<u>\$766,995</u>

- (1) Based on actual results for the six-month period ended December 31, 2006 and an estimate for the last six months of fiscal year 2007.
(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: \$5.9 million, \$5.9 million, \$5.8 million, \$5.8 million and \$5.8 million for fiscal years ending June 30, 2007, 2008, 2009, 2010 and 2011, respectively. See "Subsidies, Contributions in Lieu of Taxes and Set Aside" under *The System* in Appendix A hereto.

TAX MATTERS

In the opinion of 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 income taxation. Bond Counsel will express no opinion as to any other tax consequences regarding the Bonds.

The opinion on tax matters will be based on and will assume the accuracy of certain representations and certifications, and continuing compliance with certain covenants, of the Authority 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 the Authority's certifications and representations or the continuing compliance with the Authority's covenants.

The opinion of Bond Counsel is based on current legal authority and covers certain matters not directly addressed by such authority. It represents Bond Counsel's legal judgment as to exclusion of interest on the Bonds from gross income for federal income tax purposes but is not a guaranty of that conclusion. The opinion is not binding on the Internal Revenue Service ("IRS") or any court. Bond Counsel expresses no opinion about (i) the effect of future changes in the Code and the applicable regulations under the Code or (ii) the interpretation and the enforcement of the Code or those regulations by the IRS.

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. Noncompliance with these requirements by the Authority may cause the loss of such status and result in the interest on the Bonds being included in gross income for federal income tax purposes retroactively to the date of issuance of the Bonds. The Authority 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. After the date of issuance of the Bonds, Bond Counsel will not undertake to determine (or to so inform any person) whether any actions taken or not taken, or any events occurring or not occurring, or any other matters coming to Bond Counsel's attention, may adversely affect the exclusion from gross income for federal income tax purposes of interest on the Bonds or the market prices of the Bonds. Bond Counsel is not aware of any provision of the Constitution or laws of the Commonwealth that would prevent the Authority 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.

Legislation affecting tax-exempt obligations is regularly considered by the United States Congress. There can be no assurance that legislation enacted or proposed, or clarification of the Code, after the date of issuance of the Bonds, will not have an adverse effect on the tax status of interest on the Bonds or the market prices of the Bonds.

Prospective purchasers of the Bonds should consult their own tax advisers regarding pending or proposed federal tax legislation, and prospective 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 also consult their own tax advisers regarding other tax considerations such as the consequences of market discount, as to all of which Bond Counsel expresses no opinion.

Bond Counsel's engagement with respect to the Bonds ends with the issuance of the Bonds, and, unless separately engaged, Bond Counsel is not obligated to defend the Authority or the beneficial owners regarding the tax status of interest on the Bonds in the event of an audit examination by the IRS. The IRS has a program to audit tax-exempt obligations to determine whether the interest thereon is includible in gross income for federal income tax purposes. If the IRS does audit the Bonds, under current IRS procedures, the IRS will treat the Authority as the taxpayer and the beneficial owners of the Bonds will have only limited rights, if any, to obtain and participate in judicial review of such audit. Any action of the IRS, including but not limited to selection of the Bonds for audit, or the course or result of such audit, or an audit of other obligations presenting similar tax issues, may affect the market prices for the Bonds.

Original Issue Premium

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

VERIFICATION OF MATHEMATICAL COMPUTATIONS

Causey Demgen & Moore, 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 \$2,904,512.28 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.

LEGAL MATTERS

The proposed form of opinion of Squire, Sanders & Dempsey L.L.P., Bond Counsel, is set forth in Appendix B to this Official Statement. Certain legal matters will be passed upon for the Underwriters by Adsuar Muñiz Goyco Seda & Pérez-Ochoa, P.S.C., San Juan, Puerto Rico.

RATINGS

The Bonds have been assigned ratings of “A3” by Moody’s Investors Service, “BBB+” by Standard & Poor’s, a division of The McGraw-Hill Companies, Inc. and “A” by Fitch Ratings. 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, S&P and Fitch have assigned ratings of “Aaa,” “AAA,” and “AAA,” respectively, to the FGIC Insured Bonds, the FSA Insured Bonds and the MBIA 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 any or all of such rating agencies, if in the judgment of any or all, circumstances so warrant. Any such downward revision or withdrawal of any 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, 45th Floor, New York, New York 10041; FT Interactive Data, Attn: NRMSIR, 100 William Street, 15th 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 to Appendix A, *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

This Official Statement includes as Appendix A the Authority's Official Statement dated April 19, 2007, relating to the Authority's \$643,530,000 aggregate principal amount of Power Revenue Bonds, Series TT and \$1,300,035,000 aggregate principal amount of Power Revenue Refunding Bonds, Series UU, as Appendix B the proposed form of opinion of Squire, Sanders & Dempsey L.L.P., Bond Counsel, as Appendix C a specimen of the FGIC Policy, as Appendix D a specimen of the FSA Policy, and as Appendix E a specimen of the MBIA Policy. This Official Statement will be filed with the repository established by the MSRB and each NRMSIR.

PUERTO RICO ELECTRIC POWER AUTHORITY

By: /s/ Jorge A. Rodríguez Ruiz
 Jorge A. Rodríguez Ruiz
 Executive Director

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**OFFICIAL STATEMENT DATED APRIL 19, 2007, RELATING TO THE AUTHORITY'S
\$643,530,000 AGGREGATE PRINCIPAL AMOUNT OF POWER REVENUE BONDS, SERIES TT
AND \$1,300,035,000 AGGREGATE PRINCIPAL AMOUNT OF POWER REVENUE REFUNDING
BONDS, SERIES UU.**

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\$1,943,565,000
PUERTO RICO ELECTRIC POWER AUTHORITY
\$643,530,000 Power Revenue Bonds, Series TT
\$1,300,035,000 Power Revenue Refunding Bonds, Series UU

The Power Revenue Bonds, Series TT (the “Series TT Bonds”) and the Power Revenue Refunding Bonds, Series UU (the “Series UU Bonds” and, together with the Series TT Bonds, the “Bonds”) of the 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 Fixed Rate Bonds will be payable on January 1, 2008 and on each July 1 and January 1 thereafter. Interest on the LIBOR Bonds and the Muni-BMS Bonds will be payable on July 1, 2007 and on each October 1, January 1, April 1 and July 1 thereafter.
- The Fixed Rate Bonds and the LIBOR Bonds will be subject to redemption, commencing on July 1, 2017, as described herein. The Muni-BMS Bonds are not subject to redemption.
- The inside cover page contains information concerning the maturity schedule, interest rates and yields of the Bonds.
- The Bonds will be issued as Fixed Rate Bonds, LIBOR Bonds and Muni-BMS Bonds. The interest rate on the Fixed Rate Bonds will be a fixed interest rate as set forth on the inside cover page of this Official Statement. The interest rate on the LIBOR Bonds will be equal to 67% of the Three-Month LIBOR Rate plus 0.68%, 0.52% and 0.70% per annum for the LIBOR Bonds maturing July 1 of the years 2025, 2029 and 2031, respectively, but will not be greater than the maximum rate permitted under Puerto Rico law (currently 12%), and will be reset quarterly. The interest rate on the Muni-BMS Bonds will be equal to 100% of the USD-SIFMA Swap Rate plus 0%, but will not be greater than the maximum rate permitted under Puerto Rico law (currently 12%), and will be reset quarterly.
- 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 Security Assurance Inc. or MBIA Insurance Corporation, 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 May 3, 2007.
- 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. Adsuar Muñoz Goyco Seda & Pérez-Ochoa, P.S.C., 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

UBS Investment Bank
Banc of America Securities LLC
Goldman, Sachs & Co.
Morgan Stanley
Samuel A. Ramírez & Co.

Wachovia Bank, National Association
BBVAPR MSD
Lehman Brothers
Popular Securities

Citigroup
Merrill Lynch & Co.
RBC Capital Markets
Santander Securities

\$1,943,565,000
Puerto Rico Electric Power Authority

\$643,530,000 Power Revenue Bonds, Series TT
Fixed Rate Bonds

<u>Maturity (July 1)</u>	<u>Principal Amount</u>	<u>Interest Rate</u>	<u>Yield</u>
2017	\$18,145,000	5.00%	4.140%
2018	19,050,000	5.00	4.180
2019	20,000,000	4.20	4.220
2020	20,840,000	5.00	4.250
2021	21,885,000	5.00	4.280
2022	22,980,000	5.00	4.300
2023	24,125,000	5.00	4.330
2024	25,335,000	5.00	4.350
2025	26,600,000	5.00	4.360
2026	27,930,000	5.00	4.370
2027	29,325,000	5.00	4.380
\$170,155,000 5.00% Series TT Term Bonds due July 1, 2032 - Yield 4.400%			
\$217,160,000 5.00% Series TT Term Bonds due July 1, 2037 - Yield 4.420%			

\$1,300,035,000 Power Revenue Refunding Bonds, Series UU
\$454,020,000.00 Fixed Rate Bonds

<u>Maturity (July 1)</u>	<u>Principal Amount</u>	<u>Interest Rate</u>	<u>Yield</u>
2010	\$1,885,000	4.00%	3.889%
2011	3,115,000	4.00	3.909
2012	3,280,000	4.00	3.898
2013	19,935,000	4.25	3.970
2014 ^{❖❖}	23,400,000	5.00	3.800
2014 ⁺	14,810,000	4.00	3.800
2015 ^{❖❖}	13,515,000	5.00	3.850
2015 ^{❖❖}	15,000,000	4.00	3.850
2016 ^{❖❖}	25,835,000	5.00	3.880
2018 ⁺	17,995,000	4.50	3.980
2018 ⁺	15,000,000	4.00	3.980
2019 ⁺	29,485,000	5.00	4.000
2020 ^{❖❖}	25,870,000	5.00	4.030
2021 ^{❖❖}	27,170,000	5.00	4.060
2022 ^{❖❖}	28,525,000	5.00	4.090
2023 ^{❖❖}	52,820,000	5.00	4.110
2023 ^{❖❖}	10,000,000	4.00	4.110
2024 ^{❖❖}	65,865,000	5.00	4.130
2026 [❖]	29,520,000	5.00	4.220
2027 [❖]	30,995,000	4.25	4.420

\$774,435,000 LIBOR Bonds, Series UU

\$184,870,000 LIBOR-Based Interest Rate Bonds Due July 1, 2025 – price 100% (L)
 \$252,875,000 LIBOR-Based Interest Rate Bonds Due July 1, 2029 – price 100% (L) ^{❖❖}
 \$336,690,000 LIBOR-Based Interest Rate Bonds Due July 1, 2031 – price 100% (L)

- (L) The LIBOR Bonds will bear interest from their date of delivery at a per annum rate for each period equal to (a) 67% of the Three-Month LIBOR Rate for such period plus (b) a per annum spread equal to 0.68%, 0.52% and 0.70% per annum for the LIBOR Bonds maturing July 1 of the years 2025, 2029 and 2031, respectively; provided that the LIBOR-Based Interest Rate will never exceed the maximum rate permitted under Puerto Rico law (currently 12%).

\$71,580,000 Muni-BMS Bonds, Series UU

\$25,525,000 Muni-BMS Interest Rate Bonds Due July 1, 2017 – price 100% (M)
 \$17,000,000 Muni-BMS Interest Rate Bonds Due July 1, 2018 – price 100% (M)
 \$29,055,000 Muni-BMS Interest Rate Bonds Due July 1, 2020 – price 100% (M)

- (M) The Muni-BMS Bonds will bear interest from their date of delivery at a per annum rate for each period equal to (a) 100 % of the USD-SIFMA Swap Rate plus 0%; provided that the Muni-BMS Interest Rate will never exceed the maximum rate permitted under Puerto Rico law (currently 12%).

❖ Insured by CIFG
 ❖❖ Insured by FSA
 + Insured by MBIA

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. ("CIFG"), Financial Security Assurance Inc. ("FSA") and MBIA Insurance Corporation ("MBIA") contained under the heading "Bond Insurance" of this Official Statement, none of the information in this Official Statement has been supplied or verified by CIFG, FSA or MBIA. CIFG, FSA and MBIA 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.

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\$1,943,565,000
Puerto Rico Electric Power Authority
\$643,530,000 Power Revenue Bonds, Series TT
\$1,300,035,000 Power Revenue Refunding Bonds, Series UU

INTRODUCTORY STATEMENT

The purpose of this Official Statement of the 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 TT (the “Series TT Bonds”), and its Power Revenue Refunding Bonds, Series UU (the “Series UU Bonds” and, together with the Series TT 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 UU Bonds maturing July 1, 2026 and July 1, 2027, as shown on the inside cover page of this Official Statement (the “CIFG Insured Bonds”), when due, will be insured by a municipal bond insurance policy to be issued by CDC IXIS Financial Guaranty North America, Inc. (“CIFG”) simultaneously with the delivery of the CIFG Insured Bonds.

Payment of the principal of and interest on the Series UU Bonds maturing July 1, 2014 through July 1, 2016, inclusive (except for the \$14,810,000 principal amount maturing July 1, 2014), 2020 through 2024 (except for the \$29,055,000 principal amount maturing July 1, 2020), inclusive, and 2029, 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 UU Bonds maturing July 1 of the years 2014, 2018 and 2019 (except for the \$23,400,000 principal amount maturing July 1, 2014 and \$17,000,000 principal amount maturing July 1, 2018), 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.

Capitalized terms used in this Official Statement and not defined shall have the meanings given to them in Appendix I, *Definitions of Certain Terms*, Appendix V *LIBOR Bonds and LIBOR-Based Interest Rate Definitions* and Appendix VI *Muni-BMS Bonds and Muni-BMS Interest Rate Definitions*.

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 (i) the Commonwealth’s Financial Information and Operating Data Report dated July 1, 2006 included as *Appendix I* to the Official Statement, dated August 2, 2006, relating to the offering of the Commonwealth’s Public Improvement Bonds of 2006, Series A and Public Improvement Refunding Bonds, Series 2006 B and (ii) the Comprehensive Annual Financial Report of the Commonwealth for the Fiscal Year ended June 30, 2005, prepared by the Department of the Treasury of Puerto Rico, which report includes the basic financial statements of the Commonwealth as of and for the Fiscal Year ended June 30, 2005, which have been audited by KPMG LLP, independent auditors, as stated in their report dated March 14, 2006, accompanying the financial statements. The Commonwealth’s Annual Financial Report was filed by the Commonwealth 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 December 29, 2006, one of the Authority’s four oil-fired generating units located at Palo Seco suffered damage from a fire. On December 30, 2006, another fire damaged the control room which controls all four units at Palo Seco. As a result, 602 MW of oil-fired capacity, representing 11% of the System’s installed dependable capacity, is not currently available.

On January 11, 2007, Standard & Poor’s (“S&P”) put the Authority on “Credit Watch Negative” as a result of the two accidental fires that damaged the Palo Seco generating station in December. S&P’s concern was that the temporary loss of Palo Seco would bring the Authority’s reserve capacity margin to an unacceptably low level. On February 23, 2007, S&P removed PREPA from “Credit Watch Negative” and restored the rating to BBB+ with a Stable outlook. The “Credit Watch Negative” was removed by S&P after the Authority provided additional information showing that despite the loss of the 602 MW Palo Seco station, the reserve margin was expected to exceed 27% of the projected yearly peak demand. Prior to the Palo Seco fires, the Authority’s reserve margin was 46%.

On March 29, 2007, Moody’s Investor Services affirmed A3 rating on the Authority and upgraded its outlook from Negative to Stable in recognition of general improvements in the Authority’s operation and finances. The Authority also engaged Fitch Ratings for the first time to rate the Authority and its upcoming transaction. On March 27, 2007, Fitch informed the Authority of its A- rating with Stable outlook.

The Authority anticipates that the two smaller units at Palo Seco, which each have 85 MW of capacity and can be operated independently of the control room, will be available by the end of 2007. The Authority believes that the control room, which is needed to operate the two larger 216 MW units, will be repaired by summer 2008. In addition, the Authority expects other units to come online this year, which will further mitigate the temporary loss of availability. The new units are four 50 MW gas-fired units located at Mayagüez (two of which are expected to come online by the end of 2007, and the other two by the middle of 2008), which replace four 21 MW units, as well as the repowered 464 MW steam-generating units of the San Juan Steam Plant (Units 5 and 6), which are expected to come online by the end of 2007.

The cost of repairing the Palo Seco units is estimated at around \$106 million and is expected to be covered by insurance. Insurance is also expected to cover higher fuel and other costs associated with the alternate generation capacity. In addition, the Authority has several funding sources, including self insurance

and reserve funds, which it can use for the payment of repairs pending payment of its claims by its insurance companies.

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, 2006, it served approximately 1.4 million clients and had utility plant totaling approximately \$9.5 billion, including \$2.5 billion of production plant in service and \$3.5 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") (4,763 MW without Palo Seco). As of December 31, 2006, the Authority had 2,389 circuit miles of transmission lines and 30,565 circuit miles of distribution lines. In September 2005, the Authority realized a historical peak load of 3,685 MW.

For the twelve months ended December 31, 2006, the average percentage of the Authority's generating capacity available for service ("equivalent availability"), which includes the two co-generation facilities mentioned above, was 87%, 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 2002 through fiscal year 2006, the number of clients served by the Authority increased at a compound annual rate of 1.2%, and electric energy sales in kilowatt hours ("kWh") increased at a compound annual rate of 1.9%. During this period, Revenues and Current Expenses increased at a compound annual rate of 14.2% and 18.0%, 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 1.2% and 5.5% respectively, primarily due to higher energy demand.

During the first six months of fiscal year 2007, Revenues and Current Expenses decreased by .1% and 1.1%, respectively, compared to the same period for the prior fiscal year. The decrease in Revenues and in Current Expenses was mainly due to a decrease of \$2.40 per barrel (or 4.2%) in the price of fuel oil. Excluding the cost of fuel oil and purchased power, Revenues decreased by 3.4% and Current Expenses increased by 1.5% compared to the same period of the prior fiscal year.

Net Revenues increased at a compound annual rate of 2.7% during the period from fiscal year 2002 to fiscal year 2006. For the first six months of fiscal year 2006, Net Revenues increased by 4.0% compared to the same period in fiscal year 2005.

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 2006 indicate that the economy registered an increase of 0.7% in real gross product. The Planning Board reports indicate that real gross product increased by 1.9% in fiscal year 2005, 2.7% in fiscal year 2004, 2.1% in fiscal year 2003, and decreased by 0.3% in fiscal year 2002. For fiscal year 2007, the Planning Board is forecasting a decrease in real gross product of 1.4%. Projections of future peak energy demand for the five fiscal year period ending June 30, 2011, prepared by the Authority, show an average annual increase of 2.8%.

The following table summarizes the operating results of the Authority for the five fiscal years ended June 30, 2006 and for the six-month periods ended December 31, 2005 and 2006. 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, 2005 and 2006 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)					Six Months Ended	
	Fiscal Years Ended June 30,					December 31,	
	2002	2003	2004	2005	2006	2005	2006
Electric energy sales (in millions of kWh).....	19,130	19,887	20,260	20,507	20,620	10,739	10,737
Percentage change from year before	2.2%	3.9%	1.9%	1.2%	0.6%	3.0%	(0.02)%
Peak load (in MW).....	3,297	3,376	3,499	3,603	3,685	3,685	3,685
Percentage change from year before	3.0%	2.4%	3.6%	3.0%	2.3%	3.5%	-
Total Revenues	\$2,193,681	\$2,536,250	\$2,613,006	\$3,060,122	\$3,731,925	\$1,921,968	\$1,919,671
Less: Current Expenses.....	<u>1,566,595</u>	<u>1,871,476</u>	<u>1,979,756</u>	<u>2,422,603</u>	<u>3,033,924</u>	<u>1,555,254</u>	<u>1,538,283</u>
Net Revenues.....	<u>\$ 627,086</u>	<u>\$ 664,774</u>	<u>\$ 633,250</u>	<u>\$ 637,519</u>	<u>\$ 698,001</u>	<u>\$ 366,714</u>	<u>\$ 381,388</u>
Principal and Interest Requirements.....	<u>\$ 392,043</u>	<u>\$ 381,178</u>	<u>\$ 427,088</u>	<u>\$ 404,022</u>	<u>\$ 449,318</u>	-	-
Ratio of Net Revenues to Principal and Interest Requirements.....	1.60	1.74	1.48	1.58	1.55	-	-

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 has 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 has 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 is 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 2008.

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

constructed a new 230 kV transmission line in 2005 which completes the transmission loop on the eastern part of the island. 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 2012.

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, 2006 and the projected capital improvement program and financing sources for the five fiscal years ending June 30, 2011. See “Historical Capital Improvement and Financing Program” and “Projected Five-Year Capital Improvement and Financing Program” under *The System*.

Capital Improvements (dollars in thousands)				
Capital Improvements	Fiscal Years			
	2002-2006	% of Total	2007-2011	% of Total
Production Plant	\$ 707,760	30.9	\$ 981,388	44.9
Transmission facilities.....	608,814	26.6	\$490,860	22.4
Distribution facilities.....	661,084	28.8	401,499	18.3
Other ⁽¹⁾	312,878	13.7	314,208	14.4
	<u>\$2,290,536</u>	<u>100.0</u>	<u>\$2,187,955</u>	<u>100.0</u>
Financing Sources				
Internally generated funds.....	\$ 398,047	17.4	507,572	23.2
Borrowed funds.....	1,892,489	82.6	1,680,383	76.8
	<u>\$2,290,536</u>	<u>100.0</u>	<u>\$2,187,955</u>	<u>100.0</u>

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

PLAN OF FINANCING

Series TT Bonds

The Authority is issuing the Series TT 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 2007 and 2008 and to repay notes held by certain private banks issued by the Authority for such purpose.

Series UU Bonds

The Authority is issuing the Series UU Bonds pursuant to Section 210 of the 1974 Agreement to provide funds, together with other available moneys, 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, or pay such Refunded Bonds at maturity as follows:

<u>Refunded Bonds</u>	<u>Maturity Date</u>	<u>Principal Amount to be Refunded</u>	<u>Interest Rate (%)</u>	<u>Redemption Date</u>	<u>Redemption Price (%)</u>
Series AA	07/01/2008	1,000,000 ⁽¹⁾	5.000	At maturity	N/A
	07/01/2013	1,500,000	5.400	07/01/2007	101.50
	07/01/2027 ⁽²⁾	59,835,000	5.375	07/01/2007	101.50
Series DD	07/01/2013	15,170,000	5.125	07/01/2008	101.50
	07/01/2014	15,950,000	5.250	07/01/2008	101.50
	07/01/2015	16,785,000	5.250	07/01/2008	101.50
	07/01/2016	18,025,000	5.250	07/01/2008	101.50
	07/01/2028 ⁽³⁾	212,780,000 ⁽⁴⁾	5.000	07/01/2008	101.50
Series FF	07/01/2008	2,175,000 ⁽⁵⁾	5.250	At maturity	N/A
	07/01/2009	8,200,000 ⁽⁶⁾	5.250	At maturity	N/A
	07/01/2014	13,660,000 ⁽⁷⁾	5.250	07/01/2009	101.50
Series HH	07/01/2008	11,000,000 ⁽⁸⁾	4.400	At maturity	N/A
	07/01/2009	7,700,000 ⁽⁹⁾	5.250	At maturity	N/A
	07/01/2014	5,020,000	4.900	07/01/2010	101.00
	07/01/2015	8,295,000	5.000	07/01/2010	101.00
	07/01/2016	2,485,000	5.100	07/01/2010	101.00
	07/01/2020	24,165,000	5.300	07/01/2010	101.00
	07/01/2029 ⁽¹⁰⁾	283,515,000	5.250	07/01/2010	101.00
Series II	07/01/2017	22,490,000	5.375	07/01/2012	101.00
	07/01/2018	23,700,000	5.375	07/01/2012	101.00
	07/01/2019	24,975,000	5.375	07/01/2012	101.00
	07/01/2020	26,315,000	5.000	07/01/2012	101.00
	07/01/2022 ⁽¹¹⁾	56,710,000	5.250	07/01/2012	101.00
	07/01/2026 ⁽¹²⁾	132,175,000	5.125	07/01/2012	101.00
Series NN	07/01/2031 ⁽¹³⁾	207,595,000	5.250	07/01/2012	101.00
	07/01/2018	21,435,000	5.500	07/01/2013	100.00
	07/01/2028	35,755,000 ⁽¹⁴⁾	5.125	07/01/2013	100.00

¹ Represents a portion of the \$11,035,000 aggregate principal amount maturing July 1, 2007

² Represents the Amortization Requirements due July 1 of the years 2026 and 2027

³ Represents the Amortization Requirements due July 1 of the years 2021 through 2028, inclusive

⁴ Represents a portion of the \$234,000,000 aggregate principal amount maturing July 1, 2028

⁵ Represents a portion of the \$23,525,000 aggregate principal amount maturing July 1, 2008

⁶ Represents a portion of the \$24,685,000 aggregate principal amount maturing July 1, 2009

⁷ Represents a portion of the \$33,935,000 aggregate principal amount maturing July 1, 2014

⁸ Represents a portion of the \$12,865,000 aggregate principal amount maturing July 1, 2008

⁹ Represents a portion of the \$9,705,000 aggregate principal amount maturing July 1, 2009

¹⁰ Represents the Amortization Requirements due July 1 of the years 2021 through 2029, inclusive

¹¹ Represents the Amortization Requirements due July 1 of the years 2021 and 2022

¹² Represents the Amortization Requirements due July 1 of the years 2023 through 2026, inclusive

¹³ Represents the Amortization Requirements due July 1 of the years 2027 through 2031, inclusive

¹⁴ Represents the Amortization Requirement due July 1, 2028 of the term bond maturing July 1, 2029

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 UU Bonds with the 1974 Trustee, as escrow agent, under the terms of an escrow deposit agreement. The net proceeds of the Series UU 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 or maturity date, as applicable.

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 Causey Demgen & Moore, 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 TT Bonds

Sources:	
Principal amount of the Series TT Bonds	\$643,530,000.00
Net original issue premium	<u>31,832,567.40</u>
Total Sources	<u>\$675,362,567.40</u>
Uses:	
Deposit to 1974 Construction Fund	\$450,000,955.23
Capitalized Interest on Series TT Bonds through 1/1/08	20,581,176.36
Repayment of bank line of credit	200,000,000.00
Underwriting discount, and estimated legal, printing and other financing expenses	<u>4,780,435.81</u>
Total Uses	<u>\$675,362,567.40</u>

Series UU Bonds

Sources:	
Principal amount of the Series UU Bonds	\$1,300,035,000.00
Net original issue premium	25,352,703.80
Other available moneys ⁽¹⁾	<u>21,777,849.17</u>
Total Sources	<u>\$1,347,165,552.97</u>
Uses:	
Deposit to Escrow Fund for the Refunded Bonds.....	\$1,328,964,760.50
Underwriting discount, municipal bond insurance premiums, and estimated legal, printing and other financing expenses.....	<u>18,200,792.47</u>
Total Uses	<u>\$1,347,165,552.97</u>

(1) Derived from moneys on deposit in the Bond Service 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.

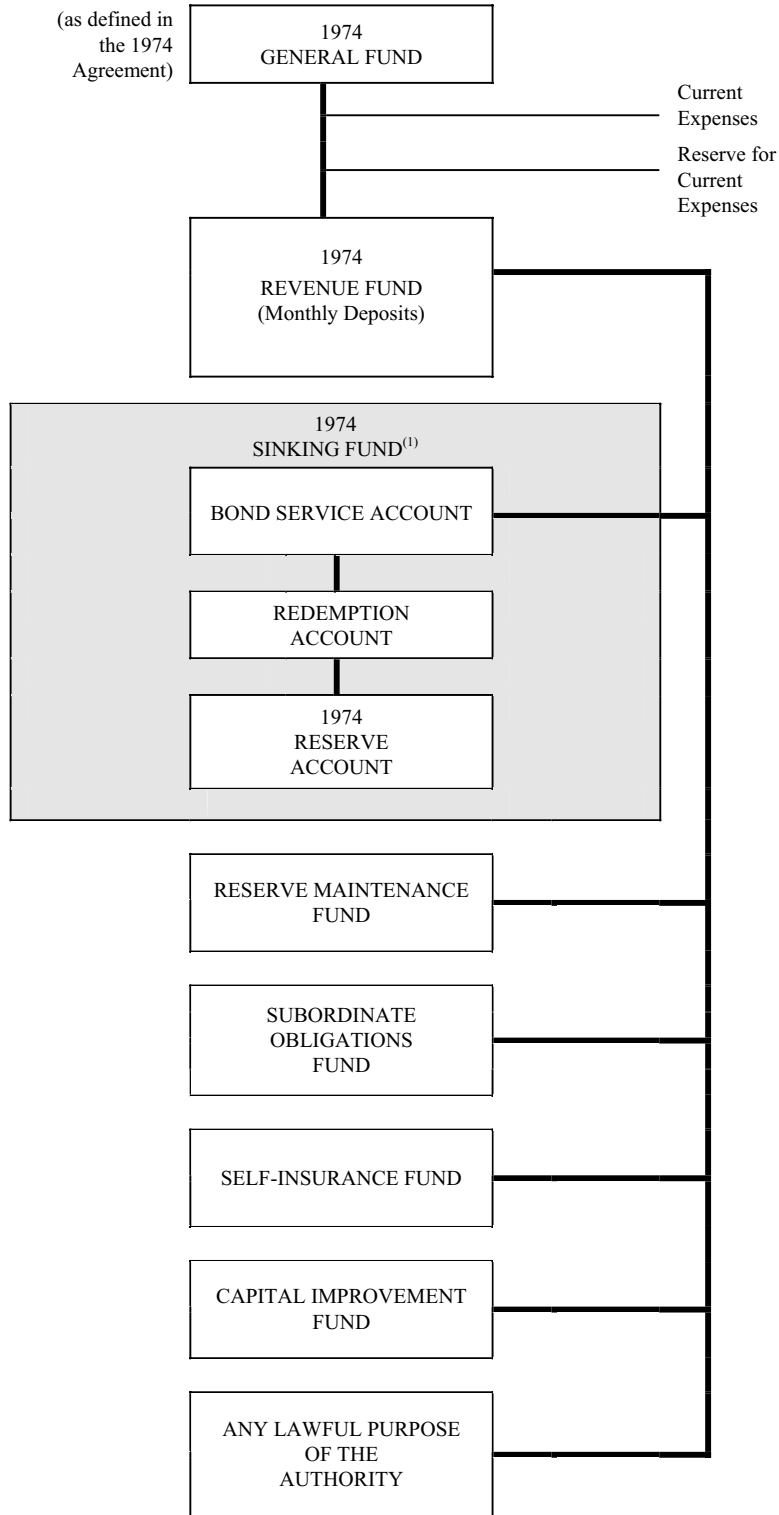
Source of Payment

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 bearing interest at a fixed rate 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. Monthly deposits to the Bond Service Account for the LIBOR Bonds and the Muni-BMS Bonds will be made at 1/3 of the interest due on the next quarterly 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 December 31, 2006, approximately \$267 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 \$259.6 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 refunding of the Refunded Bonds. The Authority will transfer the excess amount to the Bond Service Account of the 1974 Sinking Fund.

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, 2006, the balances of the Reserve Maintenance Fund and

the Self-insurance Fund were \$51.4 million and \$67.2 million, respectively. In addition, as of such date, the Authority had set aside \$28.6 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 November 30, 2006 of \$712.7 million were 156% of the maximum aggregate annual Principal and Interest Requirements of \$456.7 million on all outstanding Power Revenue Bonds. Estimated average annual Net Revenues for the five fiscal years ending June 30, 2012 of \$752.7 million would be 167% of the maximum aggregate annual Principal and Interest Requirements of \$451.5 million on all outstanding Power Revenue Bonds (including the Bonds, but excluding the Refunded Bonds).

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 CFIG Bond Insurance Policy

The information set forth in the following paragraphs has been provided by CDC IXIS Financial Guaranty North America, Inc. (“CFIG”) for inclusion in this Official Statement. No representation is made by the Authority as to the accuracy or completeness of this information. CFIG 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 CFIG set forth under the heading “Bond Insurance.” CFIG makes no representation regarding the Bonds or the advisability of investing in the Bonds.

CFIG is a monoline financial guaranty insurance company incorporated under the laws of the State of New York. The address of the principal executive offices of the Insurer is 825 Third Avenue, Sixth Floor, New York, New York 10022; its toll-free telephone number is (866) CFIG-212 and its general telephone number is (212) 909-3939; and its website is located at www.cifg.com.

The Insurer is a member of the CFIG Group of financial guaranty companies, which also includes CFIG Europe, a French insurance company licensed to do business in the European Union, and CFIG Guaranty, a dedicated French reinsurance corporation. In addition to its capital and surplus as set forth below, the Insurer is supported by a net worth maintenance agreement from CFIG Guaranty, which provides that CFIG Guaranty will maintain the Insurer’s New York statutory capital and surplus at no less than \$80 million.

The Insurer also may cede a substantial portion (not to exceed 90%) of its exposure on each transaction to CFIG Guaranty through a facultative reinsurance agreement.

Each of the Insurer, CFIG Europe and CFIG Guaranty has received an insurer financial strength rating of “AAA” from Fitch, an insurer financial strength rating of “Aaa” from Moody’s, and an insurer financial enhancement rating of “AAA” from Standard and Poor’s, the highest rating assigned by each rating agency. Each such rating should be evaluated independently. The ratings reflect the respective rating agency’s current assessment of each company’s capacity to pay claims on a timely basis and are not recommendations to buy, sell or hold the Bonds. Such ratings may be subject to revision or withdrawal at any time.

The Insurer 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 48 jurisdictions. The Insurer 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 such insurers maintain a minimum surplus to policyholders, establishes contingency, loss and unearned premium reserve requirements for such insurers, and limits the size of individual transactions and the volume of transactions that may be underwritten by such insurers. Other provisions of the New York Insurance Law applicable to non-life insurance companies such as the Insurer 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.

The following tables set forth the capitalization of the Insurer on the basis of accounting principles generally accepted in the United States (“US GAAP”) and statutory accounting practices prescribed or permitted by the New York State Insurance Department, respectively.

	US GAAP September 30, 2006 (in thousands of US dollars)	US GAAP December 31, 2005 (in thousands of US dollars)
Total Assets	\$369,050	\$ 324,134
Total Liabilities	\$248,239	\$ 202,042
Shareholder's Equity	\$120,811	\$ 122,092
	Statutory Accounting Practices September 30, 2006 (in thousands of US dollars)	Statutory Accounting Practices December 31, 2005 (in thousands of US dollars)
Admitted Assets	\$183,468	\$ 175,333
Liabilities.....	\$78,045	\$ 66,758
Capital and Surplus	\$105,423	\$ 108,575

For further information concerning the Insurer, see the audited financial statements of the Insurer, including the notes thereto, prepared in accordance with US GAAP as of December 31, 2005 and 2004 and for each of the three years in the period ended December 31, 2005, and the unaudited interim financial statements of the Insurer as of September 30, 2006 and for the nine-month period ended September 30, 2006, which are available on the CIFG Group's website at www.cifg.com. Copies of the most recent audited annual and unaudited interim financial statements of the Insurer prepared in accordance with accounting principles prescribed or permitted by the New York State Insurance Department, are also available on the website and may be obtained, without charge, upon request to the Insurer at its address above, Attention: Finance Department.

Effective February 23, 2005, the Department of Insurance of the State of New York approved the change of CIFG's name to CIFG Assurance North America, Inc. Application for approval of the name change has been filed with the regulator in the Commonwealth of Puerto Rico, and in the event the name change is approved by the Commissioner of Insurance of the Commonwealth of Puerto Rico prior to the delivery date of the CIFG Insurance Policy, the CIFG Insurance Policy will be issued under CIFG's new name.

The FSA Bond Insurance Policy

The following information has been furnished by Financial Security Assurance, Inc. ("FSA") for use in this Official Statement. No representation is made by the Authority 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 on the Bonds when due as set forth in the form of the FSA Policy included as an exhibit to this Official Statement.

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 December 31, 2006, FSA's combined policyholders' surplus and contingency reserves were approximately \$2,554,147,000 and its total net unearned premium reserve was approximately \$2,070,751,000

in accordance with statutory accounting principles. At December 31, 2006, FSA's consolidated shareholder's equity was approximately \$2,722,312,000 and its total net unearned premium reserve was approximately \$1,648,334,000 in accordance with generally accepted accounting principles.

The consolidated financial statements of FSA included in, or as exhibits to, the annual and quarterly reports filed after December 31, 2005 by Holdings with the Securities and Exchange Commission are hereby incorporated by reference into this Official Statement. All financial statements of FSA included in, or as exhibits to, documents filed by Holdings pursuant to Section 13(a), 13(c), 14 or 15(d) of the Securities Exchange Act of 1934 after the date of this Official Statement and before the termination of the offering of the Bonds shall be deemed incorporated by reference into this Official Statement. Copies of materials incorporated by reference will be provided upon request to Financial Security Assurance Inc.: 31 West 52nd Street, New York, New York 10019, Attention: Communications Department (telephone (212) 826-0100).

The FSA Policy does not protect investors against changes in market value of the 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 Bonds or the advisability of investing in the Bonds. FSA makes no representation regarding the Official Statement, nor has it participated in the preparation thereof, except that FSA has provided to the Authority the information presented under this caption for inclusion in the Official Statement.

The MBIA Bond Insurance Policy

The following information has been furnished by MBIA Insurance Corporation ("MBIA") 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.

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 Policy and MBIA set forth under the heading "Bond Insurance". Additionally, MBIA makes no representation regarding the MBIA Insured Bonds or the advisability of investing in the MBIA Insured Bonds.

The MBIA 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 (the "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").

MBIA's Policy does not insure against loss of any prepayment premium which may at any time be payable with respect to any MBIA Insured Bonds. MBIA's 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. MBIA's 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.

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 MBIA from the 1974 Trustee or any owner of a 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, either directly or through subsidiaries, is licensed to do business in the Republic of France, the United Kingdom and the Kingdom of Spain and is subject to regulation under the laws of those jurisdictions.

Regulation. The principal executive offices of MBIA are located at 113 King Street, Armonk, New York 10504 and the main telephone number at that address is (914) 273-4545.

As a financial guaranty insurance company licensed to do business in the State of New York, MBIA is subject to the New York Insurance Law which, among other things, prescribes minimum capital requirements and contingency reserves against liabilities for MBIA, limits the classes and concentrations of investments that are made by MBIA and requires the approval of policy rates and forms that are employed by MBIA. State law also regulates the amount of both the aggregate and individual risks that may be insured by MBIA, the payment of dividends by MBIA, changes in control with respect to MBIA and transactions among MBIA and its affiliates.

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

Financial Strength Ratings of MBIA. Moody's Investors Service, Inc. rates the financial strength of MBIA "Aaa." S&P, 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.

MBIA Financial Information. As of December 31, 2005, MBIA had admitted assets of \$11.0 billion (audited), total liabilities of \$7.2 billion (audited), and total capital and surplus of \$3.8 billion (audited), each as determined in accordance with statutory accounting practices prescribed or permitted by insurance regulatory authorities. As of December 31, 2006, MBIA had admitted assets of \$10.9 billion (unaudited), total liabilities of \$6.9 billion (unaudited), and total capital and surplus of \$4.0 billion (unaudited), each as determined in accordance with statutory accounting practices prescribed or permitted by insurance regulatory authorities.

For further information concerning MBIA, see the consolidated financial statements of MBIA and its subsidiaries as of December 31, 2006 and December 31, 2005 and for each of the three years in the period ended December 31, 2006, prepared in accordance with generally accepted accounting principles, included in the Annual Report on Form 10-K of the Company for the year ended December 31, 2006 and the consolidated financial statements of MBIA and its subsidiaries as of December 31, 2006, which are hereby incorporated by reference into this Official Statement and shall be deemed to be a part hereof.

Copies of the statutory financial statements filed by MBIA with the State of New York Insurance Department are available over the Internet at the Company's web site at <http://www.mbia.com> and at no cost, upon request to MBIA at its principal executive offices.

Incorporation of Certain Documents by Reference. The following document filed by MBIA with the Securities and Exchange Commission (the "SEC") is incorporated by reference into this Official Statement:

- (1) MBIA's Annual Report on Form 10-K for the year ended December 31, 2006

Any documents, including any financial statements of MBIA and its subsidiaries that are included therein or attached as exhibits thereto, filed by MBIA pursuant to Sections 13(a), 13(c), 14 or 15(d) of the Exchange Act after the date of MBIA's most recent Quarterly Report on Form 10-Q or Annual Report on Form 10-K, 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 from the respective dates of filing such documents. 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.

MBIA files annual, quarterly and special reports, information statements and other information with the SEC under File No. 1-9583. Copies of MBIA's SEC filings (including (1) MBIA's Annual Report on Form 10-K for the year ended December 31, 2006, and (2) MBIA's Quarterly Reports on Form 10-Q for the quarters ended March 31, 2006, June 30, 2006 and September 30, 2006 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 MBIA's web site at <http://www.mbia.com>; and (iv) at no cost, upon request to MBIA at its principal executive offices.

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 CIFG, FSA and MBIA concurrently with the delivery of their respective municipal bond insurance policies, as long as CIFG, FSA and MBIA shall not be in default on their respective obligations under the municipal bond insurance policies, CIFG, FSA and MBIA 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

Fixed Rate Bonds

The Fixed Rate 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 Fixed Rate Bonds will be dated their date of delivery. Interest on the Fixed Rate Bonds will be payable on each January 1 and July 1, commencing on January 1, 2008.

LIBOR Bonds

Interest on the LIBOR Bonds will be payable on each July 1, October 1, January 1 and April 1 commencing on July 1, 2007 and if such day is not a U.S. Government Securities Business Day, then the next succeeding U.S. Government Securities Business Day.

During each LIBOR-Based Interest Rate Period, the LIBOR Bonds will bear interest at the LIBOR-Based Interest Rate from the first day of the LIBOR-Based Interest Rate Period and ending on the day immediately prior to the first Interest Payment Date and thereafter during the period commencing on and including an Interest Payment Date to but not including the following Interest Payment Date.

The LIBOR-Based Interest Rate will be the rate of interest per annum determined by the 1974 Trustee to be equal to the sum of (a) 67% of the Three-Month LIBOR Rate plus (b) a per annum spread equal to 0.68%, 0.52% and 0.70% per annum for the LIBOR Bonds maturing July 1 of the years 2025, 2029 and 2031, respectively; provided that in the calculation of the initial LIBOR-Based Interest Rate for the LIBOR Bonds, the Three-Month LIBOR Rate will be calculated through the use of straight-line interpolation by reference to the Three-Month LIBOR Rate and a LIBOR Rate with a four-month maturity; provided further that in all cases, the LIBOR-Based Interest Rate will never exceed the maximum rate permitted under Puerto Rico law (currently 12%).

As soon as possible after 11:00 a.m., New York City time, on each LIBOR Rate Determination Date, but in no event later than 11:00 a.m., New York City time, on the Business Day immediately following each LIBOR Rate Determination Date, the 1974 Trustee will notify the Holders of the LIBOR-Based Interest Rate for the next LIBOR-Based Interest Accrual Period.

In connection with the issuance of the LIBOR Bonds, the Authority is expected to enter into interest rate swap agreements. In general, the swap agreements provide that, subject to the terms thereof, the Authority will pay to the swap provider a fixed rate and the swap provider will pay to the Authority a floating rate based on the Three-Month LIBOR Rate plus a spread, in each case based on a notional amount equal to the principal amount of the LIBOR Bonds outstanding. The purpose of the swap agreements is generally to convert the Authority's floating rate obligations with respect to the LIBOR Bonds to fixed rate obligations.

Under certain circumstances, the swap agreements are subject to termination prior to their scheduled termination date and prior to the maturity of the LIBOR Bonds. In the event of an early termination of any of the swap agreements, there can be no assurance that (i) the Authority will receive any termination payment payable to it by the swap provider, (ii) the Authority will have sufficient amounts to pay a termination payment payable by it to the swap provider, and (iii) the Authority will be able to obtain a replacement swap agreement with comparable terms. Payment due upon early termination may be substantial. The swap provider has no obligation to make any payments to the holders of the LIBOR Bonds with respect to the principal of, interest on, or redemption price of, the LIBOR Bonds. Neither the holders of the LIBOR Bonds nor any other person acting on behalf of such holders shall have any rights under the swap agreements or against the swap provider.

The Authority will be obligated to pay interest on and the principal of the LIBOR Bonds regardless of whether the swap provider performs its obligations under the swap agreements.

Muni-BMS Bonds

Interest on the Muni-BMS Bonds will be payable on each July 1, October 1, January 1 and April 1 commencing on July 1, 2007 and if such day is not a U.S. Government Securities Business Day, then the next succeeding U.S. Government Securities Business Day. The Muni-BMS Interest Rate, which will be reset quarterly, is an interest rate based on changes in the USD-SIFMA Swap Rate. Appendix VI sets forth a more detailed description of the Muni-BMS Interest Rate and certain risks associated with an investment in the Muni-BMS Bonds.

During each Muni-BMS Interest Rate Period, the Muni-BMS Bonds will bear interest at the Muni-BMS Interest Rate from the first day of the Muni-BMS Interest Rate Period and ending on the day immediately prior to the first Interest Payment Date and thereafter during the period commencing on and including an Interest Payment Date to but not including the following Interest Payment Date.

The Muni-BMS Interest Rate will be the rate of interest per annum determined by the Calculation Agent to be equal to the sum of (a) 100% of the USD-SIFMA Swap Rate plus (b) a per annum spread equal to 0%; provided that in all cases the Muni-BMS Interest Rate will never exceed the maximum rate permitted under Puerto Rico law (currently 12%).

At or prior to 12:00 noon, New York City time, on each Reset Date, the Calculation Agent will calculate the Muni-BMS Rate applicable for that Muni-BMS Interest Accrual Period and shall immediately notify the Authority and the 1974 Trustee of the Muni-BMS Interest Rate for the next Muni-BMS Interest Accrual Period in writing or by electronic communication promptly confirmed in writing.

In connection with the issuance of the Muni-BMS Bonds, the Authority is expected to enter into interest rate swap agreements. In general, the swap agreements provide that, subject to the terms thereof, the Authority will pay to the swap provider a fixed rate and the swap provider will pay to the Authority a floating rate based on the Muni-BMS Interest Rate, in each case based on a notional amount equal to the principal

amount of the Muni-BMS Bonds outstanding. The purpose of the swap agreements is generally to convert the Authority's floating rate obligations with respect to the Muni-BMS Bonds to fixed rate obligations.

Under certain circumstances, the swap agreements are subject to termination prior to their scheduled termination date and prior to the maturity of the Muni-BMS Bonds. In the event of an early termination of any of the swap agreements, there can be no assurance that (i) the Authority will receive any termination payment payable to it by the swap provider, (ii) the Authority will have sufficient amounts to pay a termination payment payable by it to the swap provider, and (iii) the Authority will be able to obtain a replacement swap agreement with comparable terms. Payment due upon early termination may be substantial. The swap provider has no obligation to make any payments to the holders of the Muni-BMS Bonds with respect to the principal of, interest on, or redemption price of, the Muni-BMS Bonds. Neither the holders of the Muni-BMS Bonds nor any other person acting on behalf of such holders shall have any rights under the swap agreements or against the swap provider.

The Authority will be obligated to pay interest on and the principal of the Muni-BMS Bonds regardless of whether the swap provider performs its obligations under the swap agreements.

Certain Factors Relating to the Investment in Muni-BMS Bonds

Tax-exempt municipal securities bearing interest at a Muni-BMS Interest Rate is a relatively new investment instrument. There can be no assurance that a secondary market for the Muni-BMS Bonds will develop or, if a secondary market does develop that it will continue or that it will provide owners of the Muni-BMS Bonds with liquidity for their investment. In addition, as a new product, the Muni-BMS Bonds may not be widely traded or as well understood as fixed rate securities, ordinary floating rate securities or other types of index-linked securities. Lesser liquidity and fewer market participants may result in larger spreads between bid and ask prices for the Muni-BMS Bonds than the bid-asked spreads for fixed rate securities, ordinary floating rate securities or other types of index-linked securities of the same maturity as the Muni-BMS Bonds. Larger bid-asked spreads normally result in higher transaction costs and/or lower overall returns. The liquidity of the Muni-BMS Bonds may be enhanced over time as other issuers of tax-exempt bonds issue similar securities, or as more entities participate in the market for constant maturity securities, generally; but there can be no assurance that either or both of these phenomenon will occur.

Form of Bonds

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 Depository Trust Company ("DTC"), New York, NY, will act as securities depository for the bonds (the "Bonds"). The Bonds will be issued as fully-registered securities 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 security certificate will be issued for each maturity of the Bonds, each in the aggregate principal amount of such maturity, and will be deposited with DTC. If, however, the aggregate principal amount of any maturity exceeds \$500 million, one certificate will be issued with respect to each

\$500 million of principal amount and an additional certificate will be issued with respect to any remaining principal amount of such maturity.

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 100 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 and Members of the National Securities Clearing Corporation, Fixed Income Clearing Corporation, and Emerging Markets Clearing Corporation (NCSS, FICC and EMCC, also subsidiaries of DTCC), as well as 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 S&P's highest rating: AAA. The DTC rules applicable to its Participants are on file with the Securities and Exchange Commission. More information about DTC can be found at www.dtcc.com and www.dtc.org.

Purchases of Bonds under the DTC system must be made by or through Direct Participants, which will receive a credit for the Bonds on DTC's records. The ownership interest of each actual purchaser of each Bond (a "Beneficial Owner") is in turn recorded in the Direct and Indirect Participants' records. Beneficial Owners will not receive written confirmation from DTC of their purchase. 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 are to be accomplished by entries made in the books of Direct and Indirect Participants acting on behalf of the Beneficial Owners. Beneficial Owners will not receive certificates representing their ownership interest in 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 Direct or Indirect 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 security documents 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 Issuer 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).

Redemption proceeds, principal, 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 Issuer or Agent 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 nor its nominee, Agent, or Issuer, subject to any statutory or regulatory requirements as may be in effect from time to time. Payment of the principal, redemption proceeds, principal and interest payments to Cede & Co. (or such other nominee as may be requested by an authorized representative of DTC) is the responsibility of the Issuer or Agent, 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.

The information in this section concerning DTC and DTC's book-entry system has been obtained from sources that the Authority believes to be reliable, but the Authority, the 1974 Trustee and the Underwriters takes no responsibility for the accuracy thereof.

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 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 TT Bonds

The Series TT Bonds maturing on July 1, 2032 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 TT Bonds, in amounts equal to the Amortization Requirements for such Series TT Bonds (less the principal amount of any Series TT 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 TT Bonds due on July 1, 2032

<u>Year</u>	<u>Amortization Requirement</u>
2028	\$30,795,000
2029	32,335,000
2030	33,950,000
2031	35,645,000
2032	37,430,000

The Series TT Bonds maturing on July 1, 2037 will be redeemed in part on July 1, 2033, and on each July 1 thereafter for which there is an Amortization Requirement in respect of such Series TT Bonds, in amounts equal to the Amortization Requirements for such Series TT Bonds (less the principal amount of any Series TT 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 TT Bonds due on July 1, 2037

<u>Year</u>	<u>Amortization Requirement</u>
2033	\$39,300,000
2034	41,265,000
2035	43,330,000
2036	45,495,000
2037	47,770,000

The Series UU Bonds

The Series UU LIBOR Bonds maturing on July 1, 2025 will be redeemed in part on July 1, 2021, and on each July 1 thereafter for which there is an Amortization Requirement in respect of such Series UU LIBOR

Bonds, in amounts equal to the Amortization Requirements for such Series UU LIBOR Bonds (less the principal amount of any Series UU LIBOR 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 UU LIBOR Bonds due on July 1, 2025

<u>Year</u>	<u>Amortization Requirement</u>
2021	\$52,875,000
2022	55,105,000
2023	24,575,000
2024	25,615,000
2025	26,700,000

The Series UU LIBOR Bonds maturing on July 1, 2029 will be redeemed in part on July 1, 2025, and on each July 1 thereafter for which there is an Amortization Requirement in respect of such Series UU LIBOR Bonds, in amounts equal to the Amortization Requirements for such Series UU LIBOR Bonds (less the principal amount of any Series UU LIBOR 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 UU LIBOR Bonds due on July 1, 2029

<u>Year</u>	<u>Amortization Requirement</u>
2025	\$69,155,000
2026	71,970,000
2027	35,770,000
2028	37,230,000
2029	38,750,000

The Series UU LIBOR Bonds maturing on July 1, 2031 will be redeemed in part on July 1, 2026, and on each July 1 thereafter for which there is an Amortization Requirement in respect of such Series UU LIBOR Bonds, in amounts equal to the Amortization Requirements for such Series UU LIBOR Bonds (less the principal amount of any Series UU LIBOR 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 UU LIBOR Bonds due on July 1, 2031

<u>Year</u>	<u>Amortization Requirement</u>
2026	\$ 28,025,000
2027	68,360,000
2028	107,055,000
2029	42,565,000
2030	44,390,000
2031	46,295,000

Optional Redemption

Fixed Rate Bonds. The Fixed Rate Bonds that mature after July 1, 2017 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, 2017, at a redemption price equal to the principal amount of the Bonds to be redeemed plus accrued interest to the redemption date, without premium; provided, however, that the MBIA Insured Bonds in the principal amounts of \$15,000,000, \$17,995,000 and \$29,485,000 maturing July 1, of the years 2018, 2018 and 2019, respectively, shall not be subject to redemption prior to maturity.

LIBOR Bonds. The LIBOR Bonds are subject to optional redemption prior to their stated maturity, at the option of the Authority, in whole or in part, in such amounts as may be specified by the Authority (i) on any date prior to July 1, 2017 (the "Par Call Date"), at a Redemption Price equal to the Spread Premium for such Bonds and (ii) on any date on or after the Par Call Date, at a Redemption Price equal to 100% of the principal amount thereof, without premium, plus in each case accrued interest to the date fixed for redemption (the "Redemption Date").

For purposes of this provision, the "Spread Premium" shall be calculated as follows:

1. A hypothetical cash flow schedule shall be calculated by assuming that the principal of the Bonds called for redemption would be payable on the Par Call Date and that interest on such Bonds would be payable quarterly on each January 1, April 1, July 1 and October 1 until, and including, the Par Call Date (each a "Quarterly Payment Date") at a rate per annum equal to the sum of (a) 67% of the USD-ISDA-Swap Rate plus (b) the spread above the percentage of the Three-Month LIBOR Rate at which such LIBOR Bonds bear interest.

2. Each principal and interest payment in the hypothetical cash flow schedule determined accordance with the preceding paragraph shall be discounted as of each Quarterly Payment Date to the Redemption Date at a discount rate equal to the sum of (a) 67% of the USD-ISDA-Swap Rate plus (b) .25% per annum.

3. The sum of the present values of such principal and interest payments as of the Redemption Date determined pursuant to the preceding paragraph shall be the Spread Premium.

Muni-BMS Bonds. The Muni-BMS Bonds are not subject to redemption prior to their stated maturity.

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 are currently two vacancies on the Board. One of the vacancies is a client representative, who is in the process of being selected according to the procedures of the Department of Consumer Affairs. The other has been appointed by the Governor, but is pending ratification by the Legislature. The terms of the three Board members holding over expired in February 2007 and their reappointment is pending confirmation by the Senate of the Commonwealth. The members of the Board are set forth below.

<u>Name</u>	<u>Principal Occupation</u>	<u>Term Ends</u>
Luis Aníbal Avilés Pagán, Chairman	Attorney at Law	February 2009
Eliezel Rodríguez Seda, Vice-Chairman	Engineer	February 2010
Fernando I. Pont	Acting Secretary of Transportation and Public Works	<i>Ex Officio</i>
José A. Bechara-Bravo	Businessman	Holding Over
José A. Fernández-Polo	Civil Engineer and General Contractor	Holding Over
José Luis Rodríguez-Homs	Engineer	Holding Over
María A. Veras Fernández*	Recruitment Officer	September 2009

* Mrs. Veras Fernández is one of the client representatives on the Governing Board. 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.

Jorge A. Rodríguez Ruiz was appointed Executive Director on January 16, 2007. Mr. Rodríguez Ruiz is a Professional Engineer with 29 years of experience. He has occupied various positions in the private and public sector. He served as Executive President of the Puerto Rico Aqueduct and Sewer Authority between May 2004 and January 2007. Other positions he has held throughout his career include Vice President of

Worldwide Operations for SMART Modular Technologies; General Manager of DSC Communications; General Manager SMART Modular Technologies; Manager of Engineering and Quality, of New Products, of the Power Systems Business, of Quality/Reliability Engineering, and of Manufacturing Tests for Digital Equipment Corporation, Puerto Rico.

Other principal officers of the Authority include the following:

Valeriano Otero Chacón, Vice Executive Director, is a professional Engineer with 27 years of service with the Authority. He was appointed to his current position in October 2005. During that time, he has occupied various positions, including Director of Transmission and Distribution, and District Engineer.

Carlos J. Castro Montalvo, Director of Electric System, is a Professional Electrical Engineer with 22 years of service at the Authority. During that time, he has occupied various positions, including Head of Operation Division; Superintendent-Studies Clearance and Operating Procedures in Electric System; and SCADA and Application Engineering.

Juan Arroyo, Director of Transmission and Distribution, is a Professional Electrical Engineer. During his 34 years of service with the Authority, he has occupied various positions, such as Executive Advisor; Head Electric Distribution Division; Administrator of Operation and Control of Distribution System.

Wanda L. Ramos Vera, Director of Customer Service, holds a Bachelor's Degree in Business Administration. She has 23 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 17 years of service with the 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 24 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.

Luis Jiménez Pagán, Director of Administrative Services, holds a Bachelor's Degree in Business Administration – Accounting and has 25 years of experience. During his 19 years of service with the Authority, he has occupied various positions, such as Head of Material Management Division; Purchasing Manager; Cost Control Supervisor; and Retirement Officer.

Carlos Berríos Cintrón, Director of Engineering, is a Professional Mechanical Engineer. During his 28 years of service with the Authority, he has occupied various positions, such as Acting Director of Electric System; Head Division of Special Projects; Administrator of Maintenance and Technical Services Division; and Project Manager in various generating plants.

Jorge A. Concepción Rivera, General Counsel, holds a Juris Doctor, a Bachelor's Degree in Art, a Master's Degree in Public Administration, and in Labor Relations and has approximately 20 years of service with the Authority. During his tenure, he has occupied the positions of Deputy General Counsel; Head of the Opinion, Legislation and Contract Division; and Attorney at the Opinion, Legislation and Contract Division; Litigation Division; and Real Estate and Notarial Services Division.

Aníbal Hernández Ramos, Human Resources Director, holds a Bachelor's Degree in Social Sciences and a Master's Degree in Public Administration. During his 18 years of service with the Authority, among other positions, he has performed as Head Personnel Division; Human Resources Project Manager; Compensation and Position Classification Supervisor.

Raúl E. Rosado Toro, Director of Labor Affairs, holds a Juris Doctor and a Bachelor's degree in Labor Relations, and has 22 years of service with the Authority. Among the positions he has held are: Assistant General Counsel; Head of the Opinion, Legislation and Contract Division; and Personnel General Administrator.

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 2006.

THE SYSTEM

The Authority is the supplier of virtually all of the electric power consumed in the Commonwealth. As of December 31, 2006, the Authority served approximately 1.4 million clients, representing a population of 4.46 million.

Generating Facilities

As of December 31, 2006, investment in Authority-owned production plant in service totaled approximately \$2.5 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 (3,802 MW without Palo Seco). The Palo Seco Steam Plant has been out of service since December 31, 2006 because of a fire in its control room. The Authority expects all the Palo Seco units to become available again by summer 2008. 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⁽¹⁾ (7 Units)</u>
Aguirre	1,554	1,534	900 ⁽²⁾	592 ⁽³⁾	42 ⁽⁴⁾		
Costa Sur	1,118	1,132	1,090		42 ⁽⁴⁾		
Palo Seco	731	728 ⁽¹¹⁾	602 ⁽¹¹⁾		126 ⁽⁵⁾		
San Juan	400	400	400				
Mayagüez	90	84			84 ⁽⁶⁾		
Arecibo	249	249			249 ⁽⁷⁾		
Other Locations	285	277			168 ⁽⁸⁾	100	9
Subtotal	4,427	4,404 ⁽¹¹⁾	2,390 ⁽¹¹⁾	592	711	100	9
Peñuelas – EcoEléctrica	507	507		507 ⁽⁹⁾			
Guayama – AES-PR	454	454	454 ⁽¹⁰⁾				
Total	<u>5,388</u>	<u>5,365⁽¹¹⁾</u>	<u>2,844⁽¹¹⁾</u>	<u>1,099</u>	<u>711</u>	<u>100</u>	<u>9</u>

- (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.
- (11) Includes Palo Seco. Lower excluding Palo Seco.

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 28% of the Authority's annual energy requirements are being provided by non-oil-fired generating facilities. This percentage could increase to approximately 33%.

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 2002 to fiscal year 2006, the Authority invested \$1.3 billion (or 55.4% of its capital improvement program) in its transmission and distribution system. The capital improvement program for the five fiscal years ending June 30, 2011 includes \$892 million (or 41% of such program) for transmission and distribution facilities.

Transmission plant in service as of December 31, 2006 totaled \$1.1 billion based on original installed cost. As of that date, there were 2,389 circuit miles of transmission lines and 167 transmission switchyards. Transmission lines include 364 circuit miles of 230 kV lines, 676 circuit miles of 115 kV lines and 1,348 circuit miles of 38 kV lines. There are also 42 miles of underground 38 kV cable and 55 miles of 38 kV submarine cable. Seventy-four transmission substations located at generating sites and at other sites throughout the island have a total transformer capacity of 17,327,250 kilovolt amperes ("kVA").

After completing construction of the transmission loop on the eastern part of Puerto Rico in fiscal year 2006, the Authority is now constructing new 230 kV transmission lines to complete the transmission loop on the center part of the island. This center loop will connect major switching and load centers on the

southern and northern part of the island, and boost electric system capacity in Puerto Rico's northern and western regions. The center loop is expected to be operating during fiscal year 2010.

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 fiscal year 2012. 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 also constructing an underground 115 kV transmission circuit line around the San Juan metropolitan area, which is expected to be completed in fiscal year 2008, 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. 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 Mayagüez, Carolina, Viaducto, Humacao and San Fernando in San Juan. Construction of the underground 38 kV lines in Vega Baja was completed. 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 Isla Grande gas insulated transmission and distribution centers. In addition, the Candelaria Arenas (Bayamón) distribution substation, and the Veredas (Gurabo) and La Parguera (Lajas) new distribution substations were energized recently. There is also a new distribution substation in the commissioning process at Martín Peña (San Juan). Finally, new distribution substations at Hacienda San José (Caguas), Candelero (Humacao), Mora (Isabela) and an increase in capacity at Loiza Valley (Canóvanas) are under construction. These substations are expected to be in service during fiscal year 2008.

Two new 115/38 kV transmission centers in the municipality of Juana Díaz and Hatillo started operating in fiscal year 2007. These substations 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, 2006 totaled \$2.4 billion based on original cost. The capital improvement program for the five fiscal years ending June 30, 2011 includes \$402 million (or 18% 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, 2006, the electric distribution system included approximately 30,565 circuit miles of distribution lines and 1,112 distribution substations (784 are client-owned) with a total installed transformer capacity of 7,717,330 kVA.

The Authority has digitized all the transmission and distribution facilities into a geographic information system. This allows the Authority to create a common database for all its transmission and distribution facilities.

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 commercializing the surplus capacity of the installed fiber, adding flexibility and diversification to its operations and continues developing new strategies.

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, with the exception of the Palo Seco Steam plants, which are undergoing repairs. 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 77% in fiscal year 2006, and 80.2% for the seven months ended January 31, 2007), 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 \$707.8 million in capital expenditures for the five fiscal years ended June 30, 2006 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 2002 through 2006 and for the twelve months ended December 31, 2006.

Electric Generation Equivalent Availability and Reliability*

	Years Ended June 30,					Twelve Months Ended
	2002	2003	2004	2005	2006	December 31, 2006
Equivalent availability	80%	81%	81%	85%	87%	88%
Equivalent forced outage rate.....	7%	9%	9%	6%	4%	4%

*Cogenerator data is not included.

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 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 88% during the twelve months ended on December 31, 2006. 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 is constructing 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 2008.

The Authority's updated capacity expansion plan includes the replacement of four 21 MW combustion turbines at Mayagüez with four 50 MW dual fuel aero-derivative combustion turbines. This replacement, scheduled for commercial operation during fiscal year 2008, will provide improved efficiency and add approximately 116 MW of new capacity. The updated plan also includes the conversion of three simple cycle 83 MW combustion turbines at Cambalache to combined cycle operation. The Authority estimates the conversion will add approximately 100 MW of new capacity and will be completed in fiscal year 2009.

These projects will also have the capacity to burn natural gas as part of the Authority's fuel diversification strategy. The first phase of this fuel diversification strategy includes the construction of a natural gas pipeline from the EcoEléctrica complex to the Aguirre Combined Cycle plant during fiscal year 2009. The second phase includes the construction of an additional natural gas pipeline and associated infrastructure from the EcoEléctrica complex to the Cambalache plant in the north side of the island and then to the San Juan Combined Cycle plant in fiscal year 2010. A natural gas pipeline is also contemplated for the west side of the island after fiscal year 2010. After these projects are completed the expected electric generation by fuel type in fiscal year 2010 will be 37% natural gas, 13% coal, and 50% fuel oil. These projects are not included in the Capital Improvement Program because the Authority expects to finance them through a combination of private entities and its wholly owned subsidiaries.

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 these projects will provide the additional generating capacity needed to continue to provide reliable service to its clients beyond fiscal year 2011. 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 these projects will not materially affect its ability to furnish reliable service.

The following table summarizes the Authority's projected peak load, dependable capacity, reserve margin and dependable reserve margin through fiscal year 2011 under the peak load projections shown below and incorporating the assumptions of additional capacity from the repowering of San Juan Steam Plant units 5 and 6, the replacement of the four 21 MW units in Mayagüez with four 50 MW units, and the conversion of the gas turbines located at Cambalache to combined cycle operation. Projections of future peak load (for capacity planning purposes) from fiscal year 2007 to fiscal year 2011 prepared by the Authority show an average annual increase of 2.8%.

Fiscal Years	Ending	Peak	Dependable	Reserve	Dependable
Ending	June 30,	Load	Capacity	Margin	Reserve
					Margin (%)
			(in MW, except percentages)		
	2007	3,744	5,365 ¹ (4,763) ²	1,621 ¹ (1,019) ²	43 ¹ (27) ²
	2008	3,846	5,845 ¹ (5,245) ²	1,999 ¹ (1,399) ²	52 ¹ (36) ²
	2009	3,970	5,945	1,975	50
	2010	4,086	5,945	1,859	45
	2011	4,176	5,860	1,684	40

¹Includes Palo Seco Plant capacity.

²Less 602 MW Palo Seco Plant capacity. Palo Seco outage will overlap into both Fiscal Years 2007-2008.

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, 2006 and for the six-month periods ended December 31, 2005 and 2006. 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,	
	2002	2003	2004	2005	2006	2005	2006
Nameplate rating at end of period (in MW)	4,421	4,421	5,382	5,388	5,388	5,388	5,388
Dependable generating capacity at end of period (in MW).....	4,905 ⁽¹⁾	5,359 ⁽²⁾	5,359 ⁽²⁾	5,365 ⁽²⁾	5,365 ⁽²⁾	5,365 ⁽²⁾	5,365 ⁽⁵⁾
Peak load, 60-minute (in MW).....	3,297	3,376	3,499	3,603	3,685	3,685	3,685
Reserve Margin (%)	48.8	58.7	53.1	48.9	45.6	45.6	45.6 ⁽⁶⁾
Average load (in MW).....	2,576	2,707	2,744	2,797	2,839	2,919	2,936
Load factor (%).....	78.1	80.2	78.4	77.6	77.0	79.2	79.7
Energy generated, purchased and sold (in millions of kWh):							
Electric energy generated and purchased	22,562 ⁽³⁾	23,717 ⁽⁴⁾	24,100 ⁽⁴⁾	24,500 ⁽⁴⁾	24,870 ⁽⁴⁾	12,888 ⁽⁴⁾	12,965 ⁽⁴⁾
Auxiliary equipment use.....	<u>(1,076)</u>	<u>(1,076)</u>	<u>(1,085)</u>	<u>(1,122)</u>	<u>(1,116)</u>	<u>(584)</u>	<u>(575)</u>
Net electric energy generated and purchased	21,486	22,641	23,015	23,378	23,754	12,304	12,390
Losses and unaccounted for.....	<u>(2,356)</u>	<u>(2,754)</u>	<u>(2,755)</u>	<u>(2,871)</u>	<u>(3,134)</u>	<u>(1,565)</u>	<u>(1,653)</u>
Electric Energy Sold.....	<u>19,130</u>	<u>19,887</u>	<u>20,260</u>	<u>20,507</u>	<u>20,620</u>	<u>10,739</u>	<u>10,737</u>
Electric Energy Sales:							
Residential.....	6,910	7,280	7,338	7,438	7,250	3,855	3,819
Commercial.....	7,865	8,167	8,400	8,499	8,734	4,496	4,569
Industrial.....	3,876	3,963	4,092	4,177	4,242	2,185	2,156
Other.....	<u>479</u>	<u>477</u>	<u>430</u>	<u>393</u>	<u>394</u>	<u>203</u>	<u>193</u>
Total	<u>19,130</u>	<u>19,887</u>	<u>20,260</u>	<u>20,507</u>	<u>20,620</u>	<u>10,739</u>	<u>10,737</u>
Electric Energy Revenues (in thousands):							
Residential	\$725,797	\$867,684	\$897,965	\$1,066,419	\$1,284,641	\$676,728	\$667,327
Commercial.....	969,182	1,117,317	1,171,110	1,350,731	1,656,770	845,063	855,003
Industrial.....	382,140	432,296	444,070	529,285	663,041	339,805	327,584
Other	<u>85,052</u>	<u>91,461</u>	<u>87,123</u>	<u>91,675</u>	<u>104,486</u>	<u>52,712</u>	<u>50,966</u>
Total	<u>\$2,162,171</u>	<u>\$2,508,758</u>	<u>\$2,600,268</u>	<u>\$3,038,110</u>	<u>\$3,708,938</u>	<u>\$1,914,308</u>	<u>\$1,900,880</u>
Average revenue per kWh(in cents):							
Residential	10.50	11.92	12.24	14.34	17.72	17.55	17.47
Commercial.....	12.32	13.68	13.94	15.89	18.97	18.80	18.71
Industrial.....	9.86	10.91	10.85	12.67	15.63	15.55	15.19
Other	17.77	19.19	20.29	23.29	26.55	25.97	26.41
All Classes	11.30	12.61	12.83	14.81	17.99	17.83	17.70
Average number of clients:							
Residential	1,254,043	1,270,371	1,287,010	1,304,657	1,315,345	1,313,868	1,319,983
Commercial.....	124,759	125,890	127,705	129,170	130,082	129,812	130,392
Industrial.....	1,874	1,804	1,679	1,668	1,618	1,634	1,584
Other	<u>3,212</u>	<u>3,236</u>	<u>3,208</u>	<u>3,204</u>	<u>3,182</u>	<u>3,180</u>	<u>3,205</u>
Total	<u>1,383,888</u>	<u>1,401,301</u>	<u>1,419,602</u>	<u>1,438,699</u>	<u>1,450,227</u>	<u>1,448,494</u>	<u>1,455,164</u>
Monthly average revenue per client:							
Residential	\$48.23	\$56.92	\$58.14	\$68.12	\$81.39	\$85.84	\$84.26
Commercial.....	647.37	739.61	764.20	871.42	1,061.36	1,084.98	1,092.86
Industrial.....	16,993.06	19,969.33	22,040.40	26,443.10	34,149.21	34,659.83	34,468.0
Other	2,206.62	2,355.30	2,263.17	2,384.39	2,736.38	2,762.68	2,650.34
All classes	130.20	149.19	152.64	175.98	213.12	220.26	217.72

- (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.
- (5) Includes Palo Seco. Without Palo Seco, 4,763 MW.
- (6) Includes Palo Seco. Without Palo Seco, 27.3.

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, 2006 and for the six-month periods ended December 31, 2005 and 2006 is shown in the following table.

	Years Ended June 30,					Total	Six Months Ended December 31,	
	2002	2003	2004	2005	2006		2005	2006 ⁽¹⁾
Capital Improvements	(in thousands)							
Production plant	\$123,646	\$105,579	\$126,605	\$150,676	\$201,254	\$ 707,760	\$ 83,089	\$131,918
Transmission facilities	82,015	111,893	109,004	142,707	163,195	608,814	82,954	72,734
Distribution facilities	149,479	124,469	133,098	133,724	120,314	661,084	67,727	47,751
Other ⁽²⁾	60,874	50,165	78,236	83,971	39,632	312,878	21,953	17,005
Total	<u>\$416,014</u>	<u>\$392,106</u>	<u>\$446,943</u>	<u>\$511,078</u>	<u>\$524,395</u>	<u>\$2,290,536</u>	<u>\$255,723</u>	<u>\$269,408</u>
Financing								
Internally generated funds ..	\$ 77,307	\$144,537	\$ 43,066	\$ 83,533	\$ 49,604	\$ 398,047	\$ 36,017	\$ 28,629
Borrowed funds ⁽³⁾	338,707	247,569	403,877	427,545	474,791	1,892,489	219,706	240,779
Total	<u>\$416,014</u>	<u>\$392,106</u>	<u>\$446,943</u>	<u>\$511,078</u>	<u>\$524,395</u>	<u>\$2,290,536</u>	<u>\$255,723</u>	<u>\$269,408</u>
Allowance for funds used during construction.....	\$ 15,993	\$ 16,795	\$ 20,279	\$ 8,187	\$ 12,322	\$ 73,576	\$ 8,349	\$ 9,168

(1) Preliminary information.

(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 2007 was adopted in June 2006.

The projected capital improvement program for the five fiscal years ending June 30, 2011 aggregates approximately \$2.2 billion. It is currently estimated that \$390 million, or approximately 17.8%, 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 \$981 million for production plant and new generation. Of this amount, the Authority projects that approximately \$469 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 plant described under the same heading.

The projected capital improvement program also includes \$491 million for transmission facilities and \$402 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 Consulting Engineers have noted that in fiscal year 2006 the Authority's internal funding of capital expenditures was 9% of the amount spent, whereas over the last five years the Authority's average annual contribution to such funding was 17%, and have recommended that the Authority increase its internal funding level to approximately 25%. The fiscal year 2006 level of funding is indicative of the slim margins of available funds after accounting for modest operating budget overruns and the mandated Contributions in Lieu of Taxes. The Authority is forecast to spend approximately \$2.2 billion on capital projects through fiscal year 2011. During that period the Authority's internal funding is projected to constitute approximately 23.2% of the total Capital Improvement Program.

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, 2011 and its projected financing.

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

	Years Ending June 30,					Total
	2007	2008	2009	2010	2011	
Capital Improvements						
Production plant.....	\$291,200	\$242,811	\$208,620	\$130,787	\$107,970	\$981,388
Transmission.....	97,749	109,316	95,033	110,958	77,804	490,860
Distribution.....	84,076	81,445	78,030	79,733	78,215	401,499
Other ⁽¹⁾	58,468	52,694	51,860	80,884	70,302	314,208
Total.....	<u>\$531,493</u>	<u>\$486,266</u>	<u>\$433,543</u>	<u>\$402,362</u>	<u>\$334,291</u>	<u>\$2,187,955</u>
Financing Sources						
Internal Funds.....	57,229	133,312	120,261	110,268	86,502	507,572
Borrowed Funds ⁽²⁾	474,264	352,954	313,282	292,094	247,789	1,680,383
Total.....	<u>\$531,493</u>	<u>\$486,266</u>	<u>\$433,543</u>	<u>\$402,362</u>	<u>\$334,291</u>	<u>\$2,187,955</u>

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

(2) For the purpose of this table, it is assumed that of the total \$1.7 billion Power Revenue Bonds expected to be issued in the five-year period ending June 30, 2011, \$875.0 million is expected to be used to repay lines of credit with private banks 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, 2006 and the six-month periods ended December 31, 2005 and 2006.

	Electric Sales Revenues					Six Months Ended	
	(in thousands)					December 31,	
	Years Ended June 30,					2005	2006
	2002	2003	2004	2005	2006		
Basic charges.....	\$1,101,923	\$1,134,794	\$1,140,277	\$1,157,262	\$1,165,961	\$ 604,240	\$ 613,681
Fuel adjustment charges....	806,806	994,406	970,972	1,329,073	1,868,542	1,002,317	932,884
Purchased power charges..	253,442	379,558	489,019	551,775	674,435	307,751	354,315
Total.....	<u>\$2,162,171</u>	<u>\$2,508,758</u>	<u>\$2,600,268</u>	<u>\$3,038,110</u>	<u>\$3,708,938</u>	<u>\$1,914,308</u>	<u>\$1,900,880</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.

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. Actual industry savings to March 2007 are \$11.6 million.

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 approximately 14% of kWh sales and 15% of revenues from electric energy sales for the first six months of fiscal year 2007.

The ten largest industrial clients accounted for 5.4% of kWh sales and 4.3% of revenues from electric energy sales for the twelve months ended December 31, 2006. No single client accounted for more than 0.8% of electric energy sales or more than 0.6% of revenues from electric energy sales.

In September 1997, the Authority established a 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 rate is designed to induce large clients for whom it may be more economical to produce their own electricity to buy more electricity from the Authority and discourage their independent power production. As of December 31, 2006, three of the Authority's industrial clients were using such rate.

Fuel

For the fiscal year ended June 30, 2006, fuel oil expenses amounted to \$1,666 million, or 54.9% of total Current Expenses (\$1,183 million or 48.9% of total Current Expenses for the preceding fiscal year). For the six months ended December 31, 2006, fuel oil expenses amounted to \$827.7 million, or 53.8% of total Current Expenses. For the five fiscal years ended June 30, 2006, 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 72% of the net electric energy generated by the System in fiscal year 2006, 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 4.7 million barrels. As of December 31, 2006, the Authority had an inventory of 2.0 million barrels of fuel oil.

Average fuel oil costs and related costs of production for the five fiscal years ended June 30, 2006, and for the six months ended December 31, 2005 and 2006, are shown in the following table:

	Fuel Costs						
	Years Ended June 30,					Six Months Ended December 31,	
	2002	2003	2004	2005	2006	2005	2006
Average fuel oil cost per barrel (net of handling costs)	\$ 22.85	\$ 29.64	\$ 29.54	\$ 39.22	\$ 56.38	\$ 57.03	\$ 54.63
Number of barrels used (in millions)	31.53	29.91	29.27	30.16	29.55	15.67	15.15
Fuel oil cost (in millions)	\$720.3	\$886.4	\$864.7	\$1,182.9	\$1,665.9	\$893.7	\$827.6
Net kWh generated (excluding purchased power from 2000 to 2006) (in millions).....	18,247.4	17,259.0	16,740.6	17,270.7	16,933.1	8,909.5	8,731.9
Average net kWh per barrel	578.7	577.0	571.9	572.6	573.0	568.6	576.4
Average fuel oil cost per net kWh generated (in cents).....	3.95	5.14	5.17	6.85	9.84	10.03	9.48

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 37% in fiscal year 2010 (when certain natural gas pipelines are expected to be completed). See "Adequacy of Capacity - Additional Generating Facilities" under *The System*.

The Authority has 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 serves to smooth the effects of the fuel adjustment to the Authority's clients. As of December 31, 2006, 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 the 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. In June 2004, the Legislature of the Commonwealth 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. As of December 31, 2006, the amount owed by the Commonwealth was approximately \$43.1 million, of which the fuel adjustment subsidy receivable amounted to \$18.9 million. The Legislature of

Puerto Rico agreed to appropriate \$6.3 million a year until 2012 to pay this debt, and other debt owed to the Authority by various government agencies. The Authority has borrowed against such expected appropriations. Such debt constitutes so-called extra-constitutional debt of the Commonwealth and the Legislature has assigned 1% of the proceeds from the recently enacted sales and use tax towards the payment of such extra-constitutional debt. The Authority has yet to receive the \$6.3 million payment it expected in November 2006. 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 \$18.6 million per year for the five fiscal years ended June 30, 2006. 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 \$4.1 million per year for the five fiscal years ended June 30, 2006. 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. 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 2006, contributions in lieu of taxes to municipalities amounted to \$155.0 million, of which \$1.3 million was reimbursed to the municipalities and \$153.7 million was used to offset or reduce outstanding accounts receivable balances. For the six-month period ended December 31, 2006, contributions in lieu of taxes to municipalities amounted to \$89.4 million.

DEBT

The following table sets forth the bonds and notes of the Authority outstanding as of February 28, 2007, and as adjusted for the issuance of the Bonds, and the refunding of the Refunded Bonds as of May 3, 2007.

	Outstanding as of February 28, 2007	As adjusted ⁽¹⁾ as of May 3, 2007
Power Revenue Bonds	(In Thousands)	
Publicly Offered	\$5,026,315	\$5,711,470
Rural		
Electrification.....	<u>28,175</u>	<u>28,175</u>
Sub-total.....	5,054,490	5,739,645
Notes.....	929,061	729,061
Government Development		
Bank lines of credit	<u>44,467</u>	<u>44,467</u>
Total.....	<u>\$6,028,018</u>	<u>\$6,513,173</u>

(1) As adjusted for the issuance of the Bonds and the refunding of the Refunded 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 February 28, 2007, \$28.2 million of such bonds were outstanding at an interest rate of 5%.

Notes

The Authority has outstanding \$929.1 million aggregate principal amount in six notes or lines of credit issued to certain commercial banks to provide interim financing for the capital improvement program, finance the purchase of fuel oil and for other expenses. The first line of credit of \$175 million was issued to fund the purchase of fuel oil. These notes were issued under a facility that originally expired in July of 2005, but was renewed prior to that date and extended until 2008. The second note of \$32 million aggregate principal amount corresponds to subordinated notes issued to a commercial bank that was initially payable from expected annual appropriations from the Legislature of Puerto Rico of \$6.3 million (or the outstanding balance if lower) until 2012. These appropriations were 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, 2006. Such debt constitutes so-called extra-constitutional debt of the Commonwealth and the

Legislature has assigned 1% of the proceeds from the recently-enacted sales and use tax towards the payment of such extra-constitutional debt. 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 third note of \$200 million is for interim financing of the Authority's capital improvement program. A fourth line of credit in the amount of \$400 million is also for interim financing of the Authority's capital improvement program. As of February, 2007, the Authority had drawn approximately \$344 million under this line of credit. Of the amounts drawn under this line of credit, \$200 million will be paid from the proceeds of the Series TT Bonds. A fifth line of credit, in the amount of \$200 million, is for operational financing. As of February, 2007, the Authority had drawn approximately \$113.9 million from this line of credit. In addition, the Authority has obtained a \$64.2 million term loan under the settlement with the municipalities referred to above, which will be payable quarterly until 2014.

Government Development Bank – Line of Credit

The Authority has two lines of credit approved by Government Development Bank. The first line of credit of \$57 million is to fund electric infrastructure projects in connection with a settlement agreement relating to certain litigation with the municipalities of Puerto Rico (see *Litigation*). As of February 28, 2007, the Authority had drawn \$41.5 million under this line of credit. The second line of credit of \$25.3 million is to finance improvements to the Isabela irrigation system. The Authority expects that this second line of credit will be paid by the Commonwealth of Puerto Rico from the proceeds of future bond issues. As of February 28, 2007, the Authority has outstanding \$3.0 million under this second line of credit. In addition, a third line of credit of \$50 million is pending approval. Such line of credit will be used to finance repairs to the Palo Seco Steam Plant pending receipt of payment for such repairs by the Authority's insurers.

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 refunding of the Refunded 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 ⁽¹⁾	The Bonds			Total Debt Service Requirements ⁽²⁾
		Maturity and Amortization Requirements	Interest	Total	
2007	\$ 445,825,675.44		\$ 5,716,788.28	\$ 5,716,788.28	\$ 451,542,463.72
2008	346,867,335.01		97,736,079.34	97,736,079.34	444,603,414.35
2009	346,917,418.76		89,098,163.52	89,098,163.52	436,015,582.28
2010	333,891,087.50	\$ 1,885,000.00	89,098,163.52	90,983,163.52	424,874,251.02
2011	329,345,250.00	3,115,000.00	89,022,763.52	92,137,763.52	421,483,013.52
2012	332,473,026.24	3,280,000.00	88,898,163.52	92,178,163.52	424,651,189.76
2013	320,361,953.74	19,935,000.00	88,766,963.52	108,701,963.52	429,063,917.26
2014	302,591,519.98	38,210,000.00	87,919,726.02	126,129,726.02	428,721,246.00
2015	298,796,448.74	28,515,000.00	86,157,326.02	114,672,326.02	413,468,774.76
2016	297,740,598.74	25,835,000.00	84,881,576.02	110,716,576.02	408,457,174.76
2017	295,814,666.22	43,670,000.00	83,589,826.02	127,259,826.02	423,074,492.24
2018	224,518,322.46	69,045,000.00	81,658,002.50	150,703,002.50	375,221,324.96
2019	246,031,617.46	49,485,000.00	78,606,547.50	128,091,547.50	374,123,164.96
2020	240,780,437.46	75,765,000.00	76,292,297.50	152,057,297.50	392,837,734.96
2021	218,118,937.46	101,930,000.00	72,758,569.30	174,688,569.30	392,807,506.76
2022	196,432,918.70	106,610,000.00	68,068,149.30	174,678,149.30	371,111,068.00
2023	196,168,687.44	111,520,000.00	63,160,855.70	174,680,855.70	370,849,543.14
2024	176,076,687.44	116,815,000.00	57,873,591.70	174,688,591.70	350,765,279.14
2025	149,706,687.44	122,455,000.00	52,229,564.90	174,684,564.90	324,391,252.34
2026	97,203,712.44	157,445,000.00	46,948,096.90	204,393,096.90	301,596,809.34
2027	97,241,793.74	164,450,000.00	39,938,069.42	204,388,069.42	301,629,863.16
2028	61,662,225.00	175,080,000.00	32,765,206.32	207,845,206.32	269,507,431.32
2029	97,140,275.00	113,650,000.00	25,118,095.00	138,768,095.00	235,908,370.00
2030	137,410,037.50	78,340,000.00	20,096,009.12	98,436,009.12	235,846,046.62
2031	95,094,637.50	81,940,000.00	16,495,953.72	98,435,953.72	193,530,591.22
2032	95,142,887.50	37,430,000.00	12,729,500.00	50,159,500.00	145,302,387.50
2033	95,197,637.50	39,300,000.00	10,858,000.00	50,158,000.00	145,355,637.50
2034	47,333,000.00	41,265,000.00	8,893,000.00	50,158,000.00	97,491,000.00
2035	47,386,500	43,330,000.00	6,829,750.00	50,159,750.00	97,546,250.00
2036		45,495,000.00	4,663,250.00	50,158,250.00	50,158,250.00
2037		47,770,000.00	2,388,500.00	50,158,500.00	50,158,500.00
Total	\$6,169,271,982.41	\$1,943,565,000.00	\$1,669,256,548.18	\$3,612,821,548.18	\$9,782,093,530.59

- (1) Debt service requirement on all Power Revenue Bonds outstanding on May 3, 2007, including Rural Electrification Bonds, prior to giving effect to the issuance of the Bonds and after giving effect to the refunding of the Refunded Bonds.
- (2) Debt service requirement on all Power Revenue Bonds outstanding on May 3, 2007, including Rural Electrification Bonds, after giving effect to the issuance of the Bonds and the refunding of the Refunded 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, 2006 and for the six-month periods ended December 31, 2005 and 2006 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,	
	2002	2003	2004	2005	2006	2005	2006
Average number of clients	1,383,888	1,401,301	1,419,602	1,438,699	1,450,227	1,448,494	1,455,164
Electric energy sales (in millions of kWh)	19,130	19,887	20,260	20,507	20,620	10,739	10,737
Source of Net Revenues							
(dollars in thousands)							
Revenues:							
Sales of electric energy:							
Residential ⁽¹⁾	\$725,797	\$867,684	\$897,965	\$1,066,419	\$ 1,284,641	\$676,728	\$667,327
Commercial	969,182	1,117,317	1,171,110	1,350,731	1,656,770	845,063	855,003
Industrial.....	382,140	432,296	444,070	529,285	663,041	339,805	327,584
Other.....	<u>85,052</u>	<u>91,461</u>	<u>87,123</u>	<u>91,675</u>	<u>104,486</u>	<u>52,712</u>	<u>50,966</u>
	2,162,171	2,508,758	2,600,268	3,038,110	3,708,938	1,914,308	1,900,880
Revenues from Commonwealth							
for rural electrification	739	704	591	161	116	56	36
Other operating revenues	8,514	9,625	8,565	13,705	11,373	4,774	6,323
Other (principally interest earned).....	<u>22,257</u>	<u>17,163</u>	<u>3,582</u>	<u>8,146</u>	<u>11,498</u>	<u>2,830</u>	<u>12,432</u>
	<u>2,193,681</u>	<u>2,536,250</u>	<u>2,613,006</u>	<u>3,060,122</u>	<u>3,731,925</u>	<u>1,921,968</u>	<u>1,919,671</u>
Current Expenses:							
Operations:							
Fuel.....	720,292	886,425	864,700	1,182,936	1,665,866	893,740	827,649
Purchased power	227,923	339,082	436,763	492,621	603,169	273,429	316,638
Other production	56,029	44,990	48,787	55,945	57,918	29,461	29,260
Transmission and Distribution	114,971	119,408	136,509	159,843	162,956	81,584	79,963
Customer accounting and Collection	84,689	89,710	91,763	107,932	106,927	53,747	52,354
Administrative and General	146,497	163,517	163,049	187,134	198,509	97,290	107,035
Maintenance ⁽²⁾	212,959	224,941	234,563	232,464	236,633	124,152	123,461
Other.....	<u>3,235</u>	<u>3,403</u>	<u>3,622</u>	<u>3,728</u>	<u>1,946</u>	<u>1,851</u>	<u>1,923</u>
	<u>1,566,595</u>	<u>1,871,476</u>	<u>1,979,756</u>	<u>2,422,603</u>	<u>3,033,924</u>	<u>1,555,254</u>	<u>1,538,283</u>
Net Revenues	<u>\$ 627,086</u>	<u>\$ 664,774</u>	<u>\$ 633,250</u>	<u>\$ 637,519</u>	<u>\$ 698,001</u>	<u>\$ 366,714</u>	<u>\$381,388</u>
Coverage							
Principal and Interest							
Requirements.....	\$ 392,043	\$ 381,178	\$ 427,088	\$ 404,022	\$ 449,318		
Ratio of Net Revenues to Principal and Interest Requirements.....	1.60	1.74	1.48	1.58	1.55		

(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, \$112.2 million, \$122.6 million, \$135.7 million, \$136.3 million and \$133.6 million for fiscal years ended June 30, 2002, 2003, 2004, 2005 and 2006, respectively. For the six months ended December 31, 2006 and 2005, the maintenance expense of generating facilities was \$68.4 million and \$70.1 million, respectively.

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, 2005 and 2006, and for the five fiscal years ended June 30, 2006. 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, 2006, as compared to the six months ended December 31, 2005, Revenues decreased by \$2.2 million and Current Expenses decreased by \$16.9 million, resulting in an increase in Net Revenues of \$14.7 million. The decreases in Revenues and Current Expenses were mainly due to a decrease of \$2.40 per barrel (or 4.2%) in the price of fuel oil. Accounts receivable of the Authority increased slightly from \$796.1 million on June 30, 2006 to \$803.5 million on December 31, 2006. In addition, accounts receivable from the governmental sector decreased from \$265.9 million on June 30, 2006 to \$252.1 million on December 31, 2006.

For the fiscal year ended June 30, 2006, as compared to the fiscal year ended June 30, 2005, Revenues increased by \$671.8 million and Current Expenses increased by \$611.3 million, resulting in an increase in Net Revenues of \$60.5 million. These increases were mainly due to an increase of \$17.16 per barrel (or 43.7%) in the price of fuel oil, an increase of .8 cents per kWh (or 9.3%) in the average price of purchased power and an increase of 713.1 MWh (12%) in the amount of purchased power. Accounts receivable of the Authority increased from \$695.4 million on June 30, 2005 to \$796.1 million on June 30, 2006. In addition, accounts receivable from the governmental sector increased from \$176 million on June 30, 2005 to \$265.9 million on June 30, 2006 due to the Commonwealth's budget deficit for fiscal year 2005-2006.

For the fiscal year ended June 30, 2005, as compared to the fiscal year ended June 30, 2004, Revenues increased by \$447.1 million and Current Expenses increased by \$442.8 million, resulting in an increase in Net Revenues of \$4.3 million. These increases were mainly due to an increase of \$9.68 per barrel (or 32.7%) in the price of fuel oil and an increase of .12 cents per kWh (or 16.9%) in the average price of purchased power for the fiscal year 2004). Accounts receivable of the Authority increased from \$558.4 million on June 30, 2004 to \$695.4 million on June 30, 2005. In addition, accounts receivable from the governmental sector increased from \$158.9 million on June 30, 2004 to \$176 million on June 30, 2005.

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 .7 cents 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.

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.

The following table presents the disposition of Net Revenues, in the order of priority of payment, for the five fiscal years ended June 30, 2006 and for the six months ended December 31, 2005 and 2006, 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.

Disposition of Net Revenues	Historical Disposition of Net Revenues (in thousands)					Six Months Ended December 31,	
	Years Ended June 30,					2005	2006
	2002	2003	2004	2005	2006		
1974 Sinking Fund							
Interest.....	\$248,469	\$249,779	\$264,219	\$255,483	\$257,464	\$135,105	\$129,580
Principal.....	158,357	137,329	166,004	148,539	191,854	95,922	98,777
1974 Reserve Account.....	-	(30,000)	-	-	-	-	-
Reserve Maintenance Fund.....	7,000	7,000	7,000	3,498	-	-	-
Self-insurance Fund.....	-	-	-	(20,000)	-	-	-
Capital Improvement Fund.....	77,307	144,537	43,066	83,533	49,604	36,017	28,629
General Obligation Notes							
Interest.....	-	-	1,979	6,189	11,427	4,012	15,847
Contributions in lieu of taxes and other uses ⁽¹⁾	<u>135,953</u>	<u>156,129</u>	<u>150,982</u>	<u>160,277</u>	<u>187,652</u>	<u>95,658</u>	<u>108,555</u>
Net Revenues.....	<u>\$627,086</u>	<u>\$664,774</u>	<u>\$633,250</u>	<u>\$637,519</u>	<u>\$698,001</u>	<u>\$366,714</u>	<u>\$381,388</u>

(1) 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: \$26.0 million, \$28.7 million, \$30.4 million, \$30.9 million and \$32.7 million for fiscal years ended June 30, 2002, 2003, 2004, 2005 and 2006, respectively. For the six months ended December 31, 2005 and 2006, those subsidies amounted to \$16.7 million and \$19.2 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 five fiscal years ending 2011.

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 ⁽¹⁾
2007.....	\$54.88 ⁽²⁾
2008.....	52.82
2009.....	50.41
2010.....	45.86
2011.....	44.26

- (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, 2006 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, 2011, 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,				
	2007 ⁽¹⁾	2008	2009	2010	2011
Average number of clients	1,455,164	1,472,492	1,482,211	1,491,083	1,501,704
Electric energy sales (in millions of kWh).....	20,749.3	21,113.1	21,645.5	22,202.2	22,796.8
Authority generation (gross)(in millions of KWh).....	18,802.0	19,388.5	19,906.5	20,559.7	21,315.6
Purchased generation (gross)(in millions of KWh).....	6,138.0	5,994.0	6,116.0	6,132.0	6,091.0
Sources of Net Revenues					
(dollars in thousands)					
Revenues:					
Sales of electric energy:					
Residential	\$1,306,965	\$1,332,023	\$1,295,130	\$1,251,747	\$1,244,922
Commercial	1,713,602	1,765,622	1,754,359	1,733,165	1,756,159
Industrial.....	659,857	671,090	656,484	637,916	638,240
Other	105,701	107,502	104,137	100,771	99,264
	<u>3,786,125</u>	<u>3,876,237</u>	<u>3,810,110</u>	<u>3,723,599</u>	<u>3,738,585</u>
Revenues from Commonwealth for					
Rural Electrification	76	26	19	-	-
Other Operating Revenues	6,323	-	-	-	-
Other (principally interests earned).....	26,350	29,832	31,832	33,832	35,832
	<u>3,818,874</u>	<u>3,906,095</u>	<u>3,841,961</u>	<u>3,757,431</u>	<u>3,774,417</u>
Current Expenses ⁽²⁾ :					
Operations:					
Fuel	1,650,538	1,668,755	1,577,881	1,475,500	1,464,372
Purchased Power	664,220	712,572	717,176	713,655	707,383
Other Production	56,310	54,970	55,896	57,127	58,349
Transmission and Distribution	149,685	141,706	144,092	147,265	150,415
Client accounting and collection.....	107,496	112,079	113,966	116,475	118,967
Administration and general	210,917	211,147	214,703	219,430	224,124
Maintenance	253,894	265,109	269,573	275,508	281,402
Other – Interest Charges.....	3,044	2,292	2,351	2,410	2,410
	<u>3,096,104</u>	<u>3,168,630</u>	<u>3,095,640</u>	<u>3,007,371</u>	<u>3,007,422</u>
Net Revenues.....	<u>\$722,770</u>	<u>\$737,465</u>	<u>\$746,321</u>	<u>\$750,060</u>	<u>\$766,995</u>
Coverage					
Principal and Interest Requirements ⁽³⁾	\$455,022	\$420,543	\$452,317	\$464,976	\$501,873
Ratio of Net Revenues to Principal and Interest Requirements.....	1.59	1.75	1.65	1.61	1.53

(1) Based on actual results for the six-month period ended December 31, 2006 and an estimate for the last six months of fiscal year 2007.

(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, and (ii) expected Power Revenue Bond issues, all at an assumed interest rate of 6%, of \$567 million in each of fiscal years 2008 and 2010 (no repayments of principal of these issues are assumed until after fiscal year 2009)). Debt service requirement based on estimate as of June 2006. Actual principal and interest requirement will vary based on the actual principal and interest on the Bonds.

The Authority's estimates of Net Revenues, which were made as part of the adoption of its budget of Current Expenses for fiscal year 2007, 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, 2011, in accordance with the provisions of the 1974 Agreement.

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

	Years Ending June 30,				
	2007 ⁽¹⁾	2008	2009	2010	2011
Disposition of Net Revenues					
1974 Sinking Fund:					
Interest.....	\$257,457	\$256,051	\$279,277	\$286,444	\$309,975
Principal	197,565	164,492	173,040	178,532	191,898
Interest on Notes	19,055	-	-	-	-
Capital Improvement Funds	<u>57,229</u>	<u>133,312</u>	<u>120,261</u>	<u>110,268</u>	<u>86,502</u>
Total	531,306	553,855	572,578	575,244	588,375
Contributions in lieu of taxes and other ⁽²⁾	<u>191,464</u>	<u>183,610</u>	<u>173,743</u>	<u>174,816</u>	<u>178,620</u>
Total Net Revenues.....	<u>\$722,770</u>	<u>\$737,465</u>	<u>\$746,321</u>	<u>\$750,060</u>	<u>\$766,995</u>

- (1) Based on actual results for the six-month period ended December 31, 2006 and an estimate for the last six months of fiscal year 2007.
(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: \$5,904 million, \$5,877 million, \$5,840 million, \$5,769 million and \$5,769 million for fiscal years ending June 30 2007, 2008, 2009, 2010 and 2011, 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. This Division receives support and coordinates its operations with the Authority's Environmental Law Division.

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 has completed a nitrogen oxide emissions reduction program and modified the optimal operating ranges for all its units under the Consent Decree. The Authority also paid a \$300,000 civil fine and reserved \$200,000 to fund certain programs under the Consent Decree.

Since September 2004, there has been no legal action in the United States federal court nor any administrative proceedings against the Authority regarding the Consent Decree or the Consent Decree modification.

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 an 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 has 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 Authority complied successfully with the Settlement Agreement and in May of 2005, the United States federal Court terminated the Authority's probation. Since then there has been no criminal action against the Authority for environmental matters.

Other proceedings

During 1992 and 1993, the EPA and the Puerto Rico Environmental Quality Board (EQB) carried out inspections at the Palo Seco power plant. During said inspections, various situations were observed which could have an environmental impact. The agencies took soil and water samples of the affected areas. These samples revealed concentrations of dangerous substances greater than the normal values in comparison with background samples.

Based on these events and pertinent provisions of the Comprehensive Environmental Response, Compensation and Liability Act (CERCLA), the EPA proposed that the Authority enter into an Order by Consent. The purpose of this Order is that the Authority carry out a Remedial Investigation /Feasibility Study (RI/FS) as provided in the CERCLA legislation. The Authority rejected this offer. Consequently, on September 29, 1997, the EPA issued an Administrative Order for the investigation and possible remediation of seven areas identified by the EPA at the Palo Seco power plant and at the Palo Seco General Warehouse (Depot).

The RI/FS required under the Administrative Order began in 1999. Since that date, the work schedule approved by the EPA has been revised a number of times. These revisions have resulted in the requirement of additional sampling or delays in the evaluations of the reports submitted by the Authority to the EPA and the EQB. Nevertheless, in order to comply with the terms and conditions of the Order, Authority personnel, contractors and technical personnel of both the EPA and the EQB have carried out monthly conference calls to discuss the progress of the project. The completion date for the FS is August, 2007.

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. At this time, the fieldwork has been completed. The Remedial Investigation/Feasibility Study is expected to be completed and public hearings held during the latter part of 2007.

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 filed an answer to the complaint disputing the allegations. The Authority was able to reduce the proposed fine to \$67,000. This represented a 70% reduction of the fine without incurring in any additional obligation or condition. The Aguirre power plant also carried out activities designed to prevent future, similar violations.

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. At this time, we have no knowledge that the EPA has initiated, or intends to initiate, any action against the Authority concerning this matter.

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. On March 1, 2007, these power plants started to use No. 6 fuel oil with a sulfur content not greater than 0.5%. Also, the Authority continues to use No. 6 fuel oil with sulfur contents equal to or less than 0.50% at its Palo Seco and San Juan power plants, which should contribute to maintaining air quality. These are requirements under the Consent Decree discussed above, as modified in June 2004.

The Authority continues the use of fuel additives in the South Coast plant. All other plants have discontinued the use of additives, since the Authority has commenced using No. 6 fuel oil with 0.5% or less sulfur content. PREPA will discontinue the use of additives at the South Coast plant before the end of 2007.

After implementing the air quality compliance programs of the Consent Decree and reducing the sulfur content of fuel used at its major power plants, the Authority expects to be in full compliance with all visible emission requirements.

Water Quality Compliance

As of December 2006, 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 2007 is approximately \$1.5 million.

In April of 1995, the Authority submitted to EPA an updated request under Section 316(a) of the Clean Water Act that its South Coast power plant be permitted to discharge into the Caribbean Sea heated sea water that was previously used as for cooling purposes, as part of the plant's combustion and generation process, known as "thermal effluent". In December of 2000 and consistently thereafter, EPA indicated that it would deny the Authority's request.

After several discussions and meetings, in December, 2004, EPA and the Authority agreed to perform a Detailed Engineering and Environmental Review (DEER) to select a final alternative for the cooling water discharge that meets the water temperature standard of Section 316(a) or otherwise qualify for a waiver under Section 316(a). The South Coast DEER consisted of three study stages. The process was documented by progress reports at the end of each stage with a respective decision point letter. The Authority submitted the three progress reports on July 2005, March 2006 and July 2006. The Authority also submitted supplemental information in October 2006 to answer EPA questions regarding the Phase 3 Progress Report.

The final alternative proposed by the Authority is a 100% submerged discharge through the north side of the CORCO peninsula with provisions for operational adjustments to avoid any recirculation issues. The Implementation Plan is currently under discussion with EPA. The estimated capital cost of this alternative is approximately \$34.8 million. While the DEER was in progress EPA issued a draft NPDES permit for the South Coast power plant, which commenting period is currently on hold until the DEER process is finished. The Authority has also requested waivers under Section 316(a) for its Aguirre and Palo Seco plants, final decisions on which are pending.

In order to grant a new San Juan Power Plant NPDES Permit, EPA has required a Comprehensive Demonstration Study (CDS) under Section 316(b) of the Clean Water Act. This section requires complying with performance standards for entrainment and impingement at the cooling water intake structures of all of the Authority's thermoelectric power plants. The regulatory deadline to comply with the CDS was January 8, 2008. As of March 20, 2007, EPA put the due date for this regulatory requirement on hold pending resolution by the U.S. Court of Appeals for the Second Circuit of several issues raised by an environmental group (Riverkeeper, Inc. v. EPA). Except for the Palo Seco Steam Plant, all other power plants field studies are in progress. The Authority is making on-going efforts to complete the field studies for these power plants. The beginning of the Palo Seco fieldwork and subsequent CDS submittal will depend on the return to service of the units and will be the subject of EPA and the Authority negotiation. The CDS recommendations may include improvements at the intake water structures and traveling screens to meet the performance standards.

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 2007, 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 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. The implementation of this program is estimated to cost approximately \$25.3 million during the next five years. The Authority expects to spend approximately \$7.9 million for this program during fiscal year 2007.

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 for the preparation of the SPCC plan for the corresponding substations.

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 submitted a final report of the status of the program to EPA by March 31, 2005. According to EPA, the Authority has been the only utility to submit a final report with a program to sample, test, identify, remove and dispose of PCB or PCB contaminated transformers. However, the Authority continues with the removal and disposal of transformers with PCB concentrations of between 50 and 499 ppm. As of March 2007, the Authority estimates that approximately 488 of these units remain to be disposed of. The budget assignment for this program for fiscal year 2007 is approximately \$838,000.

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 million during fiscal year 2007 for this purpose.

Noise Control

In November of 2005, the Environmental Group Against Community Pollution (known as CUCCO for its Spanish language initials) filed an administrative complaint on behalf of the neighbors of the Aguirre plant seeking action to compel noise reduction and compliance with regulatory noise levels. EQB found for plaintiffs in December of 2005. The Authority is in the process of commissioning a study that will provide the necessary information and recommendations in order to submit a plan to bring the Aguirre plant to compliance with noise regulations.

Capital Improvement Program

The Authority's capital improvement program for the five fiscal years ending June 30, 2011 includes \$120 million in order to comply with existing Commonwealth and federal environmental laws and regulations. Of these, \$64.8 million belong to South Coast water related projects in compliance with the Clean Water Act 316(a) and 316(b) sections previously discussed. 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 \$750 million, consisting of a maximum of \$200 million under the all-risk property insurance policy, \$200 million under the boiler and machinery insurance policy, an excess layer of \$100 million under an all-risk and 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. As of December 31, 2006, approximately \$77 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, 2006, the Authority had 9,560 employees, of which 277 were temporary unionized employees. Four local unions represent 6,722 employees. The Electrical Industry and Irrigation Workers Union or "UTIER" represents 5,349 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 was signed on November 11, 2005 and will expire on December 15, 2007, and the collective bargaining agreement with UITICE was signed on October 22, 2005 and will expire on January 26, 2008. The collective bargaining agreement with UPAEE was signed on June 30, 2006 and will expire on July 3, 2010. The collective bargaining agreement with UTIER expired on November 14, 2005, and the parties are currently negotiating a new collective bargaining agreement.

Of the Authority’s 9,560 employees, 3,159 are employed in the transmission and distribution facilities directorate, 2,154 are employed in the generating facilities directorate, 1,646 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, 2006 were \$74.5 million, while the contributions recorded for the six months ended December 31, 2006 were \$37.4 million. This represented 6.03% of covered payroll for normal cost and 14.71% of unfunded actuarial accrued liability for fiscal year 2006, and 6.03% of covered payroll for normal cost and 15.27% of unfunded actuarial accrued liability for the six months ended December 31, 2006. Employee contributions and other withholdings are being paid to the Retirement System on a current basis. In the six months ended December 31, 2006, total pension expense of the Authority was approximately \$37.4 million, including approximately \$26.8 million for past service costs. Unfunded past service liability to be borne entirely by the Authority was approximately \$865.5 million as of June 30, 2005, the date of the last actuarial valuation of the Retirement System. As of that date, the pension plan was 61% funded. Currently, the Retirement System’s actuaries are in the process of preparing a new actuarial valuation for fiscal year 2006.

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 accepted the Authority’s offer and all of the cash portion of settlement payment has 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 counterclaim 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 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 2008.

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. 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. After this report was made public, seven lawsuits were filed separately by different plaintiffs against the Authority demanding the reimbursement of such alleged overcharges, but the court ordered that all cases be consolidated. Plaintiffs have sought certification of a class in order to proceed as a class action. The court’s ruling on this matter is pending. The total amount claimed is in excess of \$700 million. The court also ordered that the case be classified as a complex litigation. 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 income taxation. Bond Counsel will express no opinion as to any other tax consequences regarding the Bonds.

The opinion on tax matters will be based on and will assume the accuracy of certain representations and certifications, and continuing compliance with certain covenants, of the Authority 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 the Authority's certifications and representations or the continuing compliance with the Authority's covenants.

The opinion of Bond Counsel is based on current legal authority and covers certain matters not directly addressed by such authority. It represents Bond Counsel's legal judgment as to exclusion of interest on the Bonds from gross income for federal income tax purposes but is not a guaranty of that conclusion. The opinion is not binding on the Internal Revenue Service ("IRS") or any court. Bond Counsel expresses no opinion about (i) the effect of future changes in the Code and the applicable regulations under the Code or (ii) the interpretation and the enforcement of the Code or those regulations by the IRS.

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. Noncompliance with these requirements by the Authority may cause the loss of such status and result in the interest on the Bonds being included in gross income for federal income tax purposes retroactively to the date of issuance of the Bonds. The Authority 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. After the date of issuance of the Bonds, Bond Counsel will not undertake to determine (or to so inform any person) whether any actions taken or not taken, or any events occurring or not occurring, or any other matters coming to Bond Counsel's attention, may adversely affect the exclusion from gross income for federal income tax purposes of interest on the Bonds or the market prices of the Bonds. Bond Counsel is not aware of any provision of the Constitution or laws of the Commonwealth that would prevent the Authority 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.

Legislation affecting tax-exempt obligations is regularly considered by the United States Congress. There can be no assurance that legislation enacted or proposed, or clarification of the Code, after the date of issuance of the Bonds, will not have an adverse effect on the tax status of interest on the Bonds or the market prices of the Bonds.

Prospective purchasers of the Bonds should consult their own tax advisers regarding pending or proposed federal tax legislation, and prospective 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 also consult their own tax advisers regarding other tax considerations such as the consequences of market discount, as to all of which Bond Counsel expresses no opinion.

Bond Counsel's engagement with respect to the Bonds ends with the issuance of the Bonds, and, unless separately engaged, Bond Counsel is not obligated to defend the Authority or the beneficial owners regarding the tax status of interest on the Bonds in the event of an audit examination by the IRS. The IRS has a program to audit tax-exempt obligations to determine whether the interest thereon is includible in gross income for federal income tax purposes. If the IRS does audit the Bonds, under current IRS procedures, the IRS will treat the Authority as the taxpayer and the beneficial owners of the Bonds will have only limited rights, if any, to obtain and participate in judicial review of such audit. Any action of the IRS, including but not limited to selection of the Bonds for audit, or the course or result of such audit, or an audit of other obligations presenting similar tax issues, may affect the market prices for the Bonds.

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

Causey Demgen & Moore, 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 \$10,759,752.11 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.

BBVAPR Division de Valores Municipales (“BBVA”) and RBC Dain Rauscher, Inc., doing business under the name RBC Capital Markets (“RBC”), have entered into an Agreement to jointly pursue underwritings with the Commonwealth and its issuers. In furtherance of the Agreement, BBVA and RBC will form a joint account and will allocate the agreed participations in any bond offering to one another.

Morgan Stanley & Co. Incorporated (“Morgan Stanley”) has entered into a joint venture agreement (the “JV Agreement”) with Popular Securities, Inc. (“Popular”), under which the parties shall provide services and advice to each other related to the structuring and execution of certain municipal finance transactions in the U.S. capital markets with governmental entities located in the Commonwealth. Pursuant to the terms of the JV Agreement and in compliance with applicable rules, the parties will be entitled to receive a portion of each other’s net profits from the underwriting of the Bonds as consideration for their professional services.

Santander Securities Corporation (“SSC”) and Banc of America Securities LLC (“BAS”) have entered into an agreement to jointly pursue municipal securities underwriting opportunities with the Commonwealth, its agencies, and other municipalities and governmental conduit issuers in the Commonwealth. Under the terms of the agreement, SSC and BAS will be entitled to receive a portion of each other’s revenues from the underwriting of the Bonds in consideration for their professional services.

MATERIAL RELATIONSHIPS

Washington Group International, Inc. serves as the Consulting Engineers to the Authority under the provisions of the 1974 Agreement. The Authority 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*. In addition, the Authority has entered into a professional services agreement with Washington Engineers P.S.C. to provide services to the Authority in connection with the repairs to the Palo Seco generating units required as a result of the fire described above in *Recent Developments*.

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 Adsuar Muñoz Goyco Seda & Pérez-Ochoa, P.S.C., 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 AUDITORS

The financial statements of the Authority as of and for the years ended June 30, 2006 and 2005 included in Appendix II hereto have been audited by Ernst & Young LLP, San Juan, Puerto Rico, independent auditors, 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 2006 and 2005 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, “BBB+” by Standard & Poor’s, a division of The McGraw-Hill Companies, Inc. and “A” by Fitch Ratings. 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, S&P and Fitch have assigned ratings of "Aaa","AAA," and "AAA," respectively, to the CIFG Insured Bonds, the FSA Insured Bonds and the MBIA 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, 45th Floor, New York, New York 10041; FT Interactive Data, Attn: NRMSIR, 100 William Street, 15th 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, 2006 and June 30, 2005, 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 CIFG insurance policy, (vi) a specimen of the FSA insurance policy and (vii) a specimen of the MBIA 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 and IV, and the information pertaining to DTC, CIFG, FSA and MBIA was supplied by the Authority. The information pertaining to DTC, CIFG, FSA and MBIA was supplied by DTC, CIFG, FSA and MBIA, respectively.

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

PUERTO RICO ELECTRIC POWER AUTHORITY

By: /s/ Jorge A. Rodríguez Ruiz
 Jorge A. Rodríguez Ruiz
 Executive Director

APPENDIX I

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 15th 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 1974 Trustee that a SWAP agreement is in effect, the 1974 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

Audited Financial Statements

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FINANCIAL STATEMENTS AND SUPPLEMENTAL INFORMATION

Puerto Rico Electric Power Authority

Years Ended June 30, 2006 and 2005

Puerto Rico Electric Power Authority
Financial Statements and Supplemental Information
Years Ended June 30, 2006 and 2005

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Report of Independent Auditors

To the Governing Board of the
Puerto Rico Electric Power Authority

We have audited the accompanying financial statements of the Puerto Rico Electric Power Authority (the Authority), a component unit of the Commonwealth of Puerto Rico, as of and for the years ended June 30, 2006 and 2005, as listed in the table of contents. These financial statements 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. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. We were not engaged to perform an audit of the Authority's internal control over financial reporting. Our audit included 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 also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Authority as of June 30, 2006 and 2005, and the changes in its financial position 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 24, 2006, 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 grant agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on 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 considered in assessing the results of our audits.

The Management's Discussion and Analysis on pages 3 through 10 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. The supplemental information included in Schedules I - VI is presented for purposes of additional analysis and is not a required part of the basic financial statements. The supplemental information included in Schedule I - VI has been subjected to the auditing procedures applied in the audit of the basic financial statements and, in our opinion, is fairly stated in all material respects in relation to the basic financial statements taken as a whole, and is prepared in accordance with the terms of the 1974 Agreement (described herein).

Ernst & Young LLP

October 24, 2006

Stamp No. 2183479
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, 2006, 2005 and 2004. 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 increased by \$16.4 million (or 3.3 percent) and decreased by \$25.7 million (or 4.9 percent) and \$24.3 million (or 4.5 percent) as a result of operations during fiscal years ended June 30, 2006, 2005 and 2004, respectively.
- Operating income was \$403.0 million, \$353.9 million and \$371.8 million for the fiscal years ended June 30, 2006, 2005 and 2004, representing 13.9 percent increase, 4.8 percent decrease and 9.7 percent decrease when compared to fiscal years 2004-2005, 2003-2004 and 2002-2003, respectively.
- Ratios of fuel and purchased power adjustment revenues to total operating revenues were 68.4 percent for 2005-2006, 61.9 percent for 2004-2005 and 56.0 percent for 2003-2004.
- Operating expenses increased by \$623.1 million, \$455.9 million and \$131.5 million for the fiscal years ended June 30, 2006, 2005 and 2004, representing a 23.2 percent, 20.4 percent and 6.3 percent increase, when compared to previous fiscal years.
- Ratios of fuel oil and purchased power expenses to total operating expenses (excluding depreciation expense) were 74.6 percent for 2005-2006, 69.0 percent for 2004-2005 and 65.6 percent for 2003-2004.
- The increase in the fuel adjustment revenues and fuel expense of \$539.5 million and \$482.9 million, respectively, was mainly due to an increase in fuel oil price per barrel of \$17.16 (or 43.7 percent) for 2005-2006. The increase in the fuel adjustment revenues and fuel expense of \$358.1 million and \$318.2 million, respectively, was mainly due to an increase in fuel oil price per barrel of \$9.68 (or 32.7 percent) for 2004-2005. In addition, the decrease in the fuel adjustment revenues and fuel expense of \$23.4 million 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.

Puerto Rico Electric Power Authority

MANAGEMENT'S DISCUSSION AND ANALYSIS (continued)

- The increase in the purchased power adjustment revenue and expense of \$122.6 million and \$110.5 million, respectively, was mainly due to an increase of .77 cents (or 9.3 percent) per kWh in average price of purchase power and an increase of 713,149 MWh (or 12.0 percent) purchase power for 2005-2006. The increase in the purchased power adjustment revenue and expense of \$62.8 million and \$55.8 million, respectively, was mainly due to an increase of 1.2 cents per kWh in average price of purchased power for 2004-2005. In addition, the increase in the purchased power adjustment revenue and expense of \$109.4 million and \$97.7 million, respectively, was mainly due to an increase of 860,775 MWh on two cogeneration facilities and an increase of .69 cents per kWh in average price of purchased power for 2003-04.
- The Authority's Net Utility Plant increased by \$348.2 million, \$284.9 million and \$241.0 million or 6.8 percent, 5.9 percent and 5.3 percent and Total Assets increased by \$347.1 million, \$507.9 million and \$353.7 million or 4.9 percent, 7.7 percent and 5.7 percent for the fiscal years ended June 30, 2006, 2005 and 2004.
- For the fiscal year ended June 30, 2006, as compared to the fiscal year ended June 30, 2005, accounts receivable increased from \$736.0 million on June 30, 2005 to \$837.3 million on June 30, 2006, representing a 13.8 percent increase. Accounts receivable from the governmental sector increased from \$176.0 million on June 30, 2005 to \$265.9 million on June 30, 2006, representing a 51.1 percent increase, due to the Commonwealth's budget deficit for fiscal year 2005-2006. The Commonwealth enacted legislation for the fiscal and tax reform, starting collection of its new sales tax of 7% on November 15, 2006.
- For the fiscal year ended June 30, 2005, as compared to the fiscal year ended June 30, 2004, accounts receivable increased from \$604.5 million on June 30, 2004 to \$736.0 million on June 30, 2005, representing a 21.8 percent increase. Accounts receivable from the governmental sector increased from \$158.9 million on June 30, 2004 to \$176.0 million on June 30, 2005, representing a 10.8 percent increase.
- For the fiscal year ended June 30, 2004, as compared to the fiscal year ended June 30, 2003, accounts receivable increased from \$544.6 million on June 30, 2003 to \$604.5 million on June 30, 2004, representing a 11.1 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.

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.

Puerto Rico Electric Power Authority

MANAGEMENT'S DISCUSSION AND ANALYSIS (continued)

REQUIRED FINANCIAL STATEMENTS

The financial statements of the Authority consolidate the financial position and operations of Puerto Rico Electric Power Authority and its blended component units, Puerto Rico Irrigation Systems and PREPA Networks Corp., which include a Balance Sheet, Statement of Revenues, Expenses and Changes in Net Assets, Statement of Cash Flows 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 present 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.

The Statement of Cash Flows shows changes in cash and cash equivalents, resulting from operating, non-capital and capital 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 increased by \$16.4 million and decreased by \$25.7 million and \$24.3 million for the fiscal years ended June 30, 2006, 2005 and 2004, respectively. Our analysis below focuses on the Authority's net assets and changes in net assets during the year.

Authority's Net Assets *(In Thousands)*

	2006	2005	2004
Current, non-current and other assets	\$ 1,980,450	\$ 1,981,540	\$ 1,758,573
Capital assets	5,437,661	5,089,505	4,804,535
Total assets	\$ 7,418,111	\$ 7,071,045	\$ 6,563,108
Long-term debt outstanding	\$ 5,247,716	\$ 5,300,209	\$ 4,909,527
Other liabilities	1,659,211	1,276,048	1,133,074
Total liabilities	\$ 6,906,927	\$ 6,576,257	\$ 6,042,601

Puerto Rico Electric Power Authority
MANAGEMENT'S DISCUSSION AND ANALYSIS (continued)

Authority's Net Assets
(In Thousands)

	2006	2005	2004
Net assets:			
Invested in capital assets, net of related Debt	\$ 269,241	\$ 66,563	\$ 106,600
Restricted	206,748	367,353	402,780
Unrestricted	35,195	60,872	11,127
Total net assets	\$ 511,184	\$ 494,788	\$ 520,507

A significant portion of the Authority's net assets (40.4 percent for 2005-2006, 74.2 percent for 2004-2005 and 77.4 percent for 2003-2004) 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 (52.7 percent for 2005-2006, 13.5 percent for 2004-2005 and 20.5 percent for 2003-2004) reflects its investment 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 Statements of Revenues, Expenses and Changes in Net Assets.

Authority's Changes in Net Assets
(In Thousands)

	2006	2005	2004
Operating revenues	\$ 3,716,082	\$ 3,043,834	\$ 2,605,764
Other income	24,475	24,835	15,932
Total revenues	3,740,557	3,068,669	2,621,696
Operating expenses	3,313,064	2,689,940	2,233,993
Interest expense, net	286,742	285,112	270,012
Total expenses	3,599,806	2,975,052	2,504,005
Income before contribution in lieu of taxes and other	140,751	93,617	117,691
Contribution in lieu of taxes and other	(180,733)	(159,892)	(180,820)
Loss before contributed capital	(39,982)	(66,275)	(63,129)
Contributed capital	56,378	40,556	38,857
Change in net assets	16,396	(25,719)	(24,272)
Net assets, beginning of year	494,788	520,507	544,779
Net assets, end of year	\$ 511,184	\$ 494,788	\$ 520,507

Puerto Rico Electric Power Authority

MANAGEMENT'S DISCUSSION AND ANALYSIS (continued)

For the fiscal year ended June 30, 2006, as compared to June 30, 2005, operating revenues and expenses increased by \$672.2 million (or 22.1%) and \$623.1 million (or 23.2%), respectively, resulting in an increase in net assets of \$16.4 million. The increase in operating revenues and expenses was mainly due to an increase in fuel oil price per barrel of \$17.16 (or 43.7 percent), an increase of .77 cents (or 9.3 percent) per kWh in average price of purchase power and an increase of 713,149 MWh (or 12.0 percent) of purchase power for 2005-2006.

For the fiscal year ended June 30, 2005, as compared to June 30, 2004, operating revenues and expenses increased by \$438.1 million (or 16.8%) and \$455.9 million (or 20.4%), respectively, resulting in a decrease in net assets of \$25.7 million. The increase in operating revenues and expenses was mainly due to an increase in fuel oil price per barrel of \$9.68 (or 32.7 percent) and an increase of 1.2 cent per kWh in average price of purchased power for 2004-2005. In addition, the decrease in net assets was mainly due to the revenue losses of approximately \$11.0 million. Operating expense amounted to approximately \$8.0 million related to the impact of Tropical Storm Jeanne, and an increase in the reserve for uncollectible accounts of \$9.9 million.

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 in net assets of \$24.3 million. The increase in operating revenues and expenses was mainly due to an increase of \$.69 cent per kWh (or 10.8%) in the average price of purchased power and an increase of 860,775 MWh (or 16.2%) in purchased power.

CAPITAL ASSETS AND DEBT ADMINISTRATION

Capital Assets

The Authority's investment in capital assets as of June 30, 2006, 2005 and 2004, amounts to approximately \$5,438 million, \$5,089 million and \$4,805 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 increases in the Authority's investment in capital assets (net of accumulated depreciation) were 6.8 percent, 5.9 percent and 5.3 percent for 2005-2006, 2004-2005 and 2003-2004.

A substantial portion of the capital expenditures for production plant in fiscal year ended June 30, 2006, 2005 and 2004 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 2005-2006 included the following:

- To provide for additional load growth after fiscal year 2007, the Authority is replacing the two 44 MW San Juan Units No. 5 & 6 with the 464 MW of combined-cycle capacity to the Authority's system in the fiscal year 2007. Both units shall be in commercial operation in September 2007. When completed, the plant will comprise two combined-cycle units, each consisting of one combustion turbine rated at 165 kW with a heat recovery steam generator (HRSG) feeding a single 67 MW steam turbine-generator.

Puerto Rico Electric Power Authority

MANAGEMENT'S DISCUSSION AND ANALYSIS (continued)

The Authority had constructed new 230 kW transmission lines to complete the transmission loop on the eastern part of the island. The eastern loop is operating and connects major switching and load centers on the eastern part of the island boosting electric system capacity in Puerto Rico's eastern region.

- The Authority is also constructing a new 50-mile long 230 kW 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 2012. 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 kW sub-transmission system is in effect which includes construction of underground 38 kW lines in Mayagüez, Vega Baja, Viaducto and San Fernando in San Juan. In addition, most 38 kW 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 kW 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 2007. 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 kW transmission centers of Martín Peña, Isla Grande, San Juan and Palo Seco Steam Plants.
- In addition, a new 115/38 kW transmission centers under construction in the municipalities of Juana Díaz and Hatillo will increase the power transfer and improve the voltage regulation of the 38 kW system under emergency conditions.
- The Authority installed new 115 kW 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 2006-2007.
- The Authority has six new substations under construction in the distribution system. These substations are: Candelero PDS 115/13.2 kW (33.6 MVA) in Municipality of Humacao, Hacienda San José PDS 115/13.2 kW (33.6 MVA) in Caguas, La Parguera PDS 38/13.2 kW (22.4 MVA) in Lajas, Martín Peña GIS 115/13.2 kW (33.6 MVA) in San Juan, Veredas PDS 38/13.2 kW (22.4 MVA) in Gurabo, and Mora PDS 115/13.2 kW (33.6 MVA) in Isabela. In addition, the capacity of the Candelaria Arenas 115/13.2 kW substation will be increased from 22.4 MVA to 33.6 MVA. The construction of these new substations increases the distribution capacity, provides service to new clients, and improves the reliability in the distribution system.

Puerto Rico Electric Power Authority

MANAGEMENT'S DISCUSSION AND ANALYSIS (continued)

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

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 2006, 2005 and 2004, the Authority had total long-term debt outstanding of \$5,261.4 million, \$5,305.0 million and \$4,909.5 million, respectively, comprised of revenue bonds and other borrowings.

Authority's Outstanding Debt (In Thousands)

	<u>2006</u>	<u>2005</u>	<u>2004</u>
Power revenue bonds, net	\$ 5,156,531	\$ 5,263,374	\$ 4,904,527
Notes payable	104,835	41,585	5,000
	<u>5,261,366</u>	<u>5,304,959</u>	<u>4,909,527</u>
Current portion	(391,182)	(303,102)	(331,806)
Long-term debt excluding current portion	<u>\$ 4,870,184</u>	<u>\$ 5,001,857</u>	<u>\$ 4,577,721</u>

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

Additional information on the Authority's long-term debt can be found in Notes 5, 8 and 12 of the financial statements.

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 2005 U.S. Real GDP increased 3.5%.

The economy of Puerto Rico is expected to resume growing in fiscal year 2007, advancing at a rate of 0.62% in real terms, according to the latest forecast prepared by Interamerican University Global Inside (IAU-Gi).

The Authority adopted the 2007 fiscal year budget on June 20, 2006. The electric revenues for fiscal year 2006-2007 are projected to approximately \$3,919.8 million. In addition, the Capital Improvement Program amounted to approximately \$531.5 million. The 2007 consolidated budget increase by \$1,089.2 million (or 32.3 percent) from fiscal year 2005-2006, due mainly to the increase on fuel oil prices.

Puerto Rico Electric Power Authority
MANAGEMENT'S DISCUSSION AND ANALYSIS (continued)

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

	June 30	
	2006	2005
	<i>(In Thousands)</i>	
Assets		
Current assets:		
Cash and cash equivalents	\$ 18,614	\$ 21,282
Receivables, net	762,353	659,799
Fuel oil, at average cost	119,971	90,155
Materials and supplies, at average cost	157,831	149,981
Prepayments and other assets	5,406	25,893
Total current assets	<u>1,064,175</u>	947,110
Other non-current receivables	75,006	76,211
Restricted assets:		
Cash and cash equivalents held by trustee for payment of principal and interest on bonds	329,965	253,883
Investments held by trustee	323,961	318,598
Construction fund and other special funds	58,494	225,896
Total restricted assets	<u>712,420</u>	798,377
Utility plant:		
Plant in service	7,235,232	6,906,179
Accumulated depreciation	<u>(3,864,955)</u>	<u>(3,617,853)</u>
	3,370,277	3,288,326
Construction in progress	2,067,384	1,801,179
Total utility plant, net	<u>5,437,661</u>	5,089,505
Other properties	–	38,867
Deferred expenses:		
Unamortized debt issue cost	60,255	64,178
Other	68,594	56,797
Total deferred expenses	<u>128,849</u>	<u>120,975</u>
Total assets	<u>\$ 7,418,111</u>	<u>\$ 7,071,045</u>

(Continue)

	June 30	
	2006	2005
	<i>(In Thousands)</i>	
Liabilities and net assets		
Current liabilities:		
Notes payable	\$ 493,316	\$ 242,411
Accounts payable and accrued liabilities	645,525	541,816
Customers' deposits	155,366	159,376
Total current liabilities	<u>1,294,207</u>	<u>943,603</u>
Current liabilities payable from restricted assets:		
Current portion of long-term debt	377,532	298,352
Accrued interest	136,696	126,057
Other current liabilities payable from restricted assets	90,002	67,384
Total current liabilities payable from restricted assets	<u>604,230</u>	<u>491,793</u>
Noncurrent liabilities:		
Long-term debt, excluding current portion	4,870,184	5,001,857
Sick leave benefits to be liquidated after one year	138,306	139,004
Total noncurrent liabilities	<u>5,008,490</u>	<u>5,140,861</u>
Total liabilities	<u>6,906,927</u>	<u>6,576,257</u>
Net assets:		
Invested in utility plant, net of related debt	269,241	66,563
Restricted for capital activity and debt service	206,748	367,353
Unrestricted	35,195	60,872
Total net assets	<u>511,184</u>	<u>494,788</u>
Total liabilities and net assets	<u><u>\$ 7,418,111</u></u>	<u><u>\$ 7,071,045</u></u>

See accompanying notes.

Puerto Rico Electric Power Authority

Statements of Revenues, Expenses and Changes in Net Assets

	Year Ended June 30	
	2006	2005
	<i>(In Thousands)</i>	
Operating revenues	\$ 3,716,082	\$ 3,043,834
Operating expenses:		
Operations:		
Fuel	1,665,866	1,182,936
Purchased power	603,169	492,621
Other production	58,160	56,439
Transmission and distribution	164,731	162,625
Customer accounting and collection	107,570	108,604
Administrative and general	201,363	188,910
Maintenance	240,511	235,575
Depreciation	271,694	262,230
Total operating expenses	<u>3,313,064</u>	<u>2,689,940</u>
Operating income	403,018	353,894
Interest income and other	24,475	24,835
Income before interest charges, contribution in lieu of taxes and contributed capital	<u>427,493</u>	<u>378,729</u>
Interest charges:		
Interest on bonds	270,202	261,641
Interest on other long-term debt	11,427	6,189
Other interest	1,946	3,728
Amortization of debt discount, issuance costs and refunding loss	15,489	21,741
Allowance for funds used during construction	(12,322)	(8,187)
Total interest charges, net	<u>286,742</u>	<u>285,112</u>
Income before contribution in lieu of taxes and contributed capital	140,751	93,617
Contribution in lieu of taxes and other	(180,733)	(159,892)
Loss before contributed capital	(39,982)	(66,275)
Contributed capital	56,378	40,556
Changes in net assets	<u>16,396</u>	<u>(25,719)</u>
Net assets, beginning balance	494,788	520,507
Net assets, ending balance	<u>\$ 511,184</u>	<u>\$ 494,788</u>

See accompanying notes.

Puerto Rico Electric Power Authority

Statements of Cash Flows

	Year Ended June 30	
	2006	2005
	<i>(In Thousands)</i>	
Cash flows from operating activities		
Cash received from customers	\$ 3,578,114	\$ 2,897,219
Cash paid to suppliers and employees	(3,092,325)	(2,549,345)
Net cash flows provided by operating activities	485,789	347,874
Cash flows from noncapital financing activities		
Proceeds from notes payable	100,000	73,173
Principal paid on general obligation notes	(64,897)	(5,000)
Interest paid on general obligation notes	(11,427)	(6,189)
Other special funds, net	-	23,527
Principal paid on fuel line of credit	(280,000)	(625,000)
Proceeds from fuel line of credit	330,000	625,000
Interest paid on fuel line of credit	(6,836)	(2,755)
Net cash flows provided by noncapital financing activities	66,840	82,756
Cash flows from capital and related financing activities		
Construction expenditures	(544,741)	(554,105)
Proceeds received from contributed capital	36,998	23,755
Allowance for funds used during construction	12,322	8,187
Power revenue bonds:		
Proceeds from issuance of bonds, net of original issue discount	-	533,017
Principal paid on revenue bonds	(118,427)	(195,713)
Interest paid on revenue bonds	(260,721)	(272,617)
Proceeds from issuance of refunding bonds, net of original issue discount	-	851,858
Defeased bonds, net of original issue discount or premium	-	(880,588)
Payment of bond anticipation notes	-	(167,933)
Proceeds from bond anticipation notes	220,153	187,594
Interest paid on bond anticipation notes	(2,829)	(990)
Net cash flows used in capital and related financing activities	(657,245)	(467,535)
Cash flows from investing activities		
Purchases of investment securities	(1,419,024)	(1,568,162)
Proceeds from sale and maturities of investment securities	1,497,605	1,583,322
Interest on investments	20,639	21,913
Transfer from restricted funds to revenue and general fund	-	(29,852)
Net cash flows provided by investing activities	99,220	7,221
Net decrease in cash and cash equivalents	(5,396)	(29,684)
Cash and cash equivalents at beginning of year	361,754	391,438
Cash and cash equivalents at end of year	\$ 356,358	\$ 361,754

(Continue)

Puerto Rico Electric Power Authority

Statements of Cash Flows (continued)

	Year Ended June 30	
	2006	2005
	<i>(In Thousands)</i>	
Cash and cash equivalents		
Unrestricted	\$ 18,614	\$ 21,282
Restricted:		
Cash and cash equivalents held by trustee for payment of principal and interest on outstanding bonds	329,965	253,883
Cash and cash equivalents held in construction and other special funds	7,779	86,589
	<u>\$ 356,358</u>	<u>\$ 361,754</u>
Reconciliation of net operating income to net cash provided by operating activities		
Operating income	\$ 403,018	\$ 353,894
Adjustments to reconcile operating income to net cash provided by operating activities:		
Depreciation	271,694	262,230
Amortization of asbestos removal cost	1,016	4,116
Provision for uncollectible accounts and other	21,310	21,162
Changes in assets and liabilities:		
Receivables	(303,928)	(311,608)
Fuel oil	(22,980)	(21,240)
Materials and supplies	(7,843)	(15,253)
Prepayments and other assets	20,487	5,985
Deferred debits	(6,181)	(37,161)
Noncurrent liabilities, excluding note payable to GDB	(698)	1,692
Accounts payable and accrued liabilities	113,907	75,323
Customers' deposits	(4,013)	8,734
Total adjustments	<u>82,771</u>	<u>(6,020)</u>
Net cash flows provided by operating activities	<u>\$ 485,789</u>	<u>\$ 347,874</u>

See accompanying notes.

Puerto Rico Electric Power Authority
Notes to Audited Financial Statements
June 30, 2006 and 2005

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 Units

The financial statements of the Authority include the financial position and operations of the Puerto Rico Irrigation Systems (Irrigation Systems) and PREPA Networks Corp. (PREPA.Net). 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 and PREPA.Net 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 Units (continued)

Condensed financial information as of June 30, 2006 and 2005 and for the year then ended for the Irrigation Systems is as follows:

	2006	2005
	<i>(In Thousands)</i>	
Balance sheets:		
Assets:		
Receivables, net	\$ 9,589	\$ 6,503
Prepayments and other assets	2,185	2,226
Utility Plant, net of depreciation	20,665	20,903
Total assets	32,439	29,632
Liabilities:		
Accounts payable, net	951	928
Statement of revenues, expenditures and changes in net assets:		
Operating revenues	6,359	5,724
Operating expenses	(3,575)	(5,921)
	2,784	(197)
Net assets, beginning balance	28,704	28,901
Net assets, ending balance	\$ 31,488	\$ 28,704

PREPA.Net is a telecommunications subsidiary of the Authority to develop strategies for commercializing the surplus capacity of the installed Optical Fiber Network (OPN), adding flexibility and diversification to its operations. PREPA.Net was created on April, 2004 and started commercial operations during fiscal year 2005-2006.

PREPA.Net provides Next Generation Telecommunications (NGN) services to carriers, ISPs and large enterprises – with highly reliable facilities-based on MPLS and SONET network services.

Services offered include SONET, metro and long haul Ethernet transport services, wireless last mile, BPL, and IP services optimized for VoIP and other related services.

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

1. Reporting Entity

Basis of Presentation – Blended Component Units (continued)

PREPA.Net entered into a long-term lease with PREPA for the Indefeasible Right of Use (IRU) of all PREPA's Optical Infrastructure. PREPA.Net's network features nearly 200 POPs in places like – carrier facilities, undersea cable landing stations, wireless network towers, and end user locations. With over 710 Km of fiber and over 34 transport node sites PREPA.Net's network is one of the most robust networks on the Commonwealth.

Condensed financial information as of June 30, 2006 and for the year then ended for PREPA.Net is as follows:

	2006
	<i>(In Thousands)</i>
Balance sheet:	
Assets:	
Cash and cash equivalents	\$ 246
Receivables, net	191
Material and supplies	6
Prepayments and other assets	12
Utility plant, net of depreciation	3,304
Total assets	3,759
Liabilities:	
Accounts payable, net	4,140
Statement of revenues, expenditures and changes in net assets:	
Operating revenues	785
Operating expenses	(1,166)
	(381)
Net assets, beginning balance	–
Net assets, ending balance	\$ (381)

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

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 basis 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.

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.

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

2. Summary of Significant Accounting Policies (continued)

During the 2005 fiscal year, the Authority adopted the provisions of Government Accounting Standard No. 40, *Deposit and Investment Risk Disclosure – an Amendment of GASB No. 3*. The statement addresses common deposit and investment risks related to credit risk, concentration of credit risk, interest-rate risk, and foreign currency risk. Among other disclosures, the statement requires certain disclosures applicable to deposits or investments having fair values that are highly sensitive to changes in interest rates.

Reclassifications

Certain amounts of 2005 have been reclassified to conform with the current year's presentation.

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.

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.

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

2. Summary of Significant Accounting Policies (continued)

Investments (continued)

- 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, 2006 and 2005 amounted to \$12.3 million and \$8.2 million, respectively. These amounts are net of interest income earned on investments amounting to \$7.3 million and \$6.2 million, respectively.

Capital expenditures of \$1,200 or more are capitalized at cost at the date of acquisition. 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.

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 2006 and 2005.

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

2. Summary of Significant Accounting Policies (continued)

Unamortized Debt Issuance 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.

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:

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 (continued)

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.

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

- a) Twenty percent of the Authority's Adjusted Net Revenues (Net Revenues, as defined in the 1974 Agreement, less the cost of the Commonwealth rate subsidies);
- b) The cost collectively of the actual electric power consumption of the municipalities;
or
- c) 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, local and federal agencies by third parties 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, 2006 and 2005, 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):

	2006		2005	
	Carrying Amount	Bank Balance	Carrying Amount	Bank Balance
Unrestricted	\$ 18,614	\$ 26,704	\$ 21,282	\$ 30,835
Restricted:				
Held by the Trustee	329,965	329,965	253,883	253,883
Held by the Authority	7,779	7,779	86,589	86,589
	<u>\$ 356,358</u>	<u>\$ 364,448</u>	<u>\$ 361,754</u>	<u>\$ 371,307</u>

Custodial Credit Risk - Deposits

Custodial credit risk is the risk that in the event of a bank failure, the Bank's deposits may not be returned. The Authority's policy is to deposit funds with either institutions which provide insurance or collateral of securities held by the Department of the Treasury of the Commonwealth, or with the Government Development Bank for Puerto Rico (GDB), another component unit of the Commonwealth, which are uninsured and uncollateralized.

All moneys deposited with the Trustee or any other Depository hereunder in excess of the amount guaranteed by the Federal Deposit Insurance Corporation or other Federal agency are continuously secured by lodging with a bank or trust company approved by the Authority and by the Trustee as custodian, or, if then permitted by law, by setting aside under control of the trust department of the bank holding such deposit, as collateral security, Government Obligations or other marketable securities.

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

4. Accounts Receivable

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

	2006	2005
Electric and related services:		
Government agencies and municipalities	\$ 265,882	\$ 176,048
Residential, industrial, and commercial	428,954	389,002
Recoveries under fuel adjustment clause (over) under billed	(7,995)	12,796
Unbilled services	168,055	163,528
Commonwealth subsidy (fuel adjustment clause) for certain residential clients	18,980	25,272
Miscellaneous accounts and others	18,855	10,931
	892,731	777,577
Allowance for uncollectible accounts	(58,821)	(45,980)
	833,910	731,597
Accrued interest on investments	3,449	4,413
Less other non-current receivables, mostly related to the Commonwealth	(75,006)	(76,211)
	\$ 762,353	\$ 659,799

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, 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. As of June 30, 2006, the outstanding receivable amounted to approximately \$43.1 million, of which the fuel adjustment subsidy receivable amounted to \$18.9 million.

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 11% of gross electric sales, after the contribution in lieu of taxes to municipalities, 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, 2006 and 2005, 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. During fiscal year 2004-2005, the Authority withdrew \$20 million from 1974 Self-Insurance Fund to finance the repair and other cost related with Tropical Storm Jeanne.

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, 2006 and 2005, cash and cash equivalents in this account amounted to \$330.0 and \$253.9 million, respectively.

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

	2006	2005
1974 Reserve Account	\$ 258,815	\$ 255,159
1974 Self-insurance Fund	65,146	63,439
	\$ 323,961	\$ 318,598

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.

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):

	2006		2005	
	Cash and Cash Equivalents	Investments	Cash and Cash Equivalents	Investments
1974 Construction Fund	\$ 7,668	\$ 921	\$ 86,495	\$ 90,921
Reserve Maintenance Fund	111	49,794	94	48,386
Other Funds	–	–	–	–
	\$ 7,779	\$ 50,715	\$ 86,589	\$ 139,307

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

	2006	2005
U.S. Government obligations	\$ 50,647	\$ 49,307
Certificate of deposit	68	90,000
	\$ 50,715	\$ 139,307

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

5. Restricted Assets (continued)

The following table provides a summary of the Authority's investments by type at June 30, 2006:

	Coupon Rate	Maturity Dates	Face Value	Fair Value	% of Total Portfolio
1974 Reserve Maintenance Fund					
Federal Home Loan Mortgage Corporation	2.46 to 5.75%	10/2006 to 05/2009	5,240	\$ 5,223	10.5%
Federal Home Loan Bank	2.80 to 5.30%	03/2007 to 2/2009	13,435	13,272	26.7%
Federal National Mortgage Association	3.00 to 5.30%	02/2007 to 02/2009	18,680	18,796	37.7%
Federal Farm Credit Bank	5.100%	10/1/2009	12,350	12,435	25.0%
Certificate of Deposits	5.150%	7/1/2006	68	68	0.1%
Total			Total Portfolio	49,794	
1974 Self Insurance Reserve Fund					
Federal Home Loan Mortgage Corporation	5.75%	5/2009	395	396	0.6%
Federal Home Loan Bank	2.6 to 5.50%	04/2007 to 05/2009	38,625	38,219	58.7%
Federal National Mortgage Association	3.00 to 5.75%	05/2007 to 06/2009	23,363	23,165	35.5%
Certificate of Deposits	5.05 to 5.15%	07/2006	3,365	3,366	5.2%
			Total Portfolio	65,146	
1974 Reserve Account					
Federal Home Loan Mortgage Corporation	3.00 to 5.125%	11/2007 to 03/2009	27,541	27,490	10.6%
Federal Home Loan Bank	2.65 to 5.50%	04/2007 to 07/2010	112,030	109,553	42.3%
Federal National Mortgage Association	3.125 to 5.60%	03/2007 to 06/2009	75,950	74,672	28.9%
Federal Farm Credit Bank	3.375 to 3.60%	03/2009	48,622	46,758	18.1%
Certificate of Deposits	5.00 to 5.15%	07/2006	339	342	0.1%
			Total Portfolio	258,815	
1974 Construction Fund					
Other - Rea Investment			921	921	100.0%
				921	
				\$ 374,676	

Credit Risk

Credit risk is the risk that an issuer of an investment will not fulfill its obligation to the holder of the investment. This is measured by the assignment of a rating by a nationally recognized statistical rating organization. The 1974 Trust Agreements limits investments in:

- Government obligations, which are direct obligations of, or obligations whose principal and interest is guaranteed by the U.S. Government, or obligation of certain of its agencies or instrumentalities.
- Investment obligation of any of the states or territories of the United States or political subdivisions therefore (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.

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

5. Restricted Assets (continued)

Credit Risk (continued)

- 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.

As of June 30, 2006, the Authority's investments in Federal Home Loan Mortgage, Federal Home Loan Bank, Federal National Mortgage Association and Federal Farm Credit Bank were rated AAA by Standard & Poor's and Aaa by Moody's Investors Service.

Concentration Credit Risk

Concentration of credit risk is the risk of loss attributable to the magnitude of investment in a single issuer by five percent or more of total investment. The Authority's investment policy does not contain a limitation to invest in the securities of single issuer. As June 30, 2006, more than 5% of the Authority's total investments are in Federal Home Loan Mortgage, Federal Home Loan Bank, Federal National Mortgage Association, Federal Farm Credit Bank, and Certificate of Deposits.

Interest Rate Risk

Interest rate risk is the risk that changes in interest rates will adversely affect the fair value of an investment. Generally, the longer the maturity of an investment, the greater the sensitivity of its fair value to changes in market interest rates. In accordance with the 1974 Trust Agreement, the Authority manages its exposure to declines in fair values by limiting the maturity of its investment portfolio up to 5 years. Information about the sensitivity of the fair values of the Authority's investment to market interest fluctuations is provided by the following table that shows the distribution of the investments by maturity as of June 30, 2006:

Investment Type	Fair Value	Investment Maturities		Total
		Less than 1 year	1-5 years	
Federal Home Loan Mortgage	\$ 33,109	\$ 1,685	\$ 31,424	\$ 33,109
Federal Home Loan Bank	161,044	25,942	135,102	161,044
Federal National Mortgage	116,633	23,591	93,042	116,633
Federal Farm Credit Bank	59,193	-	59,193	59,193
Certificate of Deposits	3,776	3,776	-	3,776
Other - Rea Investment	921	-	921	921
Total Investments				<u><u>\$ 374,676</u></u>

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

6. Utility Plant

As of June 30, utility plant consists of:

	2006	2005
	<i>(In Thousands)</i>	
Distribution	\$ 2,326,109	\$ 2,226,932
Transmission	1,070,258	1,020,971
Production	1,727,780	1,715,525
Other production	643,840	654,474
Hydroelectric	97,896	97,508
General	1,334,113	1,160,025
Irrigation systems	31,923	30,744
PREPA.Net	3,313	-
	7,235,232	6,906,179
Less accumulated depreciation	(3,864,955)	(3,617,853)
	3,370,277	3,288,326
Construction in progress	2,067,384	1,801,179
	\$ 5,437,661	\$ 5,089,505

Utility plant activity for the years ended June 30, 2006 and 2005 was as follows:

	2005				2006
	Beginning Balance	Increases	Decreases	Transfers	Ending Balance
Utility plant	\$ 6,906,179	\$ -	\$ (24,592)	\$ 353,645	\$ 7,235,232
Construction work in progress	1,801,179	619,850	-	(353,645)	2,067,384
Total utility plant	8,707,358	619,850	(24,592)	-	9,302,616
Less:					
Accumulated depreciation	(3,617,853)	(271,694)	24,592	-	(3,864,955)
Total utility plant, net	\$ 5,089,505	\$ 348,156	\$ -	\$ -	\$ 5,437,661

	2004				2005
	Beginning Balance	Increases	Decreases	Transfers	Ending Balance
Utility plant	\$ 6,592,174	\$ 13,924	\$(17,948)	\$ 318,029	\$ 6,906,179
Construction work in progress	1,585,932	533,276	-	(318,029)	1,801,179
Total utility plant	8,178,106	547,200	(17,948)	-	8,707,358
Less:					
Accumulated depreciation	(3,373,571)	(262,230)	17,948	-	(3,617,853)
Total utility plant, net	\$ 4,804,535	\$ 284,970	\$ -	\$ -	\$ 5,089,505

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

6. Utility Plant (continued)

Construction work-in-progress at June 30, 2006 and 2005 consists principally of expansions and upgrades to the electric generation, distribution and transmission systems.

7. Other Property – Optical Fiber Network (OFN)

During year 2002, the Authority paid \$38.9 million to acquire the OFN. The Authority transferred the OFN to Plant in Service in fiscal year 2005-2006 as the commercial operation started.

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, 2006, \$1,353 million, of Power Revenue Bonds which remain outstanding are considered defeased.

9. Notes Payable

On July 2, 2003, the Authority and GDB entered into an agreement for a line of credit of \$68 million to fund payments required under a settlement agreement relating to certain litigation with the municipalities of Puerto Rico. In connection with the same litigation, GDB approved a second line of credit amounting to \$57 million for electric infrastructure projects in the Municipalities. As of June 30, 2006, the Authority had drawn \$102.9 million on these lines of credit, which \$59.2 million is considered long term.

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. As of June 30, 2006, \$4.9 million have been drawn on this line of credit.

On December 30, 2004, the Authority and a commercial bank entered into an agreement for selling at discount the funds assigned, by the Legislature of Puerto Rico through Joint Resolution 1290 of August 24, 2004, to pay the amount owed by the Commonwealth regarding the subsidy to qualified clients and certain accounts receivables from the government agencies. The proceeds of the transaction were \$41.5 million. The note bears interest between 2.6% to 4.44%. The Authority expects that this note will be paid by annual appropriation by the Commonwealth of Puerto Rico of \$6.3 million until fiscal year 2012 and a final payment of \$5.1 million on fiscal year 2013, according to Joint Resolution 1290. As of June 30, 2006, the outstanding balance of line of credit is \$36.8 million of which \$32.0 million is considered long term.

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

9. Notes Payable (continued)

On July 1, 2005, the Authority and certain commercial 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. On October 31, 2005, the line of credit was amended to increase the amount to \$175 million, which is outstanding as of June 30, 2006. The average effective interest rate during each year and at year-end was 4.69% and 5.43%, respectively, for 2006; and 2.36% and 3.30%, respectively, for 2005.

On November 15, 2005, the Authority and GDB entered into an agreement for a line of credit of \$200 million to be used as interim financing for a portion of the cost of various projects under its capital improvement program. As of June 30, 2006, this line of credit was refinanced with a bridge loan of \$200 million between the Authority and JP Morgan Chase Bank National Association, which is outstanding.

On February 2, 2006, the Authority and GDB entered into an agreement for a line of credit of \$100 million to be used for operational purposes. The payment source of such loan is certain receivables from the Commonwealth and public corporations. As of June 30, 2006, the outstanding balance of line of credit is \$64.9 million.

Short-term debt activity for the years ended June 30, 2006 and 2005 was as follows:

	<u>2006</u>	<u>2005</u>
	<i>(In Thousands)</i>	
Balance at beginning of year	\$ 242,411	\$ 186,452
Proceeds and transfers from long-term debt	599,827	848,932
Payments of short-term debt	<u>(344,922)</u>	<u>(792,973)</u>
Balance at end of year	<u>\$ 493,316</u>	<u>\$ 242,411</u>

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

10. Accounts Payable and Accrued Liabilities

	2006	2005
	<i>(In Thousands)</i>	
Accounts payable, accruals, and withholdings in process of payment	\$ 420,844	\$ 387,119
Additional accruals and withholdings:		
Injuries and damages and other	18,723	18,243
Accrued vacation and payroll benefits	50,773	46,277
Accrued sick leave and payroll benefits - exclusive of benefits to be liquidated after one year of approximately \$138.3 million in 2006 and \$139.0 in 2005	9,264	12,788
Accrued compensation	15,391	29,116
Accrued pension plan contribution and withholding from employees:		
Employees' Retirement System	67,721	18,261
Employees health plan	25,329	14,360
Contribution in lieu of taxes	1,274	1,790
Other accrued liabilities	36,206	13,862
	\$ 645,525	\$ 541,816

11. Other Current Liabilities Payable from Restricted Assets

	2006	2005
	<i>(In Thousands)</i>	
Contract retainage	\$ 35,299	\$ 32,990
Other liabilities	54,703	34,394
	\$ 90,002	\$ 67,384

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

12. Long-Term Debt

At June 30, long-term debt consists of:

	2006	2005
	<i>(In Thousands)</i>	
Power Revenue Bonds payable:		
Publicly offered at various dates from 1992 to 2005, interest rates ranging from 3.0% to 7.0%, maturing to 2035	\$ 5,217,470	\$ 5,335,215
Rural Utility Services (RUS) issues - interest rate of 5%, maturing through 2028	28,892	29,574
	5,246,362	5,364,789
Less unamortized discount and debt reacquisition costs	(89,831)	(101,415)
Revenue bonds payable, net	5,156,531	5,263,374
Notes payable	104,835	41,585
	5,261,366	5,304,959
Less current portion of long-term debt	(391,182)	(303,102)
	\$ 4,870,184	\$ 5,001,857

Long-term debt activity for the years ended June 30, 2006 and 2005 was as follows:

	2006	2005
	<i>(In Thousands)</i>	
Long-term debt excluding current portion	\$ 5,304,959	\$ 4,909,527
New issues:		
Power revenue bonds	-	509,520
Power revenue refunding bonds	-	803,900
Debt discount on new bond issues - net	-	71,455
Defeasance of bonds	-	(845,780)
Debt discount and excess reacquisition costs on cancelled bonds - net	-	(34,808)
Notes payable	68,000	41,585
	5,372,959	5,455,399
Payments:		
Power revenue bond - July 1	(118,082)	(165,256)
Power revenue bond - January 1	(345)	(329)
Notes payable	(4,750)	(5,000)
Total payments	(123,177)	(170,585)
Amortization of debt discount and excess reacquisition costs	11,584	20,145
Balance at end of year	\$ 5,261,366	\$ 5,304,959

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

12. Long-Term Debt (continued)

	2006	2005
	<i>(In Thousands)</i>	
Current portion of Notes Payable	\$ 13,650	\$ 4,750
Current portion of Power Revenue Bonds	377,532	298,352
Total current portion of long-term debt	\$ 391,182	\$ 303,102

Power Revenue Bonds Payable

During fiscal year 2005, the Authority issued its Power Revenue Bonds, Series OO, PP, QQ, RR and SS. In addition, the Authority issued the Series OO, PP, QQ and SS 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 S	\$ 4,760,000
Series U	120,280,000
Series X	89,400,000
Series Z	213,845,000
Series AA	275,065,000
Series BB	30,285,000
Series DD	10,220,000
Series EE	2,740,000
Series GG	5,875,000
Series HH	74,545,000
Series KK	7,765,000
Series MM	11,000,000
Total refunded	\$ 845,780,000

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 \$59,700,131. This will generate an economic gain (difference between present value of the old and new debt service payments) of \$53,802,795. The Authority deposited the net proceeds of the Series OO, PP, QQ and SS 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.

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

12. Long-Term Debt (continued)

Power Revenue Bonds Payable (continued)

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.

The Authority issued the Power Revenue Bonds, Series RR 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 OO, Series PP, Series QQ Series RR and Series SS application of the proceeds follows:

Principal amount of Series OO Refunding Bonds	\$ 136,105,000
Principal amount of Series PP Refunding Bonds	88,595,000
Principal amount of Series QQ Refunding Bonds	95,270,000
Principal amount of Series RR Bonds	509,520,000
Principal amount of Series SS Refunding Bonds	483,930,000
Plus:	
Net original issue premium	79,639,687
Other available moneys	40,520,299
Proceeds	<u>\$ 1,433,579,986</u>
Application of net proceeds:	
Deposit to Escrow Fund for Refunded Power Revenue Bonds	\$ 883,690,995
Deposit to 1974 Construction Fund	332,067,172
Repayment of Government Development Bank Line of credit	167,932,828
Capitalized interest on Series RR Bonds through January 1, 2006	18,481,477
Underwriting discount, municipal bond issuance premium and estimated legal, printing and other financing expenses	31,407,514
Costs of Issuance	<u>\$ 1,433,579,986</u>

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

12. Long-Term Debt (continued)

Power Revenue Bonds Payable (continued)

Maturities of the Power Revenue Refunding Bonds Series OO issued during fiscal year 2005 range from July 1, 2005 to July 1, 2015. The Series OO Bonds bear fixed interest rates ranging from 4% to 5%. Interest on the Series OO Bonds is payable on each January 1 and July 1.

Maturities of the Power Revenue Bonds Series PP issued during fiscal year 2005 range from July 1, 2005 to July 1, 2025. The Series PP Bonds bear fixed interest rates ranging from 3.00% to 5.00%. Interest on the Series PP Bonds is payable on each January 1 and July 1.

Maturities of the Power Revenue Refunding Bonds Series QQ issued during fiscal year 2005 range from July 1, 2013 to July 1, 2018. The Series QQ Bonds bear fixed interest rates ranging from 5.25% to 5.50%. Interest on the Series QQ Bonds is payable on each January 1 and July 1.

Maturities of the Power Revenue Bonds Series RR issued during fiscal year 2005 range from July 1, 2020 to July 1, 2030. The Series RR Bonds bear a fixed interest rate of 5.00%. Interest on the Series RR Bonds is payable on each January 1, and July 1.

Maturities of the Power Revenue Refunding Bonds Series SS issued during fiscal year 2005 range from July 1, 2007 to July 1, 2030. The Series SS Bonds bear fixed interest rates ranging from 3.00% to 5.00%. Interest on the Series SS Bonds is payable on each January 1 and July 1.

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.

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

12. Long-Term Debt (continued)

Scheduled Maturities of Long-Term Debt

The scheduled maturities of long-term debt with interest thereon at June 30, 2006, including sinking fund debt service requirements, are as follows:

Fiscal Year Ending June 30	Principal	Interest	Total
	<i>(In thousands)</i>		
2007	\$ 402,724	\$ 400,047	\$ 802,771
2008	192,468	255,720	448,188
2009	202,907	245,355	448,262
2010	183,306	234,143	417,449
2011	187,748	224,102	411,850
2012-2016	1,039,051	961,500	2,000,551
2017-2021	1,025,951	694,396	1,720,347
2022-2026	1,050,519	427,123	1,477,642
2027-2031	809,478	179,090	988,568
2032-2035	257,045	28,015	285,060
Total	5,351,197	3,649,491	9,000,688
Less:			
Unamortized discount and premium	79,647	-	79,647
Excess reacquisition costs	(169,478)	-	(169,478)
Interest	-	(3,649,491)	(3,649,491)
Total long-term debt	5,261,366	-	5,261,366
Current portion, net of discount and excess reacquisition costs of bonds	(377,532)	-	(377,532)
Current portion of notes payable	(13,650)	-	(13,650)
Long-term debt, excluding current portion	\$ 4,870,184	\$ -	\$ 4,870,184

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

13. 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.

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, 2004 and projected to June 30, 2005 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.

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

13. Employees' Retirement Benefits (continued)

Supplemental Benefits not Funded Through the System (continued)

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.

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

The Authority's annual pension cost for the year ended June 30, 2006 and related information for the Plan and supplemental benefits follows:

	Pension Plan
Contribution rates:	
Authority	10.02%
Plan members	9.99%
Annual pension cost (thousands)	\$74,766
Contributions made and accruals (thousands)	\$35,970
Actuarial valuation date	6/30/2004
Actuarial cost method	Entry age
Amortization method	Level percentage of pay, closed (4% payroll increases per year)
Remaining amortization period	32 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	3.0%
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)

13. Employees' Retirement Benefits (continued)

Supplemental Benefits not Funded Through the System (continued)

Fiscal Year Ending	Three-Year Trend Information (In Millions)		Net Pension Obligation
	Annual Pension Cost (APC)	Percentage of APC Contributed	
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
06/30/05	69.90	100%	12.6
06/30/06	74.80	48%	51.4

The annual required contribution amounted to \$74.5 million in 2006 and \$69.6 million in 2005.

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 \$62.1 million in 2006 and \$58.1 million in 2005. Currently, 10,442 retirees meet eligibility requirements.

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

14. Revenues from Major Clients and Related Parties

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

	2006	2005
	<i>(In Thousands)</i>	
Governmental sector, principally instrumentalities, agencies and corporations of the Commonwealth of Puerto Rico	\$ 423,677	\$ 334,155
Municipalities	154,978	129,381
	\$ 578,655	\$ 463,536

15. Net Assets

Restricted assets at June 30, 2006 and 2005 include \$206.7 million and \$367.3 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).

16. Contribution in Lieu of Taxes

	2006	2005
	<i>(In Thousands)</i>	
Municipalities	\$ 154,978	\$ 135,642
Commonwealth:		
Hotels	5,675	4,336
Fuel adjustment subsidy	19,964	19,753
Other subsidies (offset against outstanding accounts receivable and reimbursable costs)	116	161
	\$ 180,733	\$ 159,892

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

17. 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.

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 approved by the United States District Court for the District of Puerto Rico on March 19, 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.

Since the Consent Decree became effective, several Notices of Dispute Resolution were filed with the United States District Court for the District of Puerto Rico to contest EPA's interpretation of the applicable method to determine visible emission from the generating units, EPA's determination that the Costa Sur power plant was a repetitious violator of the visible emission requirements of the Consent Decree, and several other notices of violation issued by EPA regarding the applicable method to determine visible emission.

The parties reached an agreement to settle such Notices and lodged a Consent Decree Modification at the United States District Court for the District of Puerto Rico on June 24, 2004. A major program within the agreement is the reduction in two steps of the sulfur content in No. 6 fuel oil at the Authority's southbound power plants to 0.75% or less by March 1, 2005 and to 0.50% or less by March 1, 2007. The Authority believes that the agreement enables the Authority to take additional measures that will enhance its ability to comply with the Consent Decree.

Efforts are on-going to complete pending cooling seawater thermal discharge operating permits under the Clean Water Act "National Pollutant Discharge Elimination System" program, for the four Thermoelectric Power Plants. Specifically for South Coast Power Plant, extensive negotiations had led to a cooperative effort as to which alternative should be developed under a Detail Evaluation Engineer Review (DEER). Meetings have been conducted to address and keep informed the Guayanilla Community Group. The Authority submitted to EPA the reports and waiver requests, pursuant to the Clean Water Act- Section 316 Thermal Waiver, for the San Juan and Palo Seco power plants on July 11, 1997 and November 18, 1997, respectively. The fieldwork of the Aguirre 316 Demonstration Study finished in May 2004. The Final Report was submitted by May 2005.

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

17. Commitments and Contingencies (continued)

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. 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.

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.

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

17. Commitments and Contingencies (continued)

Risk Management (continued)

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 \$3.4 and \$3.2 billion at June 30, 2006 and 2005, respectively.

The net assets and restricted assets set aside in the Self-insurance Fund for self-insurance amounted to approximately \$65.1 million at June 30, 2006 and \$63.4 million at June 30, 2005.

Changes in the balances of the health insurance program and other self-insurance risks during fiscal years 2006 and 2005 were as follows:

	Liability Beginning Balance	Expenses	Payments	Liability Ending Balance
	<i>(In Thousands)</i>			
2005	\$ 31,640	\$ 127,207	\$ 126,244	\$ 32,603
2006	\$ 32,603	\$ 130,755	\$ 119,306	\$ 44,052

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.

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.

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

17. Commitments and Contingencies (continued)

Contingencies (continued)

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. During fiscal year ended June 30, 2005, the last two municipalities accepted the settlement offer, receiving \$4.4 million.

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.

In connection with the same litigation, GDB approved line of credit of \$57.0 million for electric infrastructure projects on municipalities. As of June 30, 2006, the Authority had drawn \$34.9 million.

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

17. 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. 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.

On September 15, 2004, Tropical Storm Jeanne passed through the island of Puerto Rico causing damages. Certain municipalities of the Commonwealth were declared an emergency zone by President of the United States of America, thus making it eligible for emergency assistance from the Federal Emergency Management Agency (FEMA).

The Authority total damages from Tropical Storm Jeanne, including restoration costs, amounted to approximately \$33.4 million, consisting in damages to the transmission and distribution system.

The Authority submitted claims to FEMA and has received payment of \$11.8 million.

Construction and Other Commitments

In addition to the damages to the utility plant, administrative and general expenses charged to income related to non-capitalizable activities amounted to \$8 million.

As of June 30, 2006, the Authority has commitments of approximately \$350.0 million on active construction, maintenance and engineering services contracts.

18. Significant New Accounting Pronouncement

In April 2004 the GASB issued Statement No. 43, *Financial Reporting for Post employment 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 Post employment 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:

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

18. Significant New Accounting Pronouncement (continued)

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 July 2004 the GASB issued Statement No. 45, *Accounting and Financial Reporting by Employers for Post employment 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.

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

18. Significant New Accounting Pronouncement (continued)

- 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 July 2005, the GASB issued Statement No. 47, *Accounting for Termination Benefits*. This Statement provides accounting and reporting guidance for state and local governments that offer benefits to employees who are involuntarily terminated. The Statement is intended to enhance both the consistency of reporting for termination benefits and the comparability of financial statements, by requiring that similar forms of termination benefits be accounted for in the same manner.

Statement No. 47 is effective for financial statements for periods beginning after June 15, 2005. However, for termination benefits that affect defined benefit post-employment benefits other than pensions, governments should implement Statement No. 47 along with Statement No. 45, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions*.

19. Subsequent Events

On July 20, 2006, the Authority and JP Morgan Chase Bank National Association, as Administrative Agent and Issuing Bank, entered into an agreement for a revolving line of credit of \$100 million to be used for operational purposes.

On September 13, 2006, the Authority and Citibank, N.A., as Administrative Agent, entered into an agreement for a revolving line of credit of \$400 million to be used for interim finance of a portion of the cost of various projects under its Capital Improvement Program.

**Report on Internal Control
Over Financial Reporting and on Compliance and
Other Matters Based on an Audit of
Financial Statements Performed in Accordance
with Government Auditing Standards**

To the Governing Board
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, 2006, and have issued our report thereon dated October 24, 2006. 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 an opinion 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 that might be material weaknesses. A material weakness, based on auditing standards generally accepted in the United States as established by the American Institute of Certified Public Accountants, 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.

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 grant agreements, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit and, accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*.

We noted certain matters that we reported to management of the Authority in a separate letter dated October 24, 2006.

This report is intended solely for the information and use of the Authority's board of directors, management, federal awarding agencies, 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 24, 2006

Stamp No. 2183480
affixed to
original of
this report.

Supplemental Information

Schedule I

Puerto Rico Electric Power Authority
Supplemental Schedule of Funding Progress

June 30, 2006

(In Millions)

Actuarial Valuation Date	Actuarial Value of Assets (a) Note 1	Actuarial Accrued Liability (AAL) (b)	Unfunded AAL (UAAL) (b) - (a)	Funded Ratio (a)/(b)	Covered Payroll (c)	UAAL Percentage Of Covered Payroll [(b) - (a)]/(c)
<u>Pension Plan</u>						
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%
6/30/04	1,294	2,139	846	60%	335	252%
6/30/05	1,338	2,203	865	61%	349	248%

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, 2006 and 2005 and for 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
 Supplemental Schedule of Sources and Disposition of Net Revenues
 Under the Provisions of the 1974 Agreement
 For the Years Ended June 30, 2006 and 2005
 Statements of Income (GAAP) and Reconciliation of Net Income

(In Thousands)

	2006			2005		
	1974 Trust Agreement	Statement of Income (GAAP)	Reconciliation of Net Income	1974 Trust Agreement	Statement of Income (GAAP)	Reconciliation of Net Income
Reconciliation of components of net income:						
Revenues:						
Operating revenues	\$ 3,708,938	\$ 3,716,082	\$ 7,144	\$ 3,038,110	\$ 3,043,834	\$ 5,724
Revenues from Commonwealth for rural electrification	116	116		161	161	
Other operating revenues	11,373	11,373		13,705	13,705	
Other	11,497	11,497		8,146	8,146	
1974 agreement construction fund investment income and gain on sale of other properties	—	57,866	57,866	—	43,379	43,379
	<u>3,731,924</u>	<u>3,796,934</u>		<u>3,060,122</u>	<u>3,109,225</u>	
Current expenses:						
As shown	3,033,924	3,041,369	(7,445)	2,422,603	2,427,710	(5,107)
Other interest	—	1,946	(1,946)	—	3,728	(3,728)
Total as defined	<u>3,033,924</u>	<u>3,043,315</u>		<u>2,422,603</u>	<u>2,431,438</u>	
Net revenues, as defined	<u>\$ 698,000</u>			<u>\$ 637,519</u>		
Depreciation	\$ —	271,694	(271,694)	\$ —	262,230	(262,230)
Disposition of revenues: (not classified in order of payment)						
Interest on debt	257,464	270,202	(12,738)	255,483	261,641	(6,158)
Interest on general obligation notes	11,427	11,427		6,189	6,189	
Amortization of debt discount, financing expenses	—	(4,471)	4,471	—	(2,534)	2,534
Amortization of bond defeasance	—	19,960	(19,960)	—	24,275	(24,275)
Allowance for funds used during construction	—	(12,322)	12,322	—	(8,187)	8,187
Net interest on long - term debt	<u>268,891</u>	<u>284,796</u>		<u>261,672</u>	<u>281,384</u>	
Power revenue bonds:						
Principal	191,854	—	191,854	148,539	—	148,539
Reserve	—	—	—	—	—	—
Internal Funds	49,604	—	49,604	83,533	—	83,533
Reserve Maintenance Fund	—	—	—	3,498	—	3,498
Self Insurance Fund	—	—	—	(20,000)	—	(20,000)
Contribution in lieu of taxes	187,651	180,733	6,918	160,277	159,892	385
Total expenses (GAAP)		<u>3,780,538</u>			<u>3,134,944</u>	
Net revenues, as defined	<u>\$ 698,000</u>			<u>\$ 637,519</u>		
Net income		<u>\$ 16,396</u>	<u>\$ 16,396</u>		<u>\$ (25,719)</u>	<u>\$ (25,719)</u>

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, 2006 and 2005

(In Thousands)

	2006	2005
Sources of net revenues:		
Revenues:		
Electric revenues	\$ 3,708,938	\$ 3,038,110
Revenues from the Commonwealth for rural electrification	116	161
Other operating revenues	11,373	13,705
Other (principally interest)	11,497	8,146
	3,731,924	3,060,122
Current expenses:		
Operations:		
Fuel	1,665,866	1,182,936
Purchased Power	603,169	492,621
Other production	57,918	55,945
Transmission and distribution	162,956	159,843
Customer accounting and collection	106,927	107,932
Administrative and general	198,509	187,134
Maintenance	236,633	232,464
Other Interest	1,946	3,728
	3,033,924	2,422,603
Net revenues, as defined	\$ 698,000	\$ 637,519
Disposition of net revenues:		
Revenue fund:		
Power revenue bonds - sinking fund requirements:		
Interest	\$ 257,464	\$ 255,483
Principal	191,854	148,539
Reserve maintenance fund	-	3,498
Self insurance fund	-	(20,000)
Balance available for capital improvements	49,604	83,533
	498,922	471,053
General obligation notes:		
Interest	11,427	6,189
Contribution in lieu of taxes and other	187,651	160,277
Net revenues, as defined	\$ 698,000	\$ 637,519

See accompanying notes.

Schedule IV

Puerto Rico Electric Power Authority
Supplemental Schedule of Funds Under the Provisions of the
1974 Agreement

Years Ended June 30, 2006 and 2005

(In Thousands)

	2006				2005			
	Held by Authority		Restricted Deposits with Trustee		Held by Authority		Restricted Deposits with Trustee	
	Total	Other Assets	Other Assets	Non-Current Assets	Total	Other Assets	Other Assets	Non-Current Assets
By Account								
1974 Agreement (restricted)								
Sinking Fund - principal and interest	\$ 329,965	\$ -	\$ 329,965	\$ -	\$ 253,883	\$ -	\$ 253,883	\$ -
Reserve account	258,815	-	-	258,815	255,159	-	-	255,159
Self insurance fund	65,146	-	-	65,146	63,439	-	-	63,439
Reserve maintenance fund	49,905	49,905	-	-	48,480	48,480	-	-
Construction Fund								
Rural Utilities Services (RUS)	1,685	1,685	-	-	1,637	1,637	-	-
Other	6,904	6,904	-	-	175,779	175,779	-	-
General purpose (unrestricted)								
General	16,426	16,426	-	-	18,999	18,999	-	-
Working funds	1,942	1,942	-	-	2,283	2,283	-	-
Total	<u>\$ 730,788</u>	<u>\$ 76,862</u>	<u>\$ 329,965</u>	<u>\$ 323,961</u>	<u>\$ 819,659</u>	<u>\$ 247,178</u>	<u>\$ 253,883</u>	<u>\$ 318,598</u>
By Type of Assets Held								
Working funds	\$ 1,942	\$ 1,942	\$ -	\$ -	\$ 2,283	\$ 2,283	\$ -	\$ -
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	20,582	20,582	-	-	14,094	14,094	-	-
Citibank, N. A.	(14,474)	(14,474)	-	-	(5,817)	(5,817)	-	-
US Bank	329,965	-	329,965	-	253,883	-	253,883	-
Banco Bilbao Vizcaya	1	1	-	-	1	1	-	-
Banco Bilbao Vizcaya, Mayagüez, Puerto Rico	49	49	-	-	48	48	-	-
First Bank, San Juan, Puerto Rico	670	670	-	-	382	382	-	-
Banco Santander, Santurce, Puerto Rico	8,720	8,720	-	-	9,410	9,410	-	-
Roig Commercial Bank, Humacao, P.R.					26	26	-	-
Western Bank, Mayagüez, P.R.	1,123	1,123	-	-	854	854	-	-
Economic Development Bank	-	-	-	-	-	-	-	-
Other institutions	-	-	-	-	-	-	-	-
	<u>348,579</u>	<u>18,614</u>	<u>329,965</u>	<u>-</u>	<u>275,165</u>	<u>21,282</u>	<u>253,883</u>	<u>-</u>
Less Prepa.Net cash	(246)	(246)	-	-	-	-	-	-
Investment securities	382,455	58,494	-	323,961	544,494	225,896	-	318,598
Total	<u>\$ 730,788</u>	<u>\$ 76,862</u>	<u>\$ 329,965</u>	<u>\$ 323,961</u>	<u>\$ 819,659</u>	<u>\$ 247,178</u>	<u>\$ 253,883</u>	<u>\$ 318,598</u>

See accompanying notes.

Puerto Rico Electric Power Authority

Supplemental Schedule of Changes in Cash and Investments by Funds

Year Ended June 30, 2006
(In Thousands)

	Total	General Purposes Funds		
		General Fund	Revenue Fund	Working Fund
Balances at June 30, 2005	\$ 819,659	\$ 39,285	\$ 15	\$ 2,283
Operations:	—	—	—	—
Net revenues	—	(698,000)	199,078	—
Funds provided from internal operations	529,348	529,348	—	—
1974 Agreement investment income account 4191	—	(1,488)	—	—
Offset of current year's contribution in lieu of taxes against certain government accounts receivable	—	154,978	(154,978)	—
Offset of current year's 5% contribution in lieu of taxes against Commonwealth of Puerto Rico debt and transfers to general obligations	—	32,674	(32,674)	—
Funds used for construction	(540,866)	—	—	—
Financing:	—	—	—	—
Proceeds from new bond issues-net of original discounts	—	—	—	—
Proceeds from contributed capital	36,998	—	—	—
Defeased bonds-net of original discounts	—	—	—	—
Amortization of debt discount and excess reacquisition	15,489	15,489	—	—
Sinking Funds and account transfers	—	—	—	—
Notes issued for construction	200,000	—	—	—
Notes issued for improvement to Isabela Irrigation System	2,442	—	—	—
Notes issued for fuel purchases	330,000	330,000	—	—
Notes issued for municipalities settlement agreement	17,711	—	—	—
Notes issued to commercial bank that are payable from accounts receivable - government	100,000	100,000	—	—
Payment of notes	(344,897)	(344,897)	—	—
Payment of interest	(293,238)	(18,262)	(11,426)	—
Payment of current maturities of long-term debt	(118,427)	—	—	—
Payment to municipalities settlement agreement	(17,711)	—	—	—
Changes in assets and liabilities:				
Working funds	—	341	—	(341)
Accounts receivable (includes non-current)	(107,077)	(107,077)	—	—
Fuel oil	(22,980)	(22,980)	—	—
Materials and supplies	(7,843)	(7,843)	—	—
Prepayments and other	20,457	20,457	—	—
Deferred debits	(5,164)	(5,164)	—	—
Accounts payable and accrued liabilities (includes non-current)	120,900	120,900	—	—
Customer deposits	(4,013)	(4,013)	—	—
Interfund transfers, etc.	—	3,756	1	—
Total before interfund accounts	730,788	137,504	16	1,942
Add (deduct) interfund accounts	—	(121,094)	—	—
Balances at June 30, 2006	\$ 730,788	\$ 16,410	\$ 16	\$ 1,942

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
\$ 132,470	\$ 121,413	\$ 255,159	\$ 63,439	\$ 157,115	\$ 48,480
-	-	-	-	-	-
257,464	191,854	-	-	49,604	-
-	-	-	-	-	-
-	-	-	-	1,488	-
-	-	-	-	-	-
-	-	-	-	-	-
-	-	-	-	(540,866)	-
-	-	-	-	-	-
-	-	-	-	-	-
-	-	-	-	36,998	-
-	-	-	-	-	-
12,738	-	-	-	(12,738)	-
-	-	-	-	200,000	-
-	-	-	-	2,442	-
-	-	-	-	-	-
-	-	-	-	17,711	-
-	-	-	-	-	-
(260,721)	-	-	-	(2,829)	-
-	(118,427)	-	-	-	-
-	-	-	-	(17,711)	-
-	-	-	-	-	-
-	-	-	-	-	-
-	-	-	-	-	-
-	-	-	-	-	-
-	-	-	-	-	-
-	-	-	-	-	-
-	-	-	-	-	-
-	-	-	-	-	-
-	-	-	-	-	-
-	-	-	-	-	-
-	-	-	-	-	-
(5,429)	(1,397)	3,656	1,707	(3,719)	1,425
136,522	193,443	258,815	65,146	(112,505)	49,905
-	-	-	-	121,094	-
\$ 136,522	\$ 193,443	\$ 258,815	\$ 65,146	\$ 8,589	\$ 49,905

Puerto Rico Electric Power Authority

Supplement Schedule of Changes in Cash and Investments by Funds

Year Ended June 30, 2005

(In Thousands)

	General Purposes Funds			
	Total	General Fund	Revenue Fund	Working Fund
Balances at June 30, 2004	\$ 793,735	\$ 15,296	\$ 15	\$2,295
Operations:				
Net revenues	—	(637,519)	160,277	—
Funds provided from internal operations	560,219	560,219	—	—
1974 Agreement investment income	—	(2,823)	—	—
Offset of current year's contribution in lieu of taxes against certain government accounts receivable	—	129,383	(129,383)	—
Offset of current year's 5% contribution in lieu of taxes against Commonwealth of Puerto Rico debt and transfers to General Obligations Notes Fund	—	30,509	(30,509)	—
Funds used for construction	(552,588)	—	—	—
Funds used for restoration of plant	—	—	—	—
Proceeds from penalties to AES	—	—	—	—
Financing:				
Proceeds from new bond issues-net of original issue discounts	1,384,875	—	—	—
Proceeds from contributed capital	23,755	—	—	—
Defeased bonds-net of original issue discounts	(880,588)	—	—	—
Accretion of capital appreciation bonds	—	—	—	—
Amortization of debt discount and excess reacquisition costs	21,741	21,741	—	—
Sinking Funds and account transfers	—	—	—	—
Notes issued for construction	167,933	—	—	—
Notes issued for improvement to Isabela Irrigation System	2,431	—	—	—
Notes issued for fuel purchases	625,000	625,000	—	—
Notes issued for municipalities settlement agreement	23,818	6,588	—	—
Notes issued for repair of damaged caused by Tropical Storm Jeanne	25,000	25,000	—	—
Notes issued to commercial bank that are payable from appropriation from Legislature of Puerto Rico	41,585	41,585	—	—
Payment of notes	(821,423)	(636,260)	—	—
Payment of interest	(280,571)	(8,944)	—	—
Payment of current maturities of long-term debt	(195,713)	—	—	—
Changes in assets and liabilities:				
Working funds	—	12	—	(12)
Accounts receivable (includes non-current)	(149,659)	(149,659)	—	—
Fuel oil	(21,240)	(21,240)	—	—
Materials and supplies	(15,253)	(15,253)	—	—
Prepayments and other	6,027	6,027	—	—
Deferred debits	(33,039)	(33,039)	—	—
Accounts payable and accrued liabilities (includes non-current)	84,880	84,880	—	—
Customer deposits	8,734	8,734	—	—
Interfund transfers, etc.	—	(10,952)	(385)	—
Total before interfund accounts	819,659	39,285	15	2,283
Add (deduct) interfund accounts	—	(20,301)	—	—
Balances at June 30, 2005	\$ 819,659	\$ 18,984	\$ 15	\$2,283

See accompanying notes.

Schedule V

Sinking Fund				Other Funds		
Interest 1974 Agreement	Principal 1974 Agreement	Reserve 1974 Agreement	Self Insurance Fund	Construction 1974 Agreement	Reserve Maintenance Fund	Clients Fund
\$136,495	\$166,143	\$243,260	\$ 80,767	\$ 70,245	\$53,821	\$ 25,398
261,672	148,539		(20,000)	83,533	3,498	-
-	-	-	-	-	-	-
-	-	-	-	2,823	-	-
-	-	-	-	-	-	-
-	-	-	-	-	-	-
-	-	-	-	-	-	-
-	-	-	-	(552,588)	-	-
-	-	-	-	-	-	-
-	-	-	-	1,384,875	-	-
-	-	-	-	23,755	-	-
-	-	-	-	(880,588)	-	-
-	-	-	-	-	-	-
-	-	-	-	-	-	-
-	-	-	-	167,933	-	-
-	-	-	-	2,431	-	-
-	-	-	-	-	-	-
-	-	-	-	17,230	-	-
-	-	-	-	-	-	-
-	-	-	-	(185,163)	-	-
(272,617)				990	-	-
-	(195,713)	-	-	-	-	-
-	-	-	-	-	-	-
-	-	-	-	-	-	-
-	-	-	-	-	-	-
-	-	-	-	-	-	-
-	-	-	-	-	-	-
-	-	-	-	-	-	-
-	-	-	-	-	-	-
6,920	2,444	11,899	2,672	21,639	(8,839)	(25,398)
132,470	121,413	255,159	63,439	157,115	48,480	-
-	-	-	-	20,301	-	-
\$132,470	\$121,413	\$255,159	\$ 63,439	\$ 177,416	\$48,480	\$ -

Schedule VI

Puerto Rico Electric Power Authority

Supplemental Schedule of Changes in Long-Term
Debt and Current Portion of Long-Term Debt

Years Ended June 30, 2006 and 2005

(In Thousands)

	2006	2005
Long-term debt excluding current portion		
Balance at the beginning of year	\$ 5,001,857	\$ 4,577,721
Transfers to current liabilities:		
Power revenue bonds	(199,673)	(116,736)
Payment of general obligation notes:		
Note payable	-	(5,000)
Remainder	4,802,184	4,455,985
 New issues:		
Power revenue bonds	-	509,520
Power revenue refunding bonds	-	803,900
Debt discount on new bond issues - net	-	71,455
Defeasance of bonds	-	(845,780)
Debt discount and excess reacquisition costs on cancelled bonds - net	-	(34,808)
Note payable	68,000	41,585
Balance at the end of year	\$ 4,870,184	\$ 5,001,857
 Current portion of long-term debt		
Balance at beginning of year	\$ 303,102	\$ 331,806
Transfer from long-term debt	199,673	116,736
Payments to bondholders:		
Power revenue- July 1	(118,082)	(165,256)
Power revenue- January 1	(345)	(329)
General obligation notes	(4,750)	-
Total payments	(123,177)	(165,585)
 Amortization of debt discount and excess reacquisition costs	11,584	20,145
Balance at end of year	\$ 391,182	\$ 303,102

See accompanying notes.

APPENDIX III

Letter of the Consulting Engineers

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April 5, 2007

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, in accordance with the Agreement the report includes 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 2006.

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 operable generating units;
3. that the Authority’s System will not be further compromised by a significant loss of load carrying capability until the Palo Seco Steam Plant is restored to service or until sufficient new capacity is available;

4. that the Authority's current capacity expansion plan will be realized as to increases in capacity and approximate timing;
5. that the Authority's forecasts of costs and availability of fuels are reasonable;
6. that financing will be available to the Authority at reasonable rates, in adequate amounts and at appropriate times;
7. that the Authority will not be adversely affected by labor disputes and will have adequate levels of labor productivity;
8. 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;
9. that the demographic, statistical, economic and other information regarding Puerto Rico obtained by Washington Group from publicly available sources is reliable;
10. that the Authority will not be unduly affected by natural disasters; and
11. 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, with the exception of the Palo Seco Steam Plant, which is being restored to service following the destruction of its central controls by two separate fires on consecutive days in late December 2006;
2. The Authority's generating capacity expansion plan referred to in the Official Statement, to which this letter is appended, under the caption "Adequacy of Capacity" 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.

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

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PROPOSED FORM OF BOND COUNSEL OPINION

Upon delivery of the Series TT Bonds and the Series UU Bonds, Squire, Sanders & Dempsey L.L.P. is prepared to render its final opinion with respect to the Series TT Bonds and the Series UU Bonds in substantially the following form:

May , 2007

Puerto Rico Electric Power Authority
San Juan, Puerto Rico

Re: \$643,530,000 Puerto Rico Electric Power Authority Power Revenue Bonds, Series TT and
\$1,300,035,000 Puerto Rico Electric Power Authority Power Revenue Refunding Bonds, Series UU

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 \$643,530,000 aggregate principal amount of Power Revenue Bonds, Series TT (the "Series TT Bonds") and \$1,300,035,000 aggregate principal amount of Power Revenue Refunding Bonds, Series UU (the "Series UU Bonds" and, together with the Series TT 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. 3437, duly adopted by the Authority on April 19, 2007 (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 a Series TT Bond and a Series UU Bond, 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 TT 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 2007 and 2008, including, without limitation, the repayment of a loan the proceeds of which were used to finance such Improvements.
4. The Series UU 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 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 under Section 57 of the Code for purposes of the 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.

In giving the opinion set forth in numbered paragraph 9. hereof, we have assumed and relied upon compliance with the Authority's covenants and the accuracy, which we have not independently verified, of the Authority's representations and certifications, all as contained in the Transcript. The accuracy of those representations and certifications, and compliance by the Authority 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 could 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.

Under the Code, portions 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 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."]

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LIBOR BONDS AND LIBOR-BASED INTEREST RATE

DEFINITIONS

Unless the context otherwise requires, the terms defined in this Appendix V shall have the meanings herein specified, to be equally applicable to both the singular and plural forms of terms herein defined.

“Interest Accrual Date” means for any LIBOR-Based Interest Rate Period, the first day thereof and, thereafter, each Interest Payment Date.

“Interest Payment Date” means, with respect to the LIBOR Bonds, each April 1, July 1, October 1 and January 1, beginning July 1, 2007 and if such day is not U.S. Government Securities Business Day, then the next succeeding U.S. Government Securities Business Day.

“LIBOR-Based Interest Accrual Period” means the period commencing on and including an Interest Accrual Date to but not including the following Interest Payment Date.

“LIBOR-Based Interest Rate” means a variable interest rate borne by the LIBOR Bonds and established in accordance with the provisions contained in Appendix B to the Resolution.

“LIBOR-Based Interest Rate Period” means each period with respect to the LIBOR Bonds during which a LIBOR-Based Interest Rate is in effect.

“LIBOR Bonds” means Puerto Rico Electric Power Authority Power Revenue Refunding Bonds, Series UU, in the principal amounts of \$184,870,000, \$252,875,000 and \$336,690,000, maturing on July 1 of the years 2025, 2029 and 2031, respectively.

“LIBOR Rate Determination Date” means a date that is two London Banking Days preceding the first day of each LIBOR-Based Interest Accrual Period.

“London Banking Day” means any day on which commercial banks are open for general business (including dealings in foreign exchange and foreign currency) in the City of London, United Kingdom.

“Maximum Interest Rate” means, with respect to the LIBOR Bonds, the lesser of fifteen percent (15%) per annum and the Maximum Lawful Rate, in each case calculated in the same manner as interest is calculated for the particular interest rate on the Bonds.

“Maximum Lawful Rate” means the maximum rate of interest on the relevant obligation permitted under applicable Puerto Rico law.

“Minimum Authorized Denominations” means with respect to the LIBOR Bonds, \$5,000 and any integral multiple thereof.

“Record Date” means with respect to the LIBOR Bonds, the 15th day of the calendar month preceding the calendar month in which such Interest Payment Date falls.

“Resolution” means Resolution No. 3437 adopted by the Authority on April 19, 2007.

“Three Month LIBOR Rate” means, with respect to the LIBOR Bonds, the rate for deposits in U.S. dollars with a three-month maturity that appears on Reuters Screen LIBOR 01 Page (or such other page as may replace that page on that service, or such other service as may be nominated by the British Bankers Association, for the purpose of displaying London interbank offered rates for U.S. dollar deposits) as of 11:00 a.m., London time, on the LIBOR Rate Determination Date, except that, if such rate does not appear on such page on the LIBOR Rate Determination Date, the Three Month LIBOR Rate means a rate determined on the basis of the rates at which deposits in U.S. dollars for a three-month maturity and in a principal amount of at least U.S. \$1,000,000 are offered at approximately 11:00 a.m., London time, on the LIBOR Rate Determination Date, to prime banks in the London interbank market by three major banks in the London interbank market (herein referred to as the “Reference Banks”) selected by a market agent appointed by the 1974 Trustee after consultation with the Authority to identify such Reference Banks (herein referred to as the “Market Agent”). The Market Agent is to request the principal London office of each of such Reference Banks to provide a quotation of its rate. If at least two such quotations are provided, the Three Month LIBOR Rate will be the arithmetic mean of such quotations. If fewer than two quotations are provided, the Three Month LIBOR Rate will be the arithmetic mean of the rates quoted by three (if three quotations are not provided, two or one, as applicable) major banks in New York City, selected by the Market Agent, at approximately 11:00 a.m., New York City time, on the LIBOR Rate Determination Date for loans in U.S. dollars to leading European banks in a principal amount of at least U.S. \$1,000,000 having a three-month maturity. If none of the banks in New York City selected by the Market Agent is then quoting rates for such loans, then the Three Month LIBOR Rate for the ensuing interest period will mean the Three Month LIBOR Rate then in effect in the immediately preceding LIBOR-Based Interest Accrual Period.

“USD-ISDA-SWAP Rate” means the rate for U.S. dollar SWAPs maturing on July 1, 2017, expressed as a percentage, which appears on the Reuters Money 3000 Service on the page designated ISDAFIX1 (or such other page as may replace that page on such service for the purpose of displaying comparable rates) at 11:00 a.m., New York City time, on the day which is two U.S. Government Securities Business Days prior to such date. If such rate does not appear on such page on such day, then “USD-ISDA-SWAP Rate” for such maturity and date shall mean the percentage determined on the basis of mid-market semiannual swap rate quotations provided by five leading swap dealers in the New York City interbank market at approximately such time on such day as the mean of the bid and offered rates for the semiannual fixed leg, calculated on a 30/360 day count basis, of a fixed-for-floating U.S. dollar interest rate swap transaction with an effective date of the relevant early termination date and a termination date equal to such maturity, in an amount that is representative for a single transaction in such market at such time, with an acknowledged dealer of good credit in such market, where the floating rate, calculated on the basis of a 360-day year for actual days elapsed, is equal to the London Interbank Offered Rate for loans with a three-month duration.

“U.S. Government Securities Business Day” means any day except for a Saturday, a Sunday, or a day on which the Securities Industry and Financial Markets Association recommends that the fixed income departments of its members be closed for the entire day for purposes of trading U.S. government securities.

MUNI-BMS BONDS AND MUNI-BMS INTEREST RATE

DEFINITIONS

Unless the context otherwise requires, the terms defined in this Appendix VI shall have the meanings herein specified, to be equally applicable to both the singular and plural forms of terms herein defined.

“Applicable Ratio” means the mid of the bid and offered SIFMA/LIBOR Ratios, which appear on the Bloomberg Screen PREBON13 Page as of close of business in New York City on the second U.S. Government Securities Business Day preceding the Reset Date. If such SIFMA/LIBOR Ratios do not appear on the Bloomberg Screen PREBON13 Page, the Applicable Ratio to be determined for that Reset Date will be the ratio, expressed as a percentage, determined on the basis of mid-market SIFMA/LIBOR Ratio quotations provided by the Reference Banks selected by the Calculation Agent as of close of business in New York City on the second U.S. Government Securities Business day preceding that Reset Date. The Calculation Agent will request the principal New York City office of each of the Reference Banks to provide a quotation of its SIFMA/LIBOR Ratio. If at least three quotations are provided, the Applicable Ratio for that Reset Date will be the arithmetic mean of the quotations, eliminating the highest quotation (or, in the event of equality, one of the highest) and the lowest quotation (or, in the event of equality, one of the lowest).

“Calculation Agent” means, initially, JPMorgan Chase Bank, N.A., or such other Calculation Agent as may be selected by the Authority and its successors and assigns.

“Interest Payment Date” means, with respect to the Muni-BMS Bonds, each January 1, April 1, July 1, and October 1, commencing July 1, 2007 and, if such day is not a U.S. Government Securities Business Day, then the next succeeding U.S. Government Securities Business Day.

“London Banking Day” means any day on which commercial banks are open for general business (including dealings in foreign exchange and foreign currency) in the City of London, United Kingdom.

“Maximum Interest Rate” means, with respect to the Muni-BMS Bonds, the lesser of fifteen percent (15%) per annum and the Maximum Lawful Rate.

“Maximum Lawful Rate” means the maximum rate of interest on the relevant obligation permitted under applicable Puerto Rico law.

“Minimum Authorized Denominations” means, with respect to the Muni-BMS Bonds, \$5,000 and any integral multiple thereof.

“Muni-BMS Bonds” means Puerto Rico Electric Power Authority Power Revenue Refunding Bonds, Series UU, in the principal amounts of \$25,525,000, \$17,000,000 and \$29,055,000, maturing on July 1 of the years 2017, 2018 and 2020, respectively.

“Muni-BMS Interest Accrual Period” means the period commencing on and including a Reset Date to but not including the following Interest Payment Date.

“Muni-BMS Interest Rate” means a variable interest rate borne by the Muni-BMS Bonds and which rate consists of the sum of (i) 100% of the USD-SIFMA Swap Rate and (ii) the Spread.

“Muni-BMS Interest Rate Period” means each period with respect to a Series of Bonds during which a Muni-BMS Interest Rate is in effect.

“Muni-BMS Rate Determination Date” means a date that is two U.S. Government Securities Business Days preceding a Reset Date.

“Record Date” means with respect to the Muni-BMS Bonds, the 15th day of the calendar month preceding the calendar month in which such Interest Payment Date falls.

“Reference Banks” means, with respect to the Muni-BMS Bonds, five (5) leading swap dealers in the New York City inter-bank market.

“Reset Date” means May 3, 2007 and each January 1, April 1, July 1 and October 1 thereafter which day is a U.S. Government Securities Business Day, or if such day is not a U.S. Government Securities Business Day, then the next succeeding U.S. Government Securities Business Day.

“Resolution” means Resolution No. 3437 adopted by the Authority on April 19, 2007.

“SIFMA” means the Securities Industry & Financial Markets Association (formerly The Bond Market Association).

“SIFMA/LIBOR Ratio” means a ratio appearing on the Bloomberg Screen PREBON13 Page which is a percentage of the floating rate option applicable to the LIBOR portion of a SIFMA/LIBOR basis swap transaction with a term equal to five (5) years commencing on the Reset Date, where (i) the LIBOR portion, calculated on an actual/360 day count basis, is equivalent to the Three-Month LIBOR Rate and is subject to quarterly payment dates, and (ii) the SIFMA portion, calculated on an actual/actual day count basis, is equivalent to the USD-SIFMA Municipal Swap Index and is subject to quarterly payment dates. If such ratio does not appear on the Bloomberg Screen PREBON13 Page, such ratio shall be determined as set forth in the second sentence of the definition of “Applicable Ratio” and will be in a representative amount with no upfront premium and no spread.

“Spread” means 0% per annum.

“Three Month LIBOR Rate” means, with respect to the Muni-BMS Bonds, the rate for deposits in U.S. dollars with a three-month maturity that appears on Reuters Screen LIBOR 01 Page (or such other page as may replace that page on that service, or such other service as may be nominated by the British Bankers Association, for the purpose of displaying London interbank offered rates for U.S. dollar deposits) as of 11:00 a.m., London time, on the Muni-BMS Rate Determination Date, except that, if such rate does not appear on such page on the Muni-BMS Rate Determination Date, the Three Month LIBOR Rate means a rate determined on the basis of the rates at which deposits in U.S. dollars for a three-month maturity and in a principal amount of at least U.S. \$1,000,000 are offered at approximately 11:00 a.m., London time, on the Muni-BMS Rate Determination Date, to prime banks in the London interbank market by three major banks in the London interbank market (herein referred to as the “Reference Banks”) selected by a market agent appointed by the Calculation Agent to identify such Reference Banks (herein referred to as the “Market Agent”). The Market Agent is to request the principal London office of each of such Reference Banks to provide a quotation of its rate for such deposit maturity. If at least two such quotations are provided, the Three Month LIBOR Rate will be the arithmetic mean of such quotations. If fewer than two quotations are provided, the Three Month LIBOR Rate will be the arithmetic mean of the rates quoted by three (if three quotations are not provided, two or one, as applicable) major banks in New York City, selected by the Market Agent, at approximately 11:00 a.m., New York City time, on the Muni-BMS Rate Determination Date for loans in U.S. dollars to leading European banks in a principal amount of at least U.S. \$1,000,000 having a three-month maturity. If none of the banks in New York City selected by the Market Agent is then quoting

rates for such loans, then the Three Month LIBOR Rate for the ensuing interest period will mean the Three Month LIBOR Rate then in effect in the immediately preceding Muni-BMS Interest Accrual Period.

“USD-ISDA-Swap Rate” means the rate for U.S. dollar swaps with a designated maturity of five years, expressed as a percentage, which appears on the Reuters Money 3000 Service on the page designated ISDAFIX1 (or such other page as may replace that page on such service for the purpose of displaying comparable rates) at 11:00 a.m., New York City time, on the day which is two U.S. Government Securities Business Days prior to such Reset Date. If such rate does not appear on such page on such day, then “USD-ISDA-Swap Rate” for such maturity and date shall mean the percentage determined on the basis of mid-market semiannual swap rate quotations provided by five leading swap dealers in the New York City interbank market at approximately such time on such day as the mean of the bid and offered rates for the semiannual fixed leg, calculated on a 30/360 day count basis, of a fixed-for-floating U.S. dollar interest rate swap transaction with an effective date of the relevant early termination date and a termination date equal to such maturity, in an amount that is representative for a single transaction in such market at such time, with an acknowledged dealer of good credit in such market, where the floating rate, calculated on the basis of a 360-day year for actual days elapsed, is equal to the London Interbank Offered Rate for loans with a three-month duration.

“USD-S&P Index-High Grade” means a rate equal to the S&P Weekly High Grade Index (formerly the J.J. Kenny Index) maintained by Standard & Poor’s Securities Evaluations Inc. for the designated maturity of one week as is published on Wednesday of each week, or if any Wednesday is not a U.S. Government Securities Business Day, the next U.S. Government Securities Business Day. If such index is no longer available, the rate shall be the prevailing rate as determined by the Calculation Agent in consultation with the Authority, meeting the then-current SIFMA standard.

“USD-SIFMA Municipal Swap Index” means, on any date, a rate equal to the index which is issued weekly and compiled from the weekly interest rate resets of tax-exempt variable rate issues included in a database maintained by Municipal Market Data which meet specific criteria established from time to time by SIFMA and issued on Wednesday of each week, or if any Wednesday is not a U.S. Government Securities Business Day, the next U.S. Government Securities Business Day. In the event Municipal Markets Data no longer produces an index satisfying the requirements of the preceding sentence, the USD-SIFMA Municipal Swap Index shall be USD-S&P Index-High Grade.

“USD-SIFMA Swap Rate” means the rate calculated on each Muni-BMS Rate Determination Date to take effect on a Reset Date which will apply to a Muni-BMS Interest Accrual Period as follows: $\{(1 + \text{USD-ISDA-Swap Rate (with a designated maturity of 5 years)/2})^{0.5} - 1\} * 4$ * the Applicable Ratio.

“U.S. Government Securities Business Day” means any day except for a Saturday, a Sunday, or a day on which the Securities Industry and Financial Markets Association recommends that the fixed income departments of its members be closed for the entire day for purposes of trading U.S. government securities

Hypothetical Interest Rate Calculations

By way of example, the following illustrates the way in which the Muni-BMS Interest Rate would be calculated on the Muni-BMS bonds. Based upon market rates as of Monday, April 23, 2007, the formula reads as laid out below. This rate would be effective 2 days following the date of calculation. The following is provided as an example calculation for the USD-SIFMA Swap Rate, and is not intended to represent the actual rates at any point on the Muni-BMS bonds.

Formula: $\{(1 + \text{USD-ISDA-Swap Rate (5-years)/2})^{0.5-1}\}^4 * \text{Applicable Ratio}$

Where:

USD-ISDA Swap Rate = 5.016%, and;

Applicable Ratio = 69.50%

As follows: $\{(1 + 5.016\% / 2)^{0.5-1}\}^4 * 69.50\% = 3.465\%$

The numbers in the foregoing example were provided by the Calculation Agent and are given for illustration and information purposes only. The historical market levels should not be taken as an indication of future levels, and no assurance can be given as to the market levels for any period.

Terms of the Muni-BMS Bonds; Denominations; Payment of Principal and Interest

Interest on the Muni-BMS Bonds shall be payable for the final Interest Rate Period to the date on which the Muni-BMS Bonds shall have been paid in full. Interest shall be computed on the basis of a 365 or 366-day year, as appropriate, and the actual number of days elapsed.

The initial interest rates for the Bonds and the determination for the Muni-BMS Bonds of the Muni-BMS Interest Rate by the Calculation Agent shall be conclusive and binding upon the Authority and the registered owners of the Muni-BMS Bonds.

Interest on the Muni-BMS Bonds shall be payable on each Interest Payment Date by the 1974 Trustee by check mailed on the date on which such interest is due to the registered owners of the Muni-BMS Bonds at the close of business on the Record Date in respect of such Interest Payment Date at the registered addresses of registered owners as shall appear on the registration books of the 1974 Trustee. In the case of any registered owner of Muni-BMS Bonds in an aggregate principal amount in excess of \$1,000,000 as shown on the registration books of the 1974 Trustee who, prior to the Record Date next preceding any Interest Payment Date, shall have provided the 1974 Trustee with written wire transfer instructions, interest payable on such Muni-BMS Bonds shall be paid in accordance with the wire transfer instructions provided by the registered owner of such Muni-BMS Bond.

SPECIMEN OF CIFG INSURANCE POLICY

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TRIPLE-A FINANCIAL GUARANTY

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

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SPECIMEN OF FSA INSURANCE POLICY

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**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.
31 West 52nd Street, New York, N.Y. 10019

(212) 826-0100

Form 500NY (5/90)

SPECIMEN OF MBIA INSURANCE POLICY

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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

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PROPOSED FORM OF BOND COUNSEL OPINION

Upon delivery of the Bonds, Squire, Sanders & Dempsey L.L.P. is prepared to render its final opinion with respect to the Bonds in substantially the following form:

May __, 2007

Puerto Rico Electric Power Authority
San Juan, Puerto Rico

Re: \$557,410,000 Puerto Rico Electric Power Authority Power Revenue Refunding Bonds, Series VV

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 \$557,410,000 aggregate principal amount of Power Revenue Refunding Bonds, Series VV (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. 3439, duly adopted by the Authority on May 16, 2007 (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 a Bond, as executed and authenticated. We assume that all other 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 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 Resolution.
4. The Trust Agreement provides for the issuance of additional bonds, from time to time, under the conditions, limitations and restrictions therein set forth.

5. 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.

6. 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.

7. 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.

8. 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 under Section 57 of the Code for purposes of the 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.

In giving the opinion set forth in numbered paragraph 8. hereof, we have assumed and relied upon compliance with the Authority's covenants and the accuracy, which we have not independently verified, of the Authority's representations and certifications, all as contained in the Transcript. The accuracy of those representations and certifications, and compliance by the Authority 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 could 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.

Under the Code, portions 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 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."]

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SPECIMEN OF THE FGIC POLICY



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

Issuer:	Policy Number:
	Control Number: 0010001
Bonds:	Premium:

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

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.



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

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SPECIMEN OF THE FSA POLICY



**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 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.
31 West 52nd Street, New York, N.Y. 10019

(212) 826-0100

Form 500NY (5/90)

SPECIMEN OF THE MBIA POLICY

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

President

Attest:

Assistant Secretary

