

**NEW ISSUE – BOOK-ENTRY ONLY**

**\$697,345,000**

**PUERTO RICO ELECTRIC POWER AUTHORITY**  
**Power Revenue Bonds, Series WW**

The Power Revenue Bonds, Series WW (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.
- The interest rates on the Bonds will be fixed interest rates as set forth on the inside cover page of this Official Statement.
- Interest on the Bonds will be payable on January 1, 2009 and on each July 1 and January 1 thereafter.
- The Bonds will be subject to redemption, commencing on July 1, 2018, as described herein.
- The inside cover page contains information concerning the maturity schedule, interest rates and yields of the Bonds.
- In the opinion of Squire, Sanders & Dempsey L.L.P., Bond Counsel, under existing law (i) assuming continuing compliance by the Authority 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 June 26, 2008.
- 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. Winston & Strawn LLP, New York, New York, 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**

**Banc of America Securities LLC**

**Citi**

**Lehman Brothers**

**Oppenheimer & Co. Inc.**

**Samuel A. Ramírez & Co.**

**Morgan Stanley**

**BBVAPR MSD**

**DEPFA First Albany Securities LLC**

**Loop Capital Markets**

**Popular Securities**

**Santander Securities**

**Wachovia Capital Markets, LLC**

**Goldman, Sachs & Co.**

**Eurobank MSD**

**Merrill Lynch & Co.**

**RBC Capital Markets**

**Scotia Capital**

**\$697,345,000**  
**Puerto Rico Electric Power Authority**  
**Power Revenue Bonds, Series WW**

**\$258,330,000 Serial Bonds**

<u>Maturity</u> <u>(July 1)</u>	<u>Principal</u> <u>Amount</u>	<u>Interest</u> <u>Rate</u>	<u>Yield</u>
2010	\$10,685,000	5.000%	3.37%
2011	11,220,000	5.000	3.72
2012	11,780,000	5.000	3.94
2013	12,370,000	5.250	4.11
2014	13,020,000	5.250	4.26
2015	13,705,000	5.250	4.40
2016	14,425,000	5.500	4.53
2017	15,215,000	5.500	4.68
2018	16,055,000	5.500	4.80
2019	16,935,000	5.500	4.88*
2020	17,870,000	5.500	4.95*
2021	18,850,000	5.500	5.00*
2022	19,890,000	5.375	5.05*
2023	20,955,000	5.375	5.08*
2024	22,085,000	5.375	5.13*
2025	23,270,000	5.250	5.20*

**\$77,205,000 5.00% Term Bonds due July 1, 2028 - Yield 5.22%**  
**\$157,440,000 5.25% Term Bonds due July 1, 2033 - Yield 5.34%**  
**\$204,370,000 5.50% Term Bonds due July 1, 2038 - Yield 5.30%\***

\* Yield to July 1, 2018, the first call date.

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.**

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**\$697,345,000**  
**Puerto Rico Electric Power Authority**  
**Power Revenue Bonds, Series WW**

**INTRODUCTORY STATEMENT**

The purpose of this Official Statement of the Puerto Rico Electric Power Authority (the “Authority”), which includes the cover page, the inside 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 WW (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”), and pursuant to a series resolution adopted by the Authority on June 18, 2008 (the “Resolution”). 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.”

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

In order to give potential purchasers of the Bonds general information on the Commonwealth of Puerto Rico (the “Commonwealth” or “Puerto Rico”), this Official Statement incorporates by reference (i) the Commonwealth’s Financial Information and Operating Data Report dated January 2, 2008 included as *Appendix I* to the Official Statement, dated April 25, 2008, relating to the offering of the Commonwealth’s Public Improvement Refunding Bonds, Series 2008 A and Public Improvement Refunding Bonds, Series 2008 B and (ii) the Comprehensive Annual Financial Report of the Commonwealth for the Fiscal Year ended June 30, 2006, as amended, 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, 2006, which have been audited by KPMG LLP, independent auditors, as stated in their report dated August 1, 2007, 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

### Economic Incentives Act

On May 28, 2008, the Governor of Puerto Rico signed into law Act No. 73 (the “Economic Incentives Act”), which contains certain provisions relating to the Authority.

#### *Tax Credits to Eligible Businesses*

The Economic Incentives Act provides that any business that is an industrial customer of the Authority and that has been designated as a qualifying entity by the Puerto Rico Treasury Department under the Economic Incentives Act or any prior economic incentive law of the Commonwealth (each, an “Eligible Business”), may take a base credit against its Puerto Rico income tax equal to three percent (3%) of the payments made to the Authority for its net consumption of electric energy relating to its business operations. An Eligible Business may take an additional credit of three and one-half percent (3.5%) if it employs an average of 25 or more employees in a given tax year, and an additional credit of three and one-half percent (3.5%) if it has an average payroll of \$500,000 or more in a given tax year. The maximum annual tax credit available to each Eligible Business is ten percent (10%) in a given tax year, to be reduced by one percent (1%) annually beginning in 2013 and ending in 2017, in which year the maximum annual tax credit will be five percent (5%). The tax credits available to Eligible Businesses under the Economic Incentives Act will be effective beginning July 1, 2008 and will remain in place for ten (10) years. During such period, the maximum tax credit available to all Eligible Businesses in a given tax year shall be \$75,000,000 and the maximum aggregate tax credit available to all Eligible Businesses during such 10 year period shall be \$600,000,000.

The Economic Incentives Act provides that the cost of the tax credit will be covered from moneys in the General Fund of the Commonwealth and by payments from the Authority in accordance with the proportions set forth in the Economic Incentives Act. The Economic Incentives Act provides that the Authority’s cost of the tax credit shall be absorbed by the Authority through a reduction in operational costs, increased efficiencies, revenues generated through “Wheeling” and reductions in the cost of generating or purchasing energy. The Economic Incentives Act expressly provides that the Authority’s cost in providing the tax credit shall not be subsidized by or passed through, either directly or indirectly, to the customers of the Authority, nor shall such costs cause a reduction in employment or in the payroll of the Authority. If during the 10-year term of the tax credit the average cost of energy is reduced to 10¢/kWh for a period of two consecutive years, the tax credit shall terminate.

The Authority expects to pay its portion of the cost of the tax credit from Revenues in a given year, but only after the application of Revenues to pay Current Expenses and debt service on the Authority’s outstanding bonds in such given year, and after certain debt service, maintenance, capital improvement and self-insurance reserves are funded as required under the 1974 Agreement. The Authority estimates that its portion of the cost of the tax credit will be approximately \$109 million in the aggregate over the ten year period from 2009 through and including 2018, calculated at current energy prices, with a minimum annual payment of \$2.4 million in 2010 and a maximum annual payment of \$24 million in 2018. There is no cost to the Authority associated to the tax credit for fiscal year 2009.

#### *“Wheeling”*

The Economic Incentives Act anticipates that certain Eligible Businesses dedicated to the production of energy, whether or not for commercial purposes, for consumption in Puerto Rico (the “Eligible Energy Producers”), may enter into agreements with the Authority whereby (i) the Eligible Energy Producers may use the facilities of the Authority for the transport of electric energy, or (ii) the Authority may purchase electric energy from the Eligible Energy Producers. In the event the Authority and the Eligible Energy Producers do not agree on the rates to be paid for the services described under (i) and (ii) above, within a period of sixty (60) days, the



Executive Director of the Administration for Energy Affairs has the authority to appoint an arbitrator to determine, approve and establish the rates to be paid by the Authority and the Eligible Energy Producers, as applicable.

## 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 April 30, 2008, it served approximately 1.4 million clients and had utility plant totaling approximately \$10.4 billion, including \$2.6 billion of production plant in service and \$3.9 billion of transmission and distribution plant in service, all based on original cost. The Authority's production facilities, together with two private co-generation facilities with long-term power purchase contracts with the Authority, have a dependable generating capacity of 5,365 megawatts ("MW"). As of April 30, 2008, the Authority had 2,401 circuit miles of transmission lines and 30,675 circuit miles of distribution lines. In September 2005, the Authority realized a historical peak load of 3,685 MW.

For the twelve months ended April 30, 2008, the average percentage of the Authority's generating capacity available for service ("equivalent availability"), which includes the two co-generation facilities mentioned above, was 79%, 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 2003 through fiscal year 2007, the number of clients served by the Authority increased at a compound annual rate of 0.9%, and electric energy sales in kilowatt hours ("kWh") increased at a compound annual rate of 1.0%. During this period, Revenues and Current Expenses increased at compound annual rates of 9.8% and 12.6%, respectively. Excluding the cost of fuel oil (net of fuel extra expense claimed), purchased power, both of which costs are passed on to clients through a separate charge included in electric service rates, Revenues and Current Expenses increased during such period at a compound annual rate of 0.8% and 5.1% respectively, primarily due to higher energy demand.

During the first ten months of fiscal year 2008, Revenues and Current Expenses increased by 14.0% and 17.5%, respectively, compared to the same period for the prior fiscal year. The increase in Revenues and Current Expenses was mainly due to an increase in the price of fuel oil of \$23.96 per barrel (or 43.1%). Excluding the cost of fuel oil and purchased power, Revenues decreased by 4.9% and Current Expenses increased by 3.1% compared to the same period of the prior fiscal year.

Net Revenues increased at a compound annual rate of 0.3% during the period from fiscal year 2003 to fiscal year 2007. For the first ten months of fiscal year 2008, Net Revenues decreased by 0.9% compared to the same period in fiscal year 2007.

Demand for energy is related to the level of economic and business activity in the Commonwealth, energy costs and climatological factors. On February 21, 2008, the Commonwealth Planning Board, as part of its final review of fiscal year 2007 economic statistics indicated that it expected to reduce the 2007 economic growth rate to -1.8% from -1.4% and that the forecast for fiscal years 2008 and 2009 will be lowered on account of the projected length of the current recession. The factors that influenced the Board's fiscal year 2007 indication included reductions in retail sales, private investment (especially in the construction sector) and government investment. Price increases in certain key areas such as energy and raw materials contributed to the Board's numbers as well. Projections of future peak energy demand for the five fiscal year period ending June 30, 2012, prepared by the Authority, show an average annual increase of 0.6%.

The following table summarizes the operating results of the Authority for the five fiscal years ended June 30, 2007 and for the ten-month periods ended April 30, 2007 and 2008. 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, 2006 and 2007 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.

	<b>Operating Results</b> (dollars in thousands)					<b>Ten Months Ended</b>	
	<b>Fiscal Years Ended June 30,</b>					<b>April 30,</b>	
	<b>2003</b>	<b>2004</b>	<b>2005</b>	<b>2006</b>	<b>2007</b>	<b>2007</b>	<b>2008</b>
Electric energy sales (in millions of kWh).....	19,887	20,260	20,507	20,620	20,672	17,091	16,300
Percentage change from year before.....	3.9%	1.9%	1.2%	0.6%	0.3%	0.02%	(4.63)%
Peak load (in MW).....	3,376	3,499	3,603	3,685	3,604	3,604	3,546
Percentage change from year before.....	2.4%	3.6%	3.0%	2.3%	(2.2)%	(2.2)%	(1.6)%
Total Revenues .....	\$2,536,250	\$2,613,006	\$3,060,122	\$3,731,925	\$3,687,385	\$3,059,149	\$3,487,551
Less: Current Expenses.....	1,871,476	1,979,756	2,422,603	3,033,924	3,014,983	2,481,644	2,915,046
Net Revenues .....	<u>\$ 664,774</u>	<u>\$ 633,250</u>	<u>\$ 637,519</u>	<u>\$ 698,001</u>	<u>\$ 672,402</u>	<u>\$ 577,505</u>	<u>\$ 572,505</u>
Principal and Interest Requirements .....	<u>\$ 381,178</u>	<u>\$ 427,088</u>	<u>\$ 404,022</u>	<u>\$ 449,318</u>	<u>\$ 455,022</u>		
Ratio of Net Revenues to Principal and Interest Requirements .....	1.74	1.48	1.58	1.55	1.48		

### 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, 2007 and the projected capital improvement program and financing sources for the five fiscal years ending June 30, 2012. See “Historical Capital Improvement and Financing Program” and “Projected Five-Year Capital Improvement and Financing Program” under *The System*.

**Capital Improvements  
(dollars in thousands)**

<b>Capital Improvements</b>	<b>Fiscal Years</b>			
	<b>2003-2007</b>	<b>% of Total</b>	<b>2008-2012</b>	<b>% of Total</b>
Production Plant.....	\$895,152	36.4	\$904,382	42.4
Transmission facilities.....	659,570	26.8	522,139	24.5
Distribution facilities.....	616,431	25.1	417,622	19.6
Other <sup>(1)</sup> .....	288,514	11.7	288,721	13.5
	<u>\$2,459,667</u>	<u>100.0</u>	<u>\$2,132,864</u>	<u>100.0</u>
<b>Financing Sources</b>				
Internally generated funds.....	\$330,952	13.5	\$165,747	7.8
Borrowed funds.....	2,128,715	86.5	1,967,117	92.2
	<u>\$2,459,667</u>	<u>100.0</u>	<u>\$2,132,864</u>	<u>100.0</u>

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

**PLAN OF FINANCING**

**General**

The Authority is issuing the 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 2008 and 2009, to repay a portion of a loan made by Citibank, N.A. to the Authority for such purpose and to pay capitalized interest on the Bonds through July 1, 2009. Citibank, N.A. is an affiliate of Citigroup Global Markets Inc., which is an underwriter of the Bonds.

## Estimated Sources and Uses of Funds

Sources:	
Principal amount of the Bonds.....	\$697,345,000.00
Net original issue premium .....	<u>8,853,673.05</u>
Total Sources .....	<u>\$706,198,673.05</u>
Uses:	
Deposit to 1974 Construction Fund.....	\$650,004,640.12
Capitalized Interest on the Bonds <sup>(1)</sup> .....	37,120,672.00
Underwriting discount and estimated legal, printing and other financing expenses <sup>(2)</sup> .....	<u>19,073,360.93</u>
Total Uses .....	<u>\$706,198,673.05</u>

(1) Represents capitalized interest through July 1, 2009.

(2) Includes the costs of terminating certain interest rate swaps which provided hedging mechanisms for the Bonds. See "Debt – Swap Agreements" herein.

## 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.

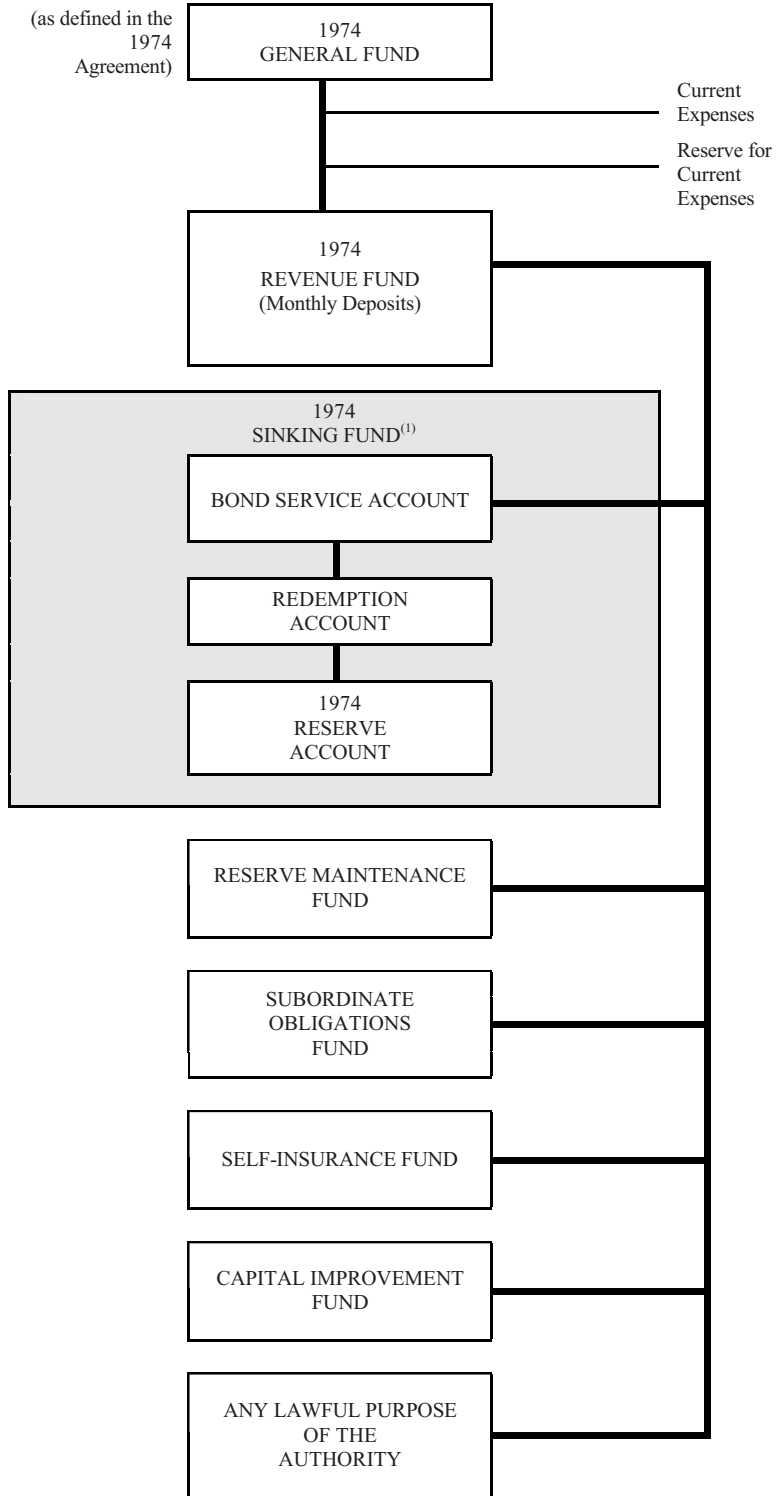
### Source of Payment

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.

## **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 April 30, 2008, approximately \$287.6 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 \$262.0 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. 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 April 30, 2008, the balances of the Reserve Maintenance Fund and the Self-insurance Fund were \$567,579 and \$45.9

million, respectively. In addition, as of such date, the Authority had set aside \$23.3 million for the Capital Improvement Fund. See “Disposition of Revenues” in Appendix I, *Summary of Certain Provisions of the 1974 Agreement Excluding Proposed Supplemental Agreement*.

### **Additional Bonds**

Additional Power Revenue Bonds may be issued under the 1974 Agreement for the purpose of paying all or any part of the cost of any improvements to the System or for any other proper corporate purpose of the Authority; provided that, among other requirements, Net Revenues (as defined in the 1974 Agreement) of the Authority for any 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 January 30, 2008 of \$672.3 million were 155% of the maximum aggregate annual Principal and Interest Requirements of \$435 million on all outstanding Power Revenue Bonds. Estimated average annual Net Revenues for the five fiscal years ending June 30, 2013 of \$756.4 million would be 1.59% of the maximum aggregate annual Principal and Interest Requirements of \$476.9 million on all outstanding Power Revenue Bonds (including the 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*.

## **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, the owners of approximately 99% of the outstanding Power Revenue Bonds will have consented to the execution of the Supplemental Agreement. See Appendix I, *Summary of Certain Provisions of Proposed Supplemental Agreement*, for additional information respecting the provisions of the Supplemental Agreement.

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

## **DESCRIPTION OF THE BONDS**

### **General**

The Bonds will bear interest at such rates and will mature on the dates and in the principal amounts set forth on the inside cover page of this Official Statement. The Bonds will be dated their date of delivery. Interest on the Bonds will be payable on each January 1 and July 1, commencing on January 1, 2009.

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 each series 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 is a limited-purpose trust company organized under the New York Banking Law, a “banking organization” with 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 3.5 million issues of U.S. and non-U.S. equity, 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 between 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 is the holding company for DTC, National Securities Clearing Corporation and Fixed Income Clearing Corporation, all of which are registered clearing agencies. DTCC is owned by the users of its regulated subsidiaries. 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](http://www.dtcc.com) and [www.dtc.org](http://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 the Authority or the 1974 Trustee on the payable date in accordance with their respective holdings shown on DTC's records. Payments by Participants to Beneficial Owners will be governed by standing instructions and customary practices, as is the case with securities held for the accounts of customers in bearer form or registered in "street name," and will be the responsibility of such Participant and not of DTC nor its nominee, the 1974 Trustee, or the Authority, subject to any statutory or regulatory requirements as may be in effect from time to time. Payment of the principal, redemption 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 Authority or the 1974 Trustee, disbursement of such payments to Direct Participants will be the responsibility of DTC, and disbursement of such payments to the Beneficial Owners will be the responsibility of Direct and Indirect Participants.

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 Bonds maturing on July 1, 2028 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 Bonds, in amounts equal to the Amortization Requirements for such Bonds (less the principal amount of any 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 Bonds due on July 1, 2028**

<u>Year</u>	<u>Amortization Requirement</u>
2026	\$24,490,000
2027	25,715,000
2028†	27,000,000

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† Maturity.

The Bonds maturing on July 1, 2033 will be redeemed in part on July 1, 2029, and on each July 1 thereafter for which there is an Amortization Requirement in respect of such Bonds, in amounts equal to the Amortization Requirements for such Bonds (less the principal amount of any 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 Bonds due on July 1, 2033**

<u>Year</u>	<u>Amortization Requirement</u>
2029	\$28,350,000
2030	29,840,000
2031	31,405,000
2032	33,055,000
2033†	34,790,000

The Bonds maturing on July 1, 2038 will be redeemed in part on July 1, 2034, and on each July 1 thereafter for which there is an Amortization Requirement in respect of such Bonds, in amounts equal to the Amortization Requirements for such Bonds (less the principal amount of any 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 Bonds due on July 1, 2038**

<u><b>Year</b></u>	<u><b>Amortization Requirement</b></u>
2034	\$36,620,000
2035	38,630,000
2036	40,755,000
2037	43,000,000
2038†	45,365,000

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† Maturity.

### **Optional Redemption**

The Bonds that mature after July 1, 2018 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, 2018, at a redemption price equal to the principal amount of the Bonds to be redeemed plus accrued interest to the redemption date, without premium.

### **Notice of Redemption**

Notice of redemption shall be mailed by the Trustee, not less than thirty (30) days nor more than sixty (60) days prior to the redemption date, to the Holders of Bonds called for redemption at their addresses appearing on the bond registration books of the Trustee. The Trustee shall also give notice of redemption by overnight mail or courier service to the Authority, and such securities depositories and/or securities information services as shall be designated by the Authority.

## **THE AUTHORITY**

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

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

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

### **Powers**

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

## Management

The Act provides that the Governing Board of the Authority (the “Board”) shall be composed of nine members. The Secretary of Transportation and Public Works of the Commonwealth serves *ex officio* as a member of the Board, and six other members are appointed by the Governor with the advice and consent of the Senate of Puerto Rico. The remaining two members are client representatives elected directly by the Authority’s clients. Members of the Board serve for a term of four years and members who are not *ex officio* can be reappointed or reelected. There is currently one vacant to be appointed by the Governor. 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
Carlos J. González Miranda	Secretary of Transportation and Public Works	<i>Ex Officio</i>
Luis Abbott Van Der Horst	Business Consultant	February 2011
José A. Fernández-Polo	Civil Engineer and General Contractor	February 2011
José Luis Rodríguez-Homs	Engineer	February 2011
María A. Veras Fernández*	College Promoter	September 2009
Francisco J. De Echegaray*	Physician	September 2009

\* Mrs. Veras Fernández and Dr. Francisco J. De Echegaray are the client representatives on the Governing Board.

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 30 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 (PRASA) 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 28 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 23 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 35 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 24 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 18 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 25 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 26 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 29 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 21 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 19 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 23 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.

*José M. Molina Oliveras*, Director of Corporate Security holds a Juris Doctor and has over 30 years of management experience in corporate security programs. He has served as Director of Corporate Security for the PRASA, Director of Security for the Department of Treasury, Security Manager for Telefonica Larga Distancia and Deputy Director of Special Investigation Bureau of the Department of Justice, among others.

*María E. Quintero Herencia*, Director of Communication and Community Relations has devoted her 21 years of professional experience in communications to the government sector in both the state and municipal levels. As a public servant, she has occupied key executive positions in the communications departments of the Sports and Recreation Department of the San Juan Municipality, the City of San Juan's Health Department, the Office of the San Juan Mayor, the Government Development Bank of Puerto Rico, and the Puerto Rico Aqueduct and Sewer Authority.

The Authority retains the firm of Washington Division of URS Corporation, successor to Washington Group International, Inc., as the consulting engineer (the "Consulting Engineers") to perform certain responsibilities under the 1974 Agreement. Washington Division of URS Corporation was formed in November 2007 following the acquisition by URS Corporation of Washington Group International, Inc. The Consulting Engineers' responsibilities include submitting an annual report to the 1974 Trustee setting forth their advice and 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 2008.

## **THE SYSTEM**

The Authority is the supplier of virtually all of the electric power consumed in the Commonwealth. As of April 30, 2008, the Authority served approximately 1.4 million clients, representing a population of 4.46 million.

### **Generating Facilities**

As of April 30, 2008, investment in Authority-owned production plant in service totaled approximately \$2.6 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. 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. The two smaller units at Palo Seco, which each have 85 MW of capacity can be operated independently of the control room. Unit 2 and Unit 1 returned to service on November 4, 2007 and April 22, 2008, respectively. The Authority believes that the control room, which is needed to operate the two larger 216 MW units, will be repaired by summer 2008. It is anticipated that Unit 4 will be returned to service by summer 2008 and the Unit 3 will be returned to service by September 2008. Consequently, all current and projected operating data contained in this Official Statement include the generating capacity of all of the Palo Seco units. 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)

Generating Plants	Nameplate Rating (84 Units)	Dependable Generating Capacity					
		Total (84 Units)	Steam (18 Units)	Combined Cycle Power Blocks (13 Units)	Combustion Turbine (25 Units)	Hydro (21 Units)	Other <sup>(1)</sup> (7 Units)
Aguirre.....	1,554	1,534	900 <sup>(2)</sup>	592 <sup>(3)</sup>	42 <sup>(4)</sup>		
Costa Sur.....	1,118	1,132	1,090		42 <sup>(4)</sup>		
Palo Seco.....	731	728	602		126 <sup>(5)</sup>		
San Juan.....	400	400	400				
Mayagüez.....	90	84			84 <sup>(6)</sup>		
Arecibo.....	249	249			249 <sup>(7)</sup>		
Other Locations.....	285	277			168 <sup>(8)</sup>	100	9
Subtotal.....	4,427	4,404	2,390	592	711	100	9
Peñuelas – EcoEléctrica.....	507	507		507 <sup>(9)</sup>			
Guayama – AES-PR.....	454	454	454 <sup>(10)</sup>				
Total.....	5,388	5,365	2,844	1,099	711	100	9

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

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

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

The AES-PR plant is a co-generation facility located in the Municipality of Guayama. The plant commenced commercial operation in November of 2002. This clean burning coal technology facility consists of two identical fluidized bed boilers and two steam turbines with 454 MW of dependable generating capacity. The Authority has entered into an agreement with AES-PR to purchase all of the power produced by this facility for a term of 25 years from the date of commencement of commercial operation. The contract with AES-PR is



substantially similar to the EcoEléctrica contract described above. Above a certain minimum amount, the Authority is only obligated to purchase energy actually produced by the facility. AES-PR is an affiliate of the AES Corporation.

The AES-PR and EcoEléctrica projects contribute to the Authority's efforts towards fuel diversification and improved reliability of service. In the past, oil-fired units produced approximately 99% of the Authority's energy. After the incorporation of the EcoEléctrica and AES-PR facilities to the System, approximately 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 2003 to fiscal year 2007, the Authority invested \$1.3 billion (or 51.9% of its capital improvement program) in its transmission and distribution system. The capital improvement program for the five fiscal years ending June 30, 2012 includes \$939.7 million (or 44% of such program) for transmission and distribution facilities.

Transmission plant in service as of April 30, 2008 totaled \$1.3 billion based on original installed cost. As of that date, there were 2,401 circuit miles of transmission lines and 167 transmission switchyards. Transmission lines include 364 circuit miles of 230 kV lines, 682 circuit miles of 115 kV lines and 1,355 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 April 30, 2008 totaled \$2.6 billion based on original cost. The capital improvement program for the five fiscal years ending June 30, 2012 includes \$417 million (or 19% 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 April 30, 2008, the electric distribution system included approximately 30,675 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 79% in fiscal year 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 \$895.2 million in capital expenditures for the five fiscal years ended June 30, 2007 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 2003 through 2007 and for the twelve months ended April 30, 2008.

## Electric Generation Equivalent Availability and Reliability

	Years Ended June 30,					Twelve Months Ended April 30,
	<u>2003</u>	<u>2004</u>	<u>2005</u>	<u>2006</u>	<u>2007</u>	<u>2008</u>
Equivalent availability <sup>(1)</sup> .....	81%	81%	85%	87%	85%	79%
Equivalent forced outage rate <sup>(2)</sup> .....	9%	9%	6%	4%	10% <sup>(3)</sup>	15% <sup>(3)</sup>

<sup>(1)</sup> Cogenerator data is included.

<sup>(2)</sup> Cogenerator data is not included.

<sup>(3)</sup> Increase over prior year due primarily to Palo Seco outage.

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 87% during fiscal year 2006. Total production plant availability decreased to 85% in fiscal year 2007 and to 79% during the twelve months ended on April 30, 2008 due to the outage at Palo Seco. 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 by the start of fiscal year 2009.

The Authority's updated capacity expansion plan includes the replacement of four 21 MW combustion turbines at Mayagüez with four 55 MW dual fuel aero-derivative combustion turbines. This replacement, scheduled for commercial operation during early fiscal year 2009, will provide improved efficiency and add approximately 136 MW of new capacity.

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 2011. A natural gas pipeline is also contemplated for the west side of the island after fiscal year 2011. After these projects are completed the expected electric generation by fuel type in fiscal year 2011 will be 44% natural gas, 13% coal, and 43% 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 2012. 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 2012 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, and the replacement of the four 21 MW units in Mayagüez with four 55 MW units. Projections of future peak load (for capacity planning purposes) from fiscal year 2008 to fiscal year 2012 prepared by the Authority show an average annual increase of 0.6%.

<b>Fiscal Years Ending June 30,</b>	<b>Peak Load</b>	<b>Dependable Capacity</b>	<b>Reserve Margin</b>	<b>Dependable Reserve Margin (%)</b>
(in MW, except percentages)				
2008	3,546	5,365	1,819	51
2009	3,529	5,865	2,336	66
2010	3,548	5,865	2,317	65
2011	3,588	5,865	2,277	63
2012	3,636	5,865	2,229	61

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, 2007 and for the ten-month periods ended April 30, 2007 and 2008. The information below reflects the inclusion of 507 MW of capacity provided pursuant to the EcoEléctrica contract and 454 MW of capacity provided pursuant to the AES-PR contract.

## Statistical Information

	Years Ended June 30,					Ten Months Ended April 30,	
	2003	2004	2005	2006	2007	2007	2008
Nameplate rating at end of period (in MW)	4,421	5,382	5,388	5,388	5,388	5,388	5,388
Dependable generating capacity at end of period (in MW).....	5,359 <sup>(1)</sup>	5,359 <sup>(1)</sup>	5,365 <sup>(1)</sup>	5,365 <sup>(1)</sup>	5,365 <sup>(1)</sup>	5,365 <sup>(1)</sup>	5,365 <sup>(1)</sup>
Peak load, 60-minute (in MW).....	3,376	3,499	3,603	3,685	3,604	3,604	3,546
Reserve Margin (%).....	58.7	53.1	48.9	45.6	48.9	48.9	51.3
Average load (in MW).....	2,707	2,744	2,797	2,839	2,863	2,843	2,714
Load factor (%).....	80.2	78.4	77.6	77.0	79.4	78.9	76.5
Energy generated, purchased and sold (in millions of kWh):							
Electric energy generated and purchased	23,717 <sup>(2)</sup>	24,100 <sup>(2)</sup>	24,500 <sup>(2)</sup>	24,870 <sup>(2)</sup>	25,082 <sup>(2)</sup>	20,743 <sup>(2)</sup>	19,864 <sup>(2)</sup>
Auxiliary equipment use.....	<u>(1,076)</u>	<u>(1,085)</u>	<u>(1,122)</u>	<u>(1,116)</u>	<u>(1,020)</u>	<u>(861)</u>	<u>(769)</u>
Net electric energy generated and purchased.....	22,641	23,015	23,378	23,754	24,062	19,882	19,095
Losses and unaccounted for.....	<u>(2,754)</u>	<u>(2,755)</u>	<u>(2,871)</u>	<u>(3,134)</u>	<u>(3,390)</u>	<u>(2,791)</u>	<u>(2,795)</u>
Electric Energy Sold.....	<u>19,887</u>	<u>20,260</u>	<u>20,507</u>	<u>20,620</u>	<u>20,672</u>	<u>17,091</u>	<u>16,300</u>
Electric Energy Sales:							
Residential.....	7,280	7,338	7,438	7,250	7,244	5,977	5,613
Commercial.....	8,167	8,400	8,499	8,734	8,910	7,353	7,265
Industrial.....	3,963	4,092	4,177	4,242	4,136	3,444	3,125
Other.....	<u>477</u>	<u>430</u>	<u>393</u>	<u>394</u>	<u>382</u>	<u>317</u>	<u>297</u>
Total.....	<u>19,887</u>	<u>20,260</u>	<u>20,507</u>	<u>20,620</u>	<u>20,672</u>	<u>17,091</u>	<u>16,300</u>
Electric Energy Revenues (in thousands):							
Residential.....	\$867,684	\$897,965	\$1,066,419	\$1,284,641	\$1,272,389	\$1,044,644	\$ 1,190,667
Commercial.....	1,117,317	1,171,110	1,350,731	1,656,770	1,666,358	1,371,758	1,606,803
Industrial.....	432,296	444,070	529,285	663,041	630,569	524,240	575,521
Other.....	<u>91,461</u>	<u>87,123</u>	<u>91,675</u>	<u>104,486</u>	<u>101,650</u>	<u>84,091</u>	<u>92,864</u>
Total.....	<u>\$2,508,758</u>	<u>\$2,600,268</u>	<u>\$3,038,110</u>	<u>\$3,708,938</u>	<u>\$3,670,966</u>	<u>\$3,024,733</u>	<u>\$3,465,855</u>
Average revenue per kWh(in cents):							
Residential.....	11.92	12.24	14.34	17.72	17.57	17.48	21.21
Commercial.....	13.68	13.94	15.89	18.97	18.70	18.66	22.12
Industrial.....	10.91	10.85	12.67	15.63	15.24	15.22	18.42
Other.....	19.19	20.29	23.29	26.55	26.60	26.55	31.29
All Classes.....	12.61	12.83	14.81	17.99	17.76	17.70	21.26
Average number of clients:							
Residential.....	1,270,371	1,287,010	1,304,657	1,315,345	1,317,454	1,318,477	1,313,952
Commercial.....	125,890	127,705	129,170	130,082	130,295	130,308	130,114
Industrial.....	1,804	1,679	1,668	1,618	1,576	1,579	1,522
Other.....	<u>3,236</u>	<u>3,208</u>	<u>3,204</u>	<u>3,182</u>	<u>3,204</u>	<u>3,206</u>	<u>3,191</u>
Total.....	<u>1,401,301</u>	<u>1,419,602</u>	<u>1,438,699</u>	<u>1,450,227</u>	<u>1,452,529</u>	<u>1,453,570</u>	<u>1,448,779</u>
Monthly average revenue per client:							
Residential.....	\$56.92	\$58.14	\$68.12	\$81.39	\$80.48	\$79.23	\$90.62
Commercial.....	739.61	764.20	871.42	1,061.36	1,065.76	1,052.70	1,234.92
Industrial.....	19,969.33	22,040.40	26,443.10	34,149.21	33,342.27	33,200.76	37,813.47
Other.....	2,355.30	2,263.17	2,384.39	2,736.38	2,643.83	2,622.93	2,910.18
All classes.....	149.19	152.64	175.98	213.12	210.61	208.09	239.23

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

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

## Historical Capital Improvement and Financing Program

Capital improvements and their financing are made pursuant to a program established by the Authority and reviewed annually by the Consulting Engineers. The program for the five fiscal years ended June 30, 2007 and for the ten-month periods ended April 30, 2007 and 2008 is shown in the following table.

	Years Ended June 30,					Total	Ten Months Ended April 30,	
	2003	2004	2005	2006	2007		2007	2008
Capital Improvements	(in thousands)							
Production plant.....	\$105,579	\$126,605	\$150,676	\$201,254	\$311,038	\$ 895,152	\$242,261	\$302,287
Transmission facilities.....	111,893	109,004	142,707	163,195	132,771	659,570	102,871	111,011
Distribution facilities.....	124,469	133,098	133,724	120,314	104,826	616,431	78,344	91,754
Other <sup>(1)</sup> .....	50,165	78,236	83,971	39,632	36,510	288,514	30,670	29,379
Total.....	<u>\$392,106</u>	<u>\$446,943</u>	<u>\$511,078</u>	<u>\$524,395</u>	<u>585,145</u>	<u>\$2,459,667</u>	<u>\$454,146</u>	<u>\$534,431</u>
<b>Financing</b>								
Internally generated funds ...	\$144,537	\$ 43,066	\$ 83,533	\$ 49,604	\$ 10,212	\$ 330,952	\$ 6,157	\$ 23,268
Borrowed funds <sup>(2)</sup> .....	247,569	403,877	427,545	474,791	574,933	2,128,715	447,989	511,163
Total.....	<u>\$392,106</u>	<u>\$446,943</u>	<u>\$511,078</u>	<u>\$524,395</u>	<u>\$585,145</u>	<u>\$2,459,667</u>	<u>\$454,146</u>	<u>\$534,431</u>
Allowance for funds used during construction.....	\$ 16,795	\$ 20,279	\$ 8,187	\$ 12,322	\$ 22,230		\$ 17,612	\$ 39,725

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

(2) 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 proposed capital budget for fiscal year 2009 was adopted on May 15, 2008.

The projected capital improvement program for the five fiscal years ending June 30, 2012 aggregates approximately \$2.1 billion. It is currently estimated that \$181.2 million, or approximately 8.5%, of the projected five-year capital improvement program will be financed by internally generated funds. Estimated capital costs reflect, among other factors, construction contingency allowances and annual cost escalations.

The five-year capital improvement program includes \$904.4 million for production plant and new generation. Of this amount, the Authority projects that approximately \$623 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 \$522.1 million for transmission facilities and \$417.6 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 2007 the Authority's internal funding of capital expenditures was 2% of the amount spent, whereas over the last five years the Authority's average annual contribution to such funding was 13.5%, and have recommended that the Authority increase its internal funding level to approximately 25%. The fiscal year 2007 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 \$2.1 billion on capital projects through fiscal year 2012. During that period the Authority's internal funding is projected to constitute approximately 8.5% 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, 2012 and its projected financing.

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

	Years Ending June 30,					Total
	2008 <sup>(1)</sup>	2009	2010	2011	2012	
<b>Capital Improvements</b>						
Production plant .....	\$360,344	\$185,328	\$126,650	\$102,270	\$129,790	\$904,382
Transmission .....	133,213	104,638	109,449	87,616	87,223	522,139
Distribution .....	110,105	80,489	76,392	72,813	77,823	417,622
Other <sup>(2)</sup> .....	35,255	75,551	73,403	48,327	56,185	288,721
<b>Total .....</b>	<b>\$638,917</b>	<b>\$446,006</b>	<b>\$385,894</b>	<b>\$311,026</b>	<b>\$351,021</b>	<b>\$2,132,864</b>
<b>Financing Sources</b>						
Internal Funds.....	\$20,550	\$59,565	\$37,143	\$17,395	\$31,094	\$165,747
Borrowed Funds <sup>(3)</sup> .....	618,367	386,441	348,751	293,631	319,927	1,967,117
<b>Total .....</b>	<b>\$638,917</b>	<b>\$446,006</b>	<b>\$385,894</b>	<b>\$311,026</b>	<b>\$351,021</b>	<b>\$2,132,864</b>

(1) Based on actual results for the ten-month period ended April 30, 2008 and an estimate for the last two months of fiscal year 2008.

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

(3) For the purpose of this table, it is assumed that of the total \$850 million Power Revenue Bonds expected to be issued in the five-year period ending June 30, 2012, \$450 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, 2007 and the ten-month periods ended April 30, 2007 and 2008.

	<b>Electric Sales Revenues</b>					<b>Ten Months Ended</b>	
	<b>(in thousands)</b>					<b>April 30,</b>	
	<b>Years Ended June 30,</b>					<b>April 30,</b>	
	<b>2003</b>	<b>2004</b>	<b>2005</b>	<b>2006</b>	<b>2007</b>	<b>2007</b>	<b>2008</b>
Basic charges.....	\$1,134,794	\$1,140,277	\$1,157,262	\$1,165,961	\$1,183,862	\$ 978,969	\$ 942,272
Fuel adjustment charges.....	994,406	970,972	1,329,073	1,868,542	1,778,198	1,461,144	1,911,169
Purchased power charges....	379,558	489,019	551,775	674,435	708,906	584,620	612,414
Total.....	<u>\$2,508,758</u>	<u>\$2,600,268</u>	<u>\$3,038,110</u>	<u>\$3,708,938</u>	<u>\$3,670,966</u>	<u>\$3,024,733</u>	<u>\$3,465,855</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. Actual industry savings to April 30, 2008 are \$18.6 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 16% of revenues from electric energy sales for the twelve months ended April 30, 2008.

The ten largest industrial clients accounted for 5.3% of kWh sales and 4.2% of revenues from electric energy sales for the fiscal year ended June 30, 2007. 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 April 30, 2008, two of the Authority's industrial clients were using such rate.

## **Fuel**

For the fiscal year ended June 30, 2007, fuel oil expenses amounted to \$1,717 million, or 56.9% of total Current Expenses (\$1,666 million or 54.9% of total Current Expenses for the preceding fiscal year). For the ten months ended April 30, 2008, fuel oil expenses amounted to \$1,802 million, or 61.8% of total Current Expenses. For the five fiscal years ended June 30, 2007, fuel oil averaged 51.3% 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 70% of the net electric energy generated by the System in fiscal year 2007, 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 April 30, 2008, the Authority had an inventory of 3.0 million barrels of fuel oil.

Average fuel oil costs and related costs of production for the five fiscal years ended June 30, 2007, and for the ten months ended April 30, 2007 and 2008, are shown in the following table:

	<b>Fuel Costs</b>					<b>Ten Months</b>	
	<b>Years Ended June 30,</b>					<b>Ended April 30,</b>	
	<b>2003</b>	<b>2004</b>	<b>2005</b>	<b>2006</b>	<b>2007</b>	<b>2007</b>	<b>2008</b>
Average fuel oil cost per barrel (net of handling costs).....	\$ 29.64	\$ 29.54	\$ 39.22	\$ 56.38	\$ 57.55	\$ 55.54	\$ 79.50
Number of barrels used (in millions).....	29.91	29.27	30.16	29.55	29.83	24.40	22.68
Fuel oil cost (in millions).....	\$886.4	\$864.7	\$1,182.9	\$1,665.9	\$1,717.0	\$1,356.9	\$1,802.9
Net kWh generated (excluding purchased power from 2000 to 2006) (in millions).....	17,259.0	16,740.6	17,270.7	16,933.1	16,974.2	13,953.7	12,946.1
Average net kWh per barrel.....	577.0	571.9	572.6	573.0	569.0	571.9	570.8
Average fuel oil cost per net kWh generated (in cents).....	5.14	5.17	6.85	9.84	10.12	9.72	13.93

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. As of April 30, 2008, the amount owed by the Commonwealth was approximately \$18.9 million. The Legislature of Puerto Rico agreed to appropriate \$6.3 million a year until 2012 to pay this debt. 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 \$19.4 million per year for the five fiscal years ended June 30, 2007. 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 \$4.6 million per year for the five fiscal years ended June 30, 2007. 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.

*Contributions In Lieu of Taxes to Municipalities*

For fiscal year 2007, the total amount of Contribution in Lieu of Taxes (CILT) to municipalities was \$129.9 million, which includes a payment of \$4.4 million to amortize the outstanding balance of a note payable used for settlement of municipalities' lawsuit discussed under *Litigation*. The CILT was based on the value of power consumed by the municipalities, which was \$159.9 million. The unpaid balance of \$34.3 million in the CILT will be carried forward for payment over the next three years. The Authority used the remaining \$125.6 million to offset or reduce the outstanding municipal accounts receivable balances.

For the ten month period ended April 30, 2008, CILT to municipalities amounted to \$167.6 million, including \$7.3 million to amortize the outstanding balance of a note payable referenced above and \$6.8 million to cover the unpaid balance of \$34.3 million as of June 30, 2007.

**DEBT**

The following table sets forth the bonds and notes of the Authority outstanding as of April 30, 2008, and as adjusted for the issuance of the Bonds as of June 26, 2008.

	<u>Outstanding as of</u> <u>April 30, 2008</u> (In Thousands)	<u>As adjusted <sup>(1)</sup></u>
Power Revenue Bonds		
Publicly Offered .....	\$5,470,435	\$6,167,780
Rural		
Electrification.....	<u>27,422</u>	<u>27,422</u>
Sub-total.....	5,497,857	6,195,202
Notes <sup>(2)</sup> .....	1,183,784	983,784
Government Development		
Bank lines of credit .....	<u>113,065</u>	<u>113,065</u>
Total.....	<u>\$6,794,706</u>	<u>\$7,292,051</u>

(1) As adjusted for the issuance of the Bonds.  
(2) See *Notes* below.

**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 April 30, 2008, \$27.4 million of such bonds were outstanding at an interest rate of 5%.

**Notes**

The Authority has outstanding \$1,183.8 million aggregate principal amount in eight 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 \$26.9 million aggregate principal amount corresponds to subordinated notes issued to a commercial bank with annual payments of \$6.3 million until 2012. These notes are 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 April 30, 2008, the outstanding balance under this line of credit was \$375 million. A fifth line of credit, in the amount of \$200 million, is for operational financing. 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. As of April 30, 2008, the outstanding amount of this term loan amounted to \$56.9 million. The Authority has drawn an additional \$100 million to finance repairs to the Palo Seco Steam Plant pending receipt of payment for such repairs by the Authority's insurers. The eighth note of \$50 million is to fund the purchase of fuel oil.

### **Government Development Bank – Line of Credit**

The Authority has three 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 April 30, 2008, the Authority had drawn approximately \$57 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 April 30, 2008, the Authority has outstanding \$6.1 million under this second line of credit. The third line of credit of \$100 million is to finance repairs to the Palo Seco Steam Plant pending receipt of payment for such repairs by the Authority's insurers. As of April 30, 2008, the outstanding amount of this line of credit was \$50 million.

### **Swap Agreements**

With effective date of July 1, 2008, the Authority entered into a basis swap agreement in the notional amount of \$1.375 billion (the "Basis Swap Agreement") with an amortization schedule matching certain maturities of the Authority's outstanding power revenue and power revenue refunding bonds issued in various years from 2027 to 2037. Under the terms of a master swap agreement, the Authority will receive from Goldman Sachs Capital Markets (an affiliate of Goldman, Sachs & Co.) quarterly payments, commencing on October 1, 2008, equal to a floating amount applied to said notional amount at a rate equal to 62% of the taxable London Inter-Bank Offering Rate ("LIBOR") index reset each week plus 29 basis points (hundredths of a percent) and a fixed rate payment of 0.4669% per annum (the "basis annuity"), quarterly for the term of swap in return for quarterly payments by the Authority, commencing also on October 1, 2008, on such notional amount at a rate based on the Securities Industry and Financial Markets Association ("SIFMA") municipal swap index. This basis swap provides the Authority the cash flow benefit of the basis annuity in exchange for the Authority taking tax and other basis risks tied to the change in the relationship between LIBOR and the SIFMA municipal swap index.

Pursuant to the 1974 Agreement, regularly scheduled payments to the counterparty by the Authority under the Basis Swap Agreement are on a parity with the principal and interest payments on the Power Revenue Bonds, including the Bonds, and the payments relating to the termination or other fees, expenses, indemnification or other obligations to the counterparty under such agreement are subordinate to the Power Revenue Bonds, including the Bonds.

In September 2007, the Authority entered into two forward floating-to-fixed interest rate swap agreements relating to the Bonds ("Forward Swap Agreements") with Goldman Sachs Capital Markets and UBS AG (an affiliate of UBS Securities Inc.) with initial notional amounts of \$200 million and \$400 million, respectively. Each of the Forward Swap Agreements has a commencement date of September 1, 2008, an end date of July 1, 2038, and provides for early optional termination as well as for a mandatory termination on

September 1, 2008. Contemporaneously with the pricing of the Bonds, the Forward Swap Agreements will be terminated and it is expected that the Authority will owe termination payments in the approximate aggregate amount of \$13.5 million to the counterparties.

In connection with future or outstanding debt, the Authority may enter into additional interest rate swap agreements, either of the fixed-to-floating rate or floating-to-fixed rate variety, which may also include forward swaps.

### **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. The Amortization Requirements are subject to adjustment as provided in the definition thereof. See Appendix I, *Summary of Certain Provisions of the 1974 Agreement Excluding Proposed Supplemental Agreement*.



## Debt Service Requirements

Years Ending June 30	Outstanding Bond Principal and Interest Requirements <sup>(1)</sup>	The Bonds			Total Debt Service Requirements <sup>(2)</sup>
		Maturity and Amortization Requirements	Interest	Total	
2008	\$443,629,689	-	-	-	\$443,629,689
2009	435,041,857	-	\$37,687,619	\$37,687,619	472,729,476
2010	423,900,526	\$10,685,000	37,171,350	47,856,350	471,756,876
2011	411,459,289	11,220,000	36,637,100	47,857,100	459,316,389
2012	414,629,965	11,780,000	36,076,100	47,856,100	462,486,065
2013	429,017,692	12,370,000	35,487,100	47,857,100	476,874,792
2014	428,675,021	13,020,000	34,837,675	47,857,675	476,532,696
2015	413,422,550	13,705,000	34,154,125	47,859,125	461,281,675
2016	408,410,950	14,425,000	33,434,613	47,859,613	456,270,563
2017	423,028,267	15,215,000	32,641,238	47,856,238	470,884,505
2018	375,175,100	16,055,000	31,804,413	47,859,413	423,034,513
2019	374,076,940	16,935,000	30,921,388	47,856,388	421,933,328
2020	390,781,510	17,870,000	29,989,963	47,859,963	438,641,473
2021	392,765,732	18,850,000	29,007,113	47,857,113	440,622,845
2022	371,069,293	19,890,000	27,970,363	47,860,363	418,929,656
2023	370,807,768	20,955,000	26,901,275	47,856,275	418,664,043
2024	348,708,504	22,085,000	25,774,944	47,859,944	396,568,448
2025	322,333,665	23,270,000	24,587,875	47,857,875	370,191,540
2026	299,540,209	24,490,000	23,366,200	47,856,200	347,396,409
2027	299,570,957	25,715,000	22,141,700	47,856,700	347,427,657
2028	269,753,081	27,000,000	20,855,950	47,855,950	317,609,031
2029	233,849,020	28,350,000	19,505,950	47,855,950	281,704,970
2030	233,787,147	29,840,000	18,017,575	47,857,575	281,644,722
2031	191,470,529	31,405,000	16,450,975	47,855,975	239,326,504
2032	143,243,312	33,055,000	14,802,213	47,857,213	191,100,525
2033	143,298,425	34,790,000	13,066,825	47,856,825	191,155,250
2034	95,434,587	36,620,000	11,240,350	47,860,350	143,294,937
2035	95,485,663	38,630,000	9,226,250	47,856,250	143,341,913
2036	50,158,250	40,755,000	7,101,600	47,856,600	98,014,850
2037	50,158,500	43,000,000	4,860,075	47,860,075	98,018,575
2038	-	45,365,000	2,495,075	47,860,075	47,860,075
<b>Total<sup>(2)</sup></b>	<b>\$9,282,683,998</b>	<b>\$697,345,000</b>	<b>\$728,214,988</b>	<b>\$1,425,559,988</b>	<b>\$10,708,243,986</b>

- (1) Debt service requirement on all Power Revenue Bonds outstanding on the date hereof, including Rural Electrification Bonds. These amounts may change after giving effect to the issuance of the Bonds.
- (2) Actual amount may vary due to rounding.

## 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, 2007 and for the ten-month periods ended April 30, 2007 and 2008 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,					Ten Months Ended April 30,	
	2003	2004	2005	2006	2007	2007	2008
Average number of clients.....	1,401,301	1,419,602	1,438,699	1,450,227	1,452,529	1,453,570	1,448,779
Electric energy sales (in millions of kWh).....	19,887	20,260	20,507	20,620	20,672	17,091	16,300
<b>Source of Net Revenues</b>							
<b>(dollars in thousands)</b>							
Revenues:							
Sales of electric energy:							
Residential <sup>(1)</sup> .....	\$867,684	\$897,965	\$1,066,419	\$ 1,284,641	\$1,272,389	\$1,044,644	\$1,190,667
Commercial.....	1,117,317	1,171,110	1,350,731	1,656,770	1,666,358	1,371,758	1,606,803
Industrial.....	432,296	444,070	529,285	663,041	630,569	524,240	575,521
Other.....	<u>91,461</u>	<u>87,123</u>	<u>91,675</u>	<u>104,486</u>	<u>101,650</u>	<u>84,091</u>	<u>92,864</u>
	2,508,758	2,600,268	3,038,110	3,708,938	3,670,966	3,024,733	3,465,855
Revenues from Commonwealth for rural electrification.....	704	591	161	116	76	60	20
Other operating revenues.....	9,625	8,565	13,705	11,373	11,068	9,019	13,727
Other (principally interest earned).....	<u>17,163</u>	<u>3,582</u>	<u>8,146</u>	<u>11,498</u>	<u>5,275</u>	<u>25,337</u>	<u>7,949</u>
	<u>2,536,250</u>	<u>2,613,006</u>	<u>3,060,122</u>	<u>3,731,925</u>	<u>3,687,385</u>	<u>3,059,149</u>	<u>3,487,551</u>
Current Expenses:							
Operations:							
Fuel.....	886,425	864,700	1,182,936	1,665,866	1,716,965	1,356,861	1,802,871
Purchased power.....	339,082	436,763	492,621	603,169	624,653	520,064	541,976
Fuel Extra Expense Claimed <sup>(2)</sup> .....					(114,261)	(41,768)	(96,273)
Other production.....	44,990	48,787	55,945	57,918	56,170	47,481	46,439
Transmission and Distribution.....	119,408	136,509	159,843	162,956	157,569	130,933	138,235
Customer accounting and Collection.....	89,710	91,763	107,932	106,927	109,361	88,317	94,776
Administrative and General.....	163,517	163,049	187,134	198,509	212,530	170,021	178,367
Maintenance <sup>(3)</sup> .....	224,941	234,563	232,464	236,633	250,563	206,549	205,373
Other.....	<u>3,403</u>	<u>3,622</u>	<u>3,728</u>	<u>1,946</u>	<u>1,433</u>	<u>3,186</u>	<u>3,282</u>
	<u>1,871,476</u>	<u>1,979,756</u>	<u>2,422,603</u>	<u>3,033,924</u>	<u>3,014,983</u>	<u>2,481,644</u>	<u>2,915,046</u>
Net Revenues.....	<u>\$ 664,774</u>	<u>\$ 633,250</u>	<u>\$ 637,519</u>	<u>\$ 698,001</u>	<u>\$ 672,402</u>	<u>\$ 577,505</u>	<u>\$ 572,505</u>
<b>Coverage</b>							
Principal and Interest Requirements.....	\$ 381,178	\$ 427,088	\$ 404,022	\$ 449,318	\$ 455,022	-	-
Ratio of Net Revenues to Principal and Interest Requirements.....	1.74	1.48	1.58	1.55	1.48	-	-

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

(2) The Authority expects insurance companies to cover higher fuel prices and other costs associated with alternate generation capacity in connection with the fires of Palo Seco units.

(3) Includes, for maintenance of generating facilities, \$122.6 million, \$135.7 million, \$136.3 million, \$133.6 million and \$134.5 million for fiscal years ended June 30, 2003, 2004, 2005, 2006 and 2007, respectively. For the ten months ended April 30, 2007 and 2008, the maintenance expense of generating facilities was \$112.2 million and \$105.2 million, respectively.

## Management's Discussion and Analysis of Operating Results

The following represents the Authority's analysis of its operations for the eight-month periods ended April 30, 2007 and 2008, and for the five fiscal years ended June 30, 2007. 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 ten months ended April 30, 2008, as compared to the same period of the previous fiscal year, Revenues and Current Expenses increased by \$428.4 million and \$433.4 million, respectively, resulting in a decrease slightly in Net Revenues of \$5.0 million. The increase in Revenues and Current Expenses were mainly due to an increase of \$23.96 per barrel (or 43.1%) in the price of fuel oil. Accounts receivable of the Authority increased from \$835.9 million on June 30, 2007 to \$875.2 million on April 30, 2008. In addition, accounts receivable from the government sector increased from \$316.6 million on June 30, 2007 to \$316.9 million on April 30, 2008. In April 2008, the Authority received \$91 million from the Puerto Rico Treasury Department to cover a portion of the accounts receivable from government sector.

For the fiscal year ended June 30, 2007, as compared to the fiscal year ended June 30, 2006, Revenues and Current Expenses decreased by \$44.5 million and \$18.9 million, respectively, resulting in a decrease in Net Revenues of \$25.6 million. The Authority holds a 30 day waiting period as a deductible on each occurrence in the extra expenses clause of business interruption insurance policy. The decrease in Net Revenues was mainly due to the Authority's assumption of the cost of such retention by \$19.4 million in connection with Palo Seco Steam Plant fire, instead of recovering it from clients through the fuel and purchased power adjustment clauses. Accounts receivable of the Authority increased slightly from \$796.1 million on June 30, 2006 to \$835.9 million on June 30, 2007. In addition, accounts receivable from government sector increased from \$265.9 on June 30, 2006 to \$316.6 on June 30, 2007.

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.

The following table presents the disposition of Net Revenues, in the order of priority of payment, for the five fiscal years ended June 30, 2007 and for the ten months ended April 30, 2007 and 2008, 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)					Ten Months Ended April 30,	
	Years Ended June 30,					2007	2008
	2003	2004	2005	2006	2007	2007	2008
1974 Sinking Fund							
Interest .....	\$249,779	\$264,219	\$255,483	\$257,464	\$257,457	\$215,959	\$206,047
Principal.....	137,329	166,004	148,539	191,854	197,565	164,636	137,075
1974 Reserve Account .....	(30,000)	-	-	-	-	-	-
Reserve Maintenance Fund.....	7,000	7,000	3,498	-	-	-	-
Self-insurance Fund .....	-	-	(20,000)	-	-	-	(25,438)
Capital Improvement Fund.....	144,537	43,066	83,533	49,604	10,212	6,157	23,268
Interest on Note.....	-	1,979	6,189	11,427	38,922	27,943	32,915
Contributions in lieu of taxes and other uses <sup>(1)</sup> .....	<u>156,129</u>	<u>150,982</u>	<u>160,277</u>	<u>187,652</u>	<u>168,246</u>	<u>162,810</u>	<u>198,638</u>
Net Revenues.....	<u>\$664,774</u>	<u>\$633,250</u>	<u>\$637,519</u>	<u>\$698,001</u>	<u>\$672,402</u>	<u>\$577,505</u>	<u>\$572,505</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: \$28.7 million, \$30.4 million, \$30.9 million, \$32.7 million and \$38.3 million for fiscal years ended June 30, 2003, 2004, 2005, 2006 and 2007, respectively. For the ten months ended April 30, 2007 and 2008, those subsidies amounted to \$32.3 million and \$31.1 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 a compound annual sales growth of (1.2%), and incorporate the Authority’s results for the five fiscal years ending 2012. With respect to revenue projections for the fiscal year ending June 30, 2012, such projections include revenues derived from rate increases and/or additional tariffs to be imposed by the Authority commencing in February of 2012.

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

**Projected Fuel Prices**

Years Ending June 30,	Average Price Per Barrel <sup>(1)</sup>
2008 .....	\$76.94 <sup>(2)</sup>
2009 .....	86.97
2010 .....	81.88
2011 .....	77.26
2012 .....	71.74

- (1) This is a blended price of No. 2 and No. 6 fuel oil and natural gas prices. The prices exclude handling charges.
- (2) Based on actual prices through April 30, 2008 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, 2012, 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,				
	2008 <sup>(1)</sup>	2009	2010	2011	2012 <sup>(2)</sup>
Average number of clients .....	1,448,855	1,451,634	1,454,449	1,456,628	1,458,805
Electric energy sales (in millions of kWh) .....	19,927	19,674.0	19,617.0	19,580.0	19,586.0
Authority generation (gross)(in millions of KWh).....	17,097.2	17,249.2	17,179.6	17,138.1	17,123.0
Purchased generation (gross)(in millions of KWh).....	7,149.5	6,691.0	6,691.0	6,691.0	6,710.0
<b>Sources of Net Revenues</b>					
(dollars in thousands)					
Revenues:					
Sales of electric energy:					
Residential.....	\$1,411,714	\$1,555,757	\$1,486,999	\$1,426,701	\$1,361,633
Commercial.....	1,901,012	2,091,986	2,035,845	1,982,953	1,917,336
Industrial .....	685,332	754,889	745,998	732,411	709,786
Other.....	110,325	118,404	116,014	113,745	112,209
	4,108,383	4,521,036	4,384,856	4,255,810	4,100,964
Revenues from Commonwealth for Rural Electrification.....	26	19	-	-	-
Other (principally interests earned) .....	<u>27,749</u>	<u>18,433</u>	<u>34,798</u>	<u>35,623</u>	<u>36,290</u>
	4,136,158	4,539,488	4,419,654	4,291,433	4,137,254
Current Expenses <sup>(2)</sup> :					
Operations:					
Fuel.....	2,081,594	2,372,066	2,231,399	2,101,829	1,917,346
Purchased Power.....	651,906	635,077	658,539	674,922	689,048
Fuel Extra Expense Claim <sup>(3)</sup> .....	(96,273)	-	-	-	-
Other Production.....	55,726	52,759	53,025	53,756	54,835
Transmission and Distribution.....	165,882	140,617	141,325	143,275	146,151
Client accounting and collection.....	113,731	109,070	109,619	111,132	113,363
Administration and general.....	214,040	199,518	200,522	203,290	207,370
Maintenance .....	246,448	259,415	260,721	264,319	269,624
Other – Interest Charges .....	<u>3,938</u>	<u>3,476</u>	<u>3,546</u>	<u>3,617</u>	<u>2,470</u>
	<u>3,436,992</u>	<u>3,771,999</u>	<u>3,658,696</u>	<u>3,556,140</u>	<u>3,400,207</u>
Net Revenues .....	\$699,166	\$767,489	\$760,958	\$735,293	\$737,047
<b>Coverage</b>					
Principal and Interest Requirements <sup>(3)</sup> .....	\$419,568	\$435,042	\$471,757	\$489,414	\$492,819
Ratio of Net Revenues to Principal and Interest Requirements .....					
	1.67	1.76	1.61	1.50	1.50

(1) Based on actual results for the ten-month period ended April 30, 2008 and an estimate for the last two months of fiscal year 2008.

(2) Includes revenues derived from rate increases and/or additional tariffs imposed by the Authority commencing in February of 2012.

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

(4) 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 \$438.1 million in fiscal years 2010 and of \$412.4 million in fiscal year 2012. 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 2008, 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, 2012, in accordance with the provisions of the 1974 Agreement.

<b>Disposition of Net Revenues</b>	<b>Projected Disposition of Net Revenues (in thousands)</b>				
	<b>Years Ending June 30,</b>				
	<b>2008<sup>(1)</sup></b>	<b>2009</b>	<b>2010</b>	<b>2011</b>	<b>2012<sup>(2)</sup></b>
1974 Sinking Fund					
Interest .....	\$255,077	\$262,002	\$290,033	\$296,264	\$286,798
Principal .....	164,492	173,040	181,724	193,150	206,021
Interest on Note .....	39,498	20,385	11,369	10,693	9,961
Capital Improvement Fund .....	20,550	59,565	37,143	17,395	31,094
Reserve Maintenance Fund .....	-	5,000	5,000	5,000	-
Self-Insurance Fund .....	(15,438)	10,000	5,000	-	-
Contribution in lieu of taxes and other .....	<u>234,987</u>	<u>237,497</u>	<u>230,689</u>	<u>212,791</u>	<u>203,173</u>
Net Revenue .....	<u>\$699,166</u>	<u>\$767,489</u>	<u>\$760,958</u>	<u>\$735,293</u>	<u>\$737,047</u>

- (1) Based on actual results for the ten-month period ended April 30, 2008 and an estimate for the last two months of fiscal year 2008.
- (2) Includes revenues derived from rate increases and/or additional tariffs to be imposed by the Authority commencing in February of 2012.
- (3) 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: \$33.9 million, \$31.7 million, \$31.2 million, \$30.7 million and \$29.8 million for fiscal years ending June 30 2008, 2009, 2010, 2011 and 2012, 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 agreed for a compliance auditor to monitor compliance with



certain visible emissions standards at certain of the Authority's generating facilities during a certain period, 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, and to 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. As of the date of this Official Statement, 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 RI/FS has been completed. Even though the EPA has indicated that they will issue a no remedial action determination for this order, they have postponed this decision due to the existence of PCB-contaminated soil which has recently been detected at the site. Even though PCB is not a substance regulated under the Administrative Order, EPA and the Authority are currently negotiating a Removal Order for this material. Once the removal is complete, the Authority expects to resolve both the Administrative Order and the Removal Order during the later part of this year.

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 work has proceeded in accordance with the schedule established by the Authority and the other designated potentially responsible party and approved by EPA. No notable events have occurred during the performance of this work.

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 to use No. 6 fuel oil with sulfur contents equal to or less than 0.50% at its Aguirre, Costa Sur, 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 has discontinued the use of additives, since the Authority has commenced using No. 6 fuel oil with 0.5% or less sulfur content.

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

### *Water Quality Compliance*

As of December 2007, the Authority had achieved a level of compliance with the Clean Water Act regulations equal or greater than 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.

In April of 1995, the Authority submitted to EPA an updated request under Section 316(a) of the Clean Water Act that its Costa Sur power plant be permitted to discharge into the Caribbean Sea heated 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 of 2004, EPA and the Authority agreed to perform a Detailed Engineering and Environmental Review (DEER) of alternatives to select a final alternative for the cooling water discharge that meets the water temperature standard or otherwise qualify for a waiver request under Section 316(a) of the Water Quality Act. While the DEER was in progress, EPA issued a draft permit for the power plant, the commenting period for which is currently on hold until the end of the DEER process.

The Costa Sur DEER consisted on three study stages defined in the scope of work. The process has been documented by progress reports at the end of each stage. All three progress reports have been submitted. The final proposed alternative is a 100% submerged discharge through the north side of the CORCO peninsula with provisions for any operational adjustments to avoid any recirculation issues. The Implementation Plan is currently under discussion with EPA. The alternative estimated capital cost is approximately \$34.8 million. The Costa Sur NPDES Draft permit will remain on hold until the DEER proceeds with the selected recommended alternative by the Authority and EPA.

EPA included, as a compliance requirement in the new San Juan Power Plant NPDES Permit, the performance of a Comprehensive Demonstration Study (CDS) under the Section 316(b) of the Clean Water Act. This section requires complying with performance standards for entrainment and impingement at the power plants cooling water intake water structures. The regulatory deadline to comply with the CDS was January 8, 2008. However, this date is on hold due to a lawsuit filed by an environmental group in New Jersey named Riverkeeper, at the Federal Court. Meanwhile, EPA will evaluate each case for entrainment and impingement based on "Best Judgement Engineering". This applies to all Authority thermoelectric power plants. Except for Palo Seco Power Plant, all other power plant's field studies have been completed. South Coast Progress Report has already been submitted while the progress reports for Aguirre and San Juan were submitted in March, 2008. The beginning of the Palo Seco fieldwork and subsequent progress report submittal will depend on the return to service of the units and will be subject to EPA and the Authority negotiation. The 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 (PREQB) 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. Of the construction projects, one is 90% complete while the rest are fully completed. The Authority is moving forward with the closing of the septic systems according to the plan approved by the PREQB.

#### *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 and maintenance of this program is estimated to cost approximately \$21.98 million during the next five years.

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 to determine priorities for the implementation of the SPCC measures. Also, the preparation of the SPCC plans is in progress for the corresponding substations.

#### *PCB Program*

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 go so far 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 approximately 450 transformers with PCB concentrations of between 50 and 499 ppm.

#### *Asbestos Abatement*

The Authority is engaged in encapsulating or gradually removing asbestos-containing insulation from its power plants.

#### *Capital Improvement Program*

The Authority's capital improvement program for fiscal year ending June 30, 2008 includes \$13.9 million in order to comply with existing Commonwealth and federal environmental laws and regulations, including the 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 April 30, 2008, approximately \$45.9 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 April 30, 2008, the Authority had 9,437 employees, of which 134 were temporary unionized employees. Four local unions represent 6,605 employees. The Electrical Industry and Irrigation Workers Union or "UTIER" represents 5,231 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 April 30, 2008 and will expire on December 13, 2010; and the collective bargaining agreement with UITICE was signed on December 10, 2007 and will expire on January 26, 2011. 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.

On March 23, 2007, UTIER authorized its leadership to strike 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.

During the last year, UTIER has called for two work stoppages, of one-day duration each. On both occasions, many union employees came to work and the Authority was able to provide the same quality of service that is given on normal operations days.

Considering these facts, the Authority does not expect a strike to occur. Notwithstanding, if a strike were to occur, the Authority is confident that it will be able to provide electrical service on a continuous basis, without major difficulties, with the participation of managerial employees, a substantial number of union employees that have not supported the stoppages and will not support a strike and, if necessary, a number of subcontractors that the Authority has selected and are ready to work for the Authority, as part of the Authority's contingency plan.

Of the Authority's 9,437 employees, 3,195 are employed in the transmission and distribution facilities directorate; 2,059 are employed in the generating facilities directorate; 1,649 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, 2007 were \$74.3 million, while the contributions recorded for the ten months ended April 30, 2008 were \$61.0 million. This represented 6.03% of covered payroll for normal cost and 15.27% of unfunded actuarial accrued liability for fiscal year 2007, and 6.03% of covered payroll for normal cost and 15.72% of unfunded actuarial accrued liability for the ten months ended April 30, 2008. Employee contributions and other withholdings are being paid to the Retirement System on a current basis. In the ten months ended April 30, 2008, total pension expense of the Authority was approximately \$61.0 million, including approximately \$44.0 million for past service costs. Unfunded past service liability to be borne entirely by the Authority was approximately \$877 million as of June 30, 2006, the date of the last actuarial valuation of the Retirement System. As of that date, the pension plan was 62% funded. Currently, the Retirement System's actuaries are in the process of preparing a new actuarial valuation for fiscal year 2008.

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. On October 31, 2007, the court certified the case as a complex civil litigation case requiring specialized judicial processing and management. 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. 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 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. The Puerto Rico Superior Court denied plaintiff's request that the case be certified as a class action. Plaintiffs filed for a certiorari before the Puerto Rico Court of Appeals. The Court of Appeals affirmed the Superior Court's order and, afterwards, plaintiffs filed for certiorari before the Puerto Rico Supreme Court. The Puerto Rico Supreme Court denied the certiorari.

## TAX MATTERS

### General

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.

Payments of interest on tax-exempt obligations, including the Bonds, are generally subject to IRS Form 1099-INT information reporting requirements. If a Bond owner is subject to backup withholding under those requirements, then payments of interest will also be subject to backup withholding. Those requirements do not affect the exclusion of such interest from gross income for federal tax purposes.

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 actions by a court, 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 values of the Bonds.

Prospective purchasers of the Bonds should consult their own tax advisers regarding pending or proposed federal and state tax legislation and court proceedings, *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 value of 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.***

## UNDERWRITING

The Underwriters have jointly and severally agreed, subject to certain conditions, to purchase the Bonds from the Authority at a discount of \$3,948,741.68 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 MSD (“BBVA”) and RBC Capital Markets Corporation (“RBC”), have entered into an agreement under which the parties provide services and advice to each other to assist the Commonwealth and its issuers in the structuring and execution of their municipal securities offerings. As part of the agreement, BBVA and RBC share in the risk from the underwriting of the Bonds as part of the consideration for their professional services.

Popular Securities, Inc. (“Popular”) has entered into a joint venture agreement (the “JV Agreement”) with Morgan Stanley & Co. Incorporated (“Morgan Stanley”), 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, municipalities and governmental conduit issuers in the Commonwealth. Under 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.

Loop Capital LLC (“LC”) and TCM Capital, Inc. (“TCM”) have entered into an agreement to jointly pursue municipal securities underwriting opportunities with the Commonwealth, its agencies, municipalities and governmental conduit issuers in the Commonwealth. Under the agreement LC and TCM will be entitled to receive a portion of each other’s revenues from the underwriting of the Bonds in consideration for their professional services.

J.P. Morgan Securities Inc. (“JPMSI”) and Scotia Capital (USA) Inc. (“SCUSA”) have entered into an agreement to assist the Commonwealth, its public corporations, agencies, instrumentalities, and municipalities in structuring and facilitating the issuance of their municipal securities. Pursuant to the agreement and in compliance with applicable rules, the parties will be entitled to receive a portion of each other’s revenues from the underwriting of the Bonds as consideration for their investment banking services.

Oppenheimer & Co. Inc. (“Oppenheimer”) and Eurobank Municipal Securities Dealer (“Eurobank MSD”) have entered into an agreement to jointly pursue municipal securities underwriting opportunities with the Commonwealth, its agencies, municipalities and governmental conduit issuers in the Commonwealth. Under the agreement Oppenheimer and Eurobank MSD 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 Division of URS Corporation 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 Division of URS Corporation, 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 “Generating Facilities” under *The System*.

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

## **LEGAL MATTERS**

The proposed form of opinion of Squire, Sanders & Dempsey L.L.P., Bond Counsel, is set forth in Appendix IV to this Official Statement. Certain legal matters will be passed upon for the Underwriters by Winston & Strawn LLP, New York, New York.

## **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, 2007 and 2006 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 2007 and 2006 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 (“Moody’s”), “BBB+”, by Standard & Poor’s, a division of The McGraw-Hill Companies, Inc. (“S&P”) and “A-” by Fitch Ratings (“Fitch”). 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.

## CONTINUING DISCLOSURE

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

(a) to file within 275 days after the end of each fiscal year with each NRMSIR and with any Commonwealth state information depository (“SID”), core financial information and operating data for the prior fiscal year, including (i) the Authority’s audited financial statements, prepared in accordance with generally accepted accounting principles in effect from time to time, and (ii) material historical quantitative data (including financial information and operating data) on the Authority’s System and revenues, expenditures, financial operations and indebtedness generally found in this Official Statement (but excluding the Commonwealth of Puerto Rico Financial Information and Operating Data Report incorporated by reference herein); and

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

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

With respect to the following events:

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

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

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

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

The Authority acknowledges that its undertaking pursuant to the Rule described above is intended for the benefit of the Beneficial Owners of the Bonds, and shall be enforceable by any such Beneficial Owners; provided

that the right to enforce the provisions of its undertaking shall be limited to a right to obtain specific enforcement of the Authority's obligations hereunder.

No Beneficial Owner may institute any suit, action or proceeding at law or in equity ("Proceeding") for the enforcement of the foregoing covenants (the "Covenants") or for any remedy for breach thereof, unless such Beneficial Owner shall have filed with the Authority written notice of and request to cure such breach, and the Authority shall have refused to comply within a reasonable time. All Proceedings shall be instituted only in the Federal district court for the District of Puerto Rico or in a Commonwealth court located in the Municipality of San Juan, Puerto Rico for the equal benefit of all Beneficial Owners of the outstanding Bonds benefited by the Covenants, and no remedy shall be sought or granted other than specific performance of the Covenant at issue. Notwithstanding the foregoing, no challenge to the adequacy of the information provided in accordance with the filings mentioned in paragraphs (a) or (b) above may be prosecuted by any Beneficial Owner except in compliance with the remedial and enforcement provisions contained in Article VIII of the 1974 Agreement. See "Remedies of Bondholders" in Appendix I, *Summary of Certain Provisions of the 1974 Agreement Excluding Proposed Supplemental Agreement*.

The Covenants may only be amended if:

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

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

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

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

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

## MISCELLANEOUS

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

There are appended to this Official Statement (i) summaries of the 1974 Agreement and the proposed Supplemental Agreement, (ii) the financial statements of the Authority for the fiscal years ended June 30, 2007 and June 30, 2006, together with the independent accountants' report of Ernst & Young LLP, San Juan, Puerto Rico, (iii) a letter from the Authority's Consulting Engineers, Washington Division of URS Corporation, regarding its opinion as to certain engineering matters in this Official Statement, and (iv) the proposed form of opinion of Squire, Sanders & Dempsey L.L.P., Bond Counsel.

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, was supplied by the Authority. The information pertaining to DTC was supplied by DTC.

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, SUMMARY OF CERTAIN PROVISIONS OF THE 1974 AGREEMENT EXCLUDING PROPOSED SUPPLEMENTAL AGREEMENT AND SUMMARY OF CERTAIN PROVISIONS OF PROPOSED SUPPLEMENTAL AGREEMENT

#### DEFINITIONS OF CERTAIN TERMS

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

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

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

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

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

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

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

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

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

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

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

“Designated Maturity Bonds” means the indebtedness incurred by the Authority under the terms of a separate trust agreement or resolution, which indebtedness has a maturity of at least ten (10) years and is secured, as to the unamortized principal thereof, on a subordinate basis to the bonds and for which (i) no amortization of principal has been established or (ii) the aggregate amount of the amortized principal that has been established is less than the principal amount of the indebtedness; provided that interest on said indebtedness and any amortized principal of said indebtedness may be payable on a parity, respectively, with interest on bonds and Amortization Requirements on term bonds, in which case said interest and amortized principal shall be included in the calculation of Principal and Interest Requirements on bonds for purposes of the 1974 Agreement and shall



otherwise be deemed to be, and be payable as, interest and Amortization Requirements on bonds for purposes of the 1974 Agreement.

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

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

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

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

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

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

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

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

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

For purposes of determining the aggregate Principal and Interest Requirements in the covenant as to rates contained in Section 502 of the 1974 Agreement, the maximum Principal and Interest Requirements for purposes of Section 704 of the 1974 Agreement and the maximum aggregate Principal and Interest Requirements for purposes of Section 712 of the 1974 Agreement, the interest rate on Variable Rate Bonds shall be assumed to be one hundred ten percent (110%) of the greater of (i) the average interest rate on such Variable Rate Bonds during the twelve months ending with the month preceding the date of calculation, or such shorter period that such Variable Rate Bonds shall have been outstanding under the 1974 Agreement, or (ii) the rate of interest on such Variable Rate Bonds on the date of calculation. For purposes of determining the maximum aggregate Principal and Interest Requirements for purposes of Sections 208, 209 and 210 of the 1974 Agreement, the interest rate on Variable Rate Bonds outstanding or proposed to be issued on the date of calculation shall be determined in accordance with the formula in the previous sentence. If Variable Rate Bonds are payable at the option of the Bondholder and the source for said payment is a credit or liquidity facility, the “put” date or dates shall be ignored and the stated dates for Amortization Requirements and principal payments thereof shall be used for purposes of this calculation. If the Authority has notified the 1974 Trustee that a SWAP agreement is in effect in respect of Variable Rate Bonds, then for all purposes of this paragraph, except for the purpose of determining the aggregate Principal and Interest Requirements in the covenant as to rates contained in Section 502 of the 1974 Agreement, in the certificate mentioned in clause (d) of Section 208 of the 1974 Agreement and in the covenant contained in Section 704 of the 1974 Agreement, the interest rate on such Variable Rate Bonds shall be the SWAP rate under such SWAP agreement.

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

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

resolution providing for said Designated Maturity bonds, on a parity with interest and Amortization Requirements on bonds.

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

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

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

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

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

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

“SWAP party” means a person who is party to a SWAP agreement and whose senior obligations are rated at the time of the execution and delivery of such SWAP agreement in one of the three highest rating categories (without regard to gradations within a category) by (i) Standard & Poor’s Corporation or its successor and (ii) Moody’s Investors Service or its successor.

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

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

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

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

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

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

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

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

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

**Security for the Power Revenue Bonds**

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

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

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

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

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

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

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

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

Section 210 of the 1974 Agreement provides for the issuance of Power Revenue Bonds to refund prior to or at their maturities all or any part of the outstanding bonds of any Series issued under the 1974 Agreement, including the payment of any redemption premium, accrued interest and financing costs and for the purpose of providing moneys for deposit to the credit of the 1974 Reserve Account, subject to the conditions and limitations set forth therein. Power Revenue Refunding Bonds may be issued under Section 210 if, among other things, either (i) the earnings tests described above for the issuance of bonds under Section 208 of the 1974 Agreement (except that effect is given to the retirement of the bonds to be refunded) are satisfied or (ii) the maximum aggregate Principal and Interest Requirements for any fiscal year thereafter on account of all outstanding Power Revenue Bonds and the bonds then to be issued (after giving effect to the retirement of the bonds to be refunded) shall be less than the maximum aggregate Principal and Interest Requirements on account of all outstanding Power Revenue Bonds (excluding the bonds then to be issued). Power Revenue Refunding Bonds may be issued without compliance with the foregoing tests to refund serial bonds of any Series of Power Revenue Bonds maturing within one year thereafter (and to pay interest thereon to maturity, if deemed necessary by the Authority), if the Authority shall determine that the moneys in the 1974 Sinking Fund will not be sufficient for paying such serial bonds at their maturity. The proceeds of Power Revenue Refunding Bonds shall, to the extent practicable, be invested and reinvested by the 1974 Trustee, with the approval of the Executive Director, in Government Obligations, Prerefunded Municipals or in Time Deposits, secured in the manner set forth in Section 601 of the 1974 Agreement, and the moneys so invested shall be available for use when required. (1974 Agreement, Section 210).

## **Collection of Revenues**

### *1974 General Fund*

A special fund is created by the 1974 Agreement and designated the “Puerto Rico Electric Power Authority General Fund” (the “1974 General Fund”). The Authority covenants that all Revenues, other than income from investments made under the provisions of the 1974 Agreement, will be deposited as received in the 1974 General Fund. (1974 Agreement, Section 503). On or before the 15th day of May in each year the Authority will cause to be prepared a proposed budget of Current Expenses and of Capital Expenditures for the ensuing fiscal year, showing separately, the amount to be expended during such fiscal year from moneys deposited to the credit of the 1974 Construction Fund and the amount of the working cash funds required for each month during such fiscal year. A public hearing on the proposed budget must be held on June 1 or on the first business day thereafter, and the Authority must finally adopt the Annual Budget on or before July 1. (1974 Agreement, Section

504). The Authority covenants that moneys in the 1974 General Fund will be used first for the payment of Current Expenses of the System, and that, if the amount expended in any fiscal year for Current Expenses shall exceed the amount provided therefor in the Annual Budget, the Authority will report such excess and the reasons therefor to the Consulting Engineers and to the 1974 Trustee as soon as practicable but not later than the end of the sixth month following the month in which such excess shall have occurred. (1974 Agreement, Section 505).

#### *1974 Revenue Fund*

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

#### **Disposition of Revenues**

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

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

1. the Bond Service Account in the 1974 Sinking Fund, until there has been accumulated therein an amount equal to the sum of (i) the Interest Accrual on all the outstanding Power Revenue Bonds to and including the first day of the next calendar month, and (ii) the Principal Accrual on the outstanding serial bonds of each Series of outstanding Power Revenue Bonds to and including the first day of the next calendar month;
2. the Redemption Account in the 1974 Sinking Fund, until there has been deposited therein an amount equal to the Amortization Accrual for the term bonds of each Series of Power Revenue Bonds then outstanding to and including the first day of the next calendar month;
3. the 1974 Reserve Account until the balance therein is equal to the interest payable on all outstanding Power Revenue Bonds within the next ensuing 12 months; provided, however, that the monthly deposit in respect of any Series of Power Revenue Bonds issued under Section 208 or 209 of the 1974 Agreement need not exceed 1/60 of the amount of the increase in the interest payable within the next ensuing 12 months resulting from the issuance of bonds of such Series, and provided, further, that if the amount so deposited in any month to the 1974 Reserve Account shall be less than the required amount for such month, the requirement therefor shall nevertheless be cumulative and the amount of any deficiency in any month shall be added to the amount otherwise required to be deposited in each month thereafter until such time as the deficiency is made up; and that in the case of Variable Rate Bonds, the minimum amount to be deposited in the 1974 Reserve Account which shall be funded over the period required in the 1974 Agreement, shall be based initially on the interest rate in effect on the date of issuance of the Variable Rate Bonds and then shall be adjusted on the 25th day of each subsequent month based on the actual interest accrued from the 25th day of the previous month to the date of adjustment, except that in the case of Variable Rate Bonds in respect of which the Authority has notified the 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, 2007 and 2006  
With Report of Independent Auditors

Puerto Rico Electric Power Authority

Financial Statements and Supplemental Information

Years Ended June 30, 2007 and 2006

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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, 2007 and 2006, 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, 2007 and 2006, 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 February 1, 2008, 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.

Management's Discussion and Analysis on pages 3 through 12 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).



February 1, 2008

Stamp No. 2273483  
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, 2007, 2006 and 2005. As management of the Authority, we offer readers of the financial statements this narrative overview and analysis of the financial activities. We encourage readers to consider the information presented here in conjunction with the financial statements that follow this section.

### FINANCIAL HIGHLIGHTS

- The Authority's net assets decreased by \$39.8 million (or 7.8 percent), increased by \$16.4 million (or 3.3 percent) and decreased by \$25.7 million (or 4.9 percent) as a result of operations during fiscal years ended June 30, 2007, 2006 and 2005, respectively.
- Operating income was \$370.9 million, \$403.0 million and \$353.9 million for the fiscal years ended June 30, 2007, 2006 and 2005, respectively, representing 8.0 percent decrease, 13.9 percent increase and 4.8 percent decrease when compared to fiscal years ended June 30, 2007, 2006 and 2005, respectively.
- Ratios of fuel and purchased power adjustment revenues to total operating revenues were 60.5 percent for 2006-2007, 68.4 percent for 2005-2006 and 61.9 percent for 2004-2005.
- Operating expenses decreased by \$3.6 million and increased by \$623.1 million and \$455.9 million for the fiscal years ended June 30, 2007, 2006 and 2005, representing a .1 percent decrease, 23.2 percent increase and 20.4 percent increase, when compared to previous fiscal years.
- Ratios of fuel oil and purchased power expenses to total operating expenses (excluding depreciation expense) were 77.4 percent for 2006-2007, 74.6 percent for 2005-2006 and 69.0 percent for 2004-2005.
- The decrease in the fuel adjustment revenues of \$90.3 million was mainly due to the excess of fuel expenses of \$123 million associated with alternate generation capacity as a result of the Palo Seco Steam Plan fire, which should be recovered from insurance companies. The increase in fuel expenses of \$51.1 million was mainly due to an increase in fuel oil price per barrel of \$1.17 (or 2.1 percent) for 2006-2007. 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. In addition, 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.

## Puerto Rico Electric Power Authority

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

- The increase in the purchased power adjustment revenue and expense of \$34.5 million and \$21.5 million, respectively, was mainly due to an increase of 311,279 MWh (or 4.6 percent) purchase power for 2006-2007. 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. In addition, 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.
- The Authority's Net Utility Plant increased by \$316.9 million, \$348.2 million and \$284.9 million or 5.8 percent, 6.8 percent and 5.9 percent, respectively. Total Assets increased by \$823.6 million, \$347.1 million and \$507.9 million or 11.1 percent, 4.9 percent and 7.7 percent, respectively, for the fiscal years ended June 30, 2007, 2006 and 2005.
- For the fiscal year ended June 30, 2007, as compared to the fiscal year ended June 30, 2006, accounts receivable increased from \$837.3 million on June 30, 2006 to \$994.6 million on June 30, 2007, representing a 18.8 percent increase. The increase was mainly due to a claim to insurance companies related to the costs associated with alternate generation capacity in connection with two fires on the Authority's generating units. Accounts receivable from the governmental sector increased from \$265.9 million on June 30, 2006 to \$316.6 million on June 30, 2007, representing a 19.1 percent increase.
- 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.



# Puerto Rico Electric Power Authority

## MANAGEMENT'S DISCUSSION AND ANALYSIS (continued)

### 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.

### 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 presents the results of the business activities over the course of the fiscal year and information as to how the net assets changed during the fiscal year.

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.

## Puerto Rico Electric Power Authority

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

#### FINANCIAL ANALYSIS

The Authority's net assets decreased by \$39.8 million, increased by \$16.4 million and decreased by \$25.7 million for the fiscal years ended June 30, 2007, 2006 and 2005, 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)*

	<b>2007</b>	<b>2006</b>	<b>2005</b>
Current, non-current and other assets	<b>\$ 2,487,122</b>	\$ 1,980,450	\$ 1,981,540
Capital assets	<b>5,754,568</b>	5,437,661	5,089,505
Total assets	<b>\$ 8,241,690</b>	\$ 7,418,111	\$ 7,071,045
Long-term debt outstanding	<b>\$ 6,115,493</b>	\$ 5,247,716	\$ 5,300,209
Other liabilities	<b>1,654,789</b>	1,659,211	1,276,048
Total liabilities	<b>\$ 7,770,282</b>	\$ 6,906,927	\$ 6,576,257
Net assets:			
Invested in capital assets, net of related debt	<b>\$ 168,307</b>	\$ 269,241	\$ 66,563
Restricted	<b>315,154</b>	206,748	367,353
Unrestricted	<b>(12,053)</b>	35,195	60,872
Total net assets	<b>\$ 471,408</b>	\$ 511,184	\$ 494,788

A significant portion of the Authority's net assets (66.9 percent for 2006-2007, 40.4 percent for 2005-2006 and 74.2 percent for 2004-2005) 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 (35.7 percent for 2006-2007, 52.7 percent for 2005-2006 and 13.5 percent for 2004-2005) reflects its investment in capital assets, less any related debt used to acquire those assets that is still outstanding.

Net assets invested in utility plant, net of related debt decreased from \$269.2 million in 2005-2006 to \$168.3 million in 2006-2007 (or 37.5%) mainly due to the increase in lines of credits by \$209.7 million to finance a portion of the cost of various projects under the capital improvement program and the increases in net utility plant by \$316.9 million and Power Revenues Bonds by \$243.9 million (excluding the nonexpended portion).

## Puerto Rico Electric Power Authority

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

Restricted for capital and debt service increased from \$206.7 million in 2005-2006 to \$315.2 million in 2006-2007 by \$108.4 million (or 52.4%) mainly due to an increase of 1974 Construction Fund by \$43.6 million and a decrease of amount payable to General Fund from 1974 Construction Fund related to new money bond issued during the year.

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)*

	<b>2007</b>	<b>2006</b>	<b>2005</b>
Operating revenues	<b>\$ 3,680,390</b>	\$ 3,716,082	\$ 3,043,834
Other income	<b>20,942</b>	24,475	24,835
Total revenues	<b>3,701,332</b>	3,740,557	3,068,669
Operating expenses	<b>3,309,445</b>	3,313,064	2,689,940
Interest expense, net	<b>296,209</b>	286,742	285,112
Total expenses	<b>3,605,654</b>	3,599,806	2,975,052
Income before contribution in lieu of taxes and other	<b>95,678</b>	140,751	93,617
Contribution in lieu of taxes and other	<b>(192,591)</b>	(180,733)	(159,892)
Loss before contributed capital	<b>(96,913)</b>	(39,982)	(66,275)
Contributed capital	<b>57,137</b>	56,378	40,556
Change in net assets	<b>(39,776)</b>	16,396	(25,719)
Net assets, beginning of year	<b>511,184</b>	494,788	520,507
Net assets, end of year	<b>\$ 471,408</b>	\$ 511,184	\$ 494,788

For the fiscal year ended June 30, 2007, as compared to June 30, 2006, operating revenues and expenses decreased by \$35.7 million (or 1%) and \$3.6 million (or .1%), respectively, resulting in a decrease in net assets of \$39.8 million. The decrease in net assets was mainly due to an increase in the reserve for uncollectible accounts of \$29.4 million and \$19.4 million related to the portion of the loss the Authority observed in connection of the Palo Seco Steam Plant fire, net of other operating income. The Authority holds a 30-day waiting period as a deductible on each occurrence in the extra expenses clause of Business Interruption Insurance Policy. The Authority assumed the cost of such retention instead of recovering it from the clients through the fuel and purchased power adjustment clauses. In addition, there was an increase on the Total Interest Charge, net, of \$9.4 million for 2006-2007.

## 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.

### CAPITAL ASSETS AND DEBT ADMINISTRATION

#### Capital Assets

The Authority's investment in capital assets as of June 30, 2007, 2006 and 2005, amounts to approximately \$5,755 million, \$5,438 million and \$5,089 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 5.8 percent, 6.8 percent and 5.9 percent for 2006-2007, 2005-2006 and 2004-2005, respectively.

A substantial portion of the capital expenditures for production plant in fiscal year ended June 30, 2007, 2006 and 2005 was spent on the rehabilitation and life extension of generating plants in order to achieve and maintain higher levels of availability, reliability and efficiency.

Major capital asset events during fiscal year 2006-2007 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 464 MW of combined-cycle capacity in fiscal year 2008. Both units shall be in commercial operation in February 2008. When completed, the plant will comprise of two combined-cycle units, each consisting of one combustion turbine rated at 165 MW 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 is working in the replacement of the four 21 MW combustion turbines at Mayagüez with new four 50 MW dual fuel aero-derivative combustion turbines, which represent a net increase in capacity of approximately 110 MW over the replaced combustion turbine and they will generate electricity more efficiently. The first two combustion turbines are schedule to be installed in fiscal year 2008 and the remainder two will be installed on fiscal year 2009.
- The Authority is modifying the eight 50 MW combustion turbines of Aguirre Combined Cycle Plant to enable them to burn either natural gas or distillate. This conversion to dual fuel capability is scheduled for completion the second half of 2008. The 40 mile long natural gas pipeline from the EcoEléctrica Facility in Guayanilla to the Aguirre Combined Cycle Plant is also scheduled for completion the second half of 2008.
- The conversion of the three simple cycle 83 MW combustion turbines at Cambalache Plant to combined cycle operation, through the installation of a steam turbine-generator, new cooling system, associated auxiliary systems, and new heat recovery steam generators. The project is currently estimated for completion in fiscal year 2011.
- The Authority is constructing a new 50-mile long 230 kV transmission line between its South Coast steam plant and the transmission center at Aguas Buenas. This new transmission line is expected to be operating in fiscal year 2011. 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 a new 38-mile long 230 kV transmission line connecting the South Coast Steam Plant and the Cambalache Plant. Currently, the line is scheduled for completion in fiscal year 2011.
- The third priority 230 kV line project will increase the capacity of the existing 230 kV line from South Coast Plant to the Manatí Transmission Center, located on the north coast. The project is scheduled for completion in fiscal year 2012.
- An aggressive program to improve the 38 kV sub-transmission system is in effect. This program includes the construction of underground 38 kV lines in Viaducto, Mayagüez and San Fernando, San Juan. In addition, most 38 kV lines in the central part of the island are being replaced. These projects will improve the reliability of the sub-transmission system.

## Puerto Rico Electric Power Authority

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

- The Authority is constructing an underground 115 kV transmission circuit line around the San Juan metropolitan area in order to reduce the incidents of loss of power in the aftermath of hurricanes and other major storms which strike Puerto Rico from time to time. This circuit line is expected to be completed in fiscal year 2008. The Federal Emergency Management Agency (FEMA) has committed to provide \$75 million in grants. As of June 30, 2007, FEMA had reimbursed \$71.6 million of the project's estimated cost of \$135. Other related projects related to the load growth forecast of the San Juan metropolitan area are the new gas-insulated switchgear (GIS) 115/38 kW transmission centers of Martín Peña, Isla Grande, San Juan and Palo Seco Steam Plants.
- In addition, major expansions to 115/38 kW transmission centers in the municipalities of Aguadilla, Isabela and Juncos will increase the power transfer and improve the voltage regulation of the 38 kW system under emergency conditions.

The Authority is installing a 90 MVARs Static Var Compensator (SVC) at the 38 kW bus of Bayamón Transmission Center to improve the voltage stability margins of the electric system by regulating this 115 kW bus. This SVC will help to improve the system dynamic reactive power response to major contingencies and outages in the generation or transmission system. The SVC is expected to be in service in fiscal year 2007-2008.

- 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.
- 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 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 and the capacity of the two substations 115/13.2 kW in Canóvanas TC will be increased from 22.4 MVA to 44.8 MVA, each one. The construction of these new substations increases the distribution capacity, provides service to new clients, and improves the reliability of the distribution system.

## Puerto Rico Electric Power Authority

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

- The Authority is repairing steam turbines generators and replacing transformers and major electrical equipments of Palo Seco Steam Plant units one, which have a 85 MW capacity. In addition, the Authority is replacing the control room for all Palo Seco Steam Plant units and switch gear for Palo Seco Steam Plant units two, three and four. The estimated cost of repairing the Palo Seco Steam Plant units is of approximately \$106 million.

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 2007, 2006 and 2005, the Authority had total long-term debt outstanding of \$5,743.9 million, \$5,261.4 million and \$5,305.0 million, respectively, comprised of revenue bonds and other borrowings.

#### **Authority's Outstanding Debt** (In thousands)

	2007	2006	2005
Power revenue bonds, net	<b>\$ 5,647,709</b>	\$ 5,156,531	\$ 5,263,374
Notes payable	<b>480,061</b>	104,835	41,585
	<b>6,127,770</b>	5,261,366	5,304,959
Current portion	<b>(363,358)</b>	(391,182)	(303,102)
Long-term debt excluding current portion	<b>\$ 5,764,412</b>	\$ 4,870,184	\$ 5,001,857

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

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

## Puerto Rico Electric Power Authority

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

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

The economy of Puerto Rico must be analyzed as a region within the U.S. economy, since it is part of the U.S. monetary and banking system, as well as within its territorial boundaries. The main drive of the Puerto Rico economy is a huge external sector closely tied to the flow of merchandise, tourists, and capital between Puerto Rico and the Mainland. In fiscal year 2007 U.S. Real GDP increased 2.10%.

The economy of Puerto Rico is expected to growth in fiscal year 2008, at a rate of .85% in real terms, according to the latest forecast prepared by the Puerto Rico Planning Board (JP).

The Authority adopted the 2008 fiscal year budget on June 20, 2007. The electric revenues for fiscal year 2007-2008 are projected to approximately \$3,932.5 million. In addition, the Capital Improvement Program amounted to approximately \$617.7 million. The 2008 consolidated budget increased by \$21.0 million (or .5 percent) from fiscal year 2006-2007, due mainly to the increase of fuel oil prices.

#### REQUEST FOR INFORMATION

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



Puerto Rico Electric Power Authority

Balance Sheets

	<b>June 30</b>	
	<b>2007</b>	<b>2006</b>
	<i>(In thousands)</i>	
<b>Assets</b>		
Current assets:		
Cash and cash equivalents	\$ 40,441	\$ 18,614
Receivables, net	895,990	762,353
Fuel oil, at average cost	147,132	119,971
Materials and supplies, at average cost	161,607	157,831
Prepayments and other assets	6,177	5,406
Total current assets	1,251,347	1,064,175
Other non-current receivables	98,577	75,006
Restricted assets:		
Cash and cash equivalents held by trustee for payment of principal and interest on bonds	287,183	329,965
Investments held by trustee	347,864	323,961
Construction fund and other special funds	374,166	58,494
Total restricted assets	1,009,213	712,420
Utility plant:		
Plant in service	7,570,186	7,235,232
Accumulated depreciation	(4,128,229)	(3,864,955)
	3,441,957	3,370,277
Construction in progress	2,312,611	2,067,384
Total utility plant, net	5,754,568	5,437,661
Other properties	—	—
Deferred expenses:		
Unamortized debt issue costs	57,085	60,255
Other	70,900	68,594
Total deferred expenses	127,985	128,849
Total assets	\$ 8,241,690	\$ 7,418,111

*(Continue)*

	<b>June 30</b>	
	<b>2007</b>	<b>2006</b>
	<i>(In thousands)</i>	
<b>Liabilities and net assets</b>		
Current liabilities:		
Notes payable	\$ 436,766	\$ 493,316
Accounts payable and accrued liabilities	749,044	645,525
Customers' deposits	159,104	155,366
Total current liabilities	<u>1,344,914</u>	<u>1,294,207</u>
Current liabilities payable from restricted assets:		
Current portion of long-term debt	351,081	377,532
Accrued interest	102,935	136,696
Other current liabilities payable from restricted assets	78,226	90,002
Total current liabilities payable from restricted assets	<u>532,242</u>	<u>604,230</u>
Noncurrent liabilities:		
Long-term debt, excluding current portion	5,764,412	4,870,184
Sick leave benefits to be liquidated after one year	128,714	138,306
Total noncurrent liabilities	<u>5,893,126</u>	<u>5,008,490</u>
Total liabilities	<u>7,770,282</u>	<u>6,906,927</u>
Net assets:		
Invested in utility plant, net of related debt	168,307	269,241
Restricted for capital activity and debt service	315,154	206,748
Unrestricted	(12,053)	35,195
Total net assets	<u>471,408</u>	<u>511,184</u>
Total liabilities and net assets	<u><u>\$ 8,241,690</u></u>	<u><u>\$ 7,418,111</u></u>

*See accompanying notes.*

Puerto Rico Electric Power Authority

Statements of Revenues, Expenses and Changes in Net Assets

	Year Ended June 30	
	2007	2006
	<i>(In thousands)</i>	
Operating revenues	\$ 3,680,390	\$ 3,716,082
Operating expenses:		
Operations:		
Fuel	1,716,965	1,665,866
Purchased power	624,653	603,169
Claim for extra fuel expense	(114,261)	-
Other production	56,722	58,160
Transmission and distribution	163,555	164,731
Customer accounting and collection	109,589	107,570
Administrative and general	216,015	201,363
Maintenance	252,444	240,511
Depreciation	283,763	271,694
Total operating expenses	<u>3,309,445</u>	<u>3,313,064</u>
Operating income	370,945	403,018
Interest income and other	<u>20,942</u>	<u>24,475</u>
Income before interest charges, contribution in lieu of taxes and contributed capital	391,887	427,493
Interest charges:		
Interest on bonds	262,616	270,202
Interest on other long-term debt	38,922	11,427
Other interest	1,434	1,946
Amortization of debt discount, issuance costs and refunding loss	15,467	15,489
Allowance for funds used during construction	<u>(22,230)</u>	<u>(12,322)</u>
Total interest charges, net	296,209	286,742
Income before contribution in lieu of taxes and contributed capital	95,678	140,751
Contribution in lieu of taxes and other	<u>(192,591)</u>	<u>(180,733)</u>
Loss before contributed capital	(96,913)	(39,982)
Contributed capital	57,137	56,378
Change in net assets	<u>(39,776)</u>	16,396
Net assets, beginning balance	511,184	494,788
Net assets, ending balance	<u>\$ 471,408</u>	<u>\$ 511,184</u>

See accompanying notes.

Puerto Rico Electric Power Authority

Statements of Cash Flows

	Year Ended June 30	
	2007	2006
	<i>(In thousands)</i>	
<b>Cash flows from operating activities</b>		
Cash received from customers	\$ 3,635,637	\$ 3,578,114
Cash paid to suppliers and employees	<b>(3,285,525)</b>	<b>(3,092,325)</b>
Net cash flows provided by operating activities	<b>350,112</b>	485,789
<b>Cash flows from noncapital financing activities</b>		
Proceeds from notes payable	<b>358,100</b>	100,000
Principal paid on general obligation notes	<b>(247,727)</b>	(64,897)
Interest paid on general obligation notes	<b>(14,144)</b>	(11,427)
Principal paid on fuel line of credit	–	(280,000)
Proceeds from fuel line of credit	–	330,000
Interest paid on fuel line of credit	<b>(9,770)</b>	(6,836)
Net cash flows provided by noncapital financing activities	<b>86,459</b>	66,840
<b>Cash flows from capital and related financing activities</b>		
Construction expenditures	<b>(574,981)</b>	(544,741)
Proceeds received from contributed capital	<b>44,015</b>	36,998
Allowance for funds used during construction	<b>22,230</b>	12,322
Power revenue bonds:		
Proceeds from issuance of bonds, net of original issue discount	<b>675,362</b>	–
Principal paid on revenue bonds	<b>(191,872)</b>	(118,427)
Interest paid on revenue bonds	<b>(297,811)</b>	(260,721)
Proceeds from issuance of refunding bonds, net of original issue discount	<b>1,951,140</b>	–
Defeased bonds, net of original issue discount or premium	<b>(1,955,158)</b>	–
Payment of bond anticipation notes	<b>409,675</b>	–
Proceeds from bond anticipation notes	<b>(200,000)</b>	220,153
Interest paid on bond anticipation notes	<b>(22,815)</b>	(2,829)
Net cash flows used in capital and related financing activities	<b>(140,215)</b>	(657,245)
<b>Cash flows from investing activities</b>		
Purchases of investment securities	<b>(1,573,424)</b>	(1,419,024)
Proceeds from sale and maturities of investment securities	<b>1,366,090</b>	1,497,605
Interest on investments	<b>17,910</b>	20,639
Transfer from restricted funds to revenue and general fund	<b>9,387</b>	–
Transfer from general fund to restricted funds	<b>(5,000)</b>	–
Net cash flows (used in) provided by investing activities	<b>(185,037)</b>	99,220
Net increase (decrease) in cash and cash equivalents	<b>111,319</b>	(5,396)
Cash and cash equivalents at beginning of year	<b>356,358</b>	361,754
Cash and cash equivalents at end of year	<b>\$ 467,677</b>	<b>\$ 356,358</b>

*(Continue)*

Puerto Rico Electric Power Authority

Statements of Cash Flows (continued)

	<b>Year Ended June 30</b>	
	<b>2007</b>	<b>2006</b>
	<i>(In thousands)</i>	
<b>Cash and cash equivalents</b>		
Unrestricted	\$ 40,441	\$ 18,614
Restricted:		
Cash and cash equivalents held by trustee for payment of principal and interest on outstanding bonds	287,183	329,965
Cash and cash equivalents held in construction and other special funds	140,053	7,779
	<u>\$ 467,677</u>	<u>\$ 356,358</u>
<b>Reconciliation of net operating income to net cash provided by operating activities</b>		
Operating income	\$ 370,945	\$ 403,018
Adjustments to reconcile operating income to net cash provided by operating activities:		
Depreciation	283,763	271,694
Amortization of asbestos removal	3,133	1,016
Provision for uncollectible accounts and other	41,584	21,310
Changes in assets and liabilities:		
Receivables	(405,581)	(303,928)
Fuel oil	(17,391)	(22,980)
Materials and supplies	(3,593)	(7,843)
Prepayments and other assets	(771)	20,487
Other deferred debits	590	(6,181)
Noncurrent liabilities, excluding revenue bonds and notes payable	(9,592)	(698)
Accounts payable and accrued liabilities	83,287	113,907
Customers' deposits	3,738	(4,013)
Total adjustments	<u>(20,833)</u>	<u>82,771</u>
Net cash flows provided by operating activities	<u>\$ 350,112</u>	<u>\$ 485,789</u>

See accompanying notes.

# Puerto Rico Electric Power Authority

## Notes to Audited Financial Statements

June 30, 2007

### **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, 2007 and 2006 and for the years then ended for the Irrigation Systems is as follows:

	<b>2007</b>	<b>2006</b>
	<i>(In thousands)</i>	
Balance sheets:		
Assets:		
Receivables, net	\$ 12,902	\$ 9,589
Prepayments and other assets	2,185	2,185
Utility Plant, net of depreciation	21,140	20,665
Total assets	<u>\$ 36,227</u>	<u>\$ 32,439</u>
Liabilities:		
Accounts payable, net	<u>\$ 974</u>	<u>\$ 951</u>
Statements of revenues, expenditures and changes in net assets:		
Operating revenues	\$ 7,681	\$ 6,359
Operating expenses	(3,916)	(3,575)
	<u>3,765</u>	<u>2,784</u>
Net assets, beginning balance	<u>31,488</u>	28,704
Net assets, ending balance	<u>\$ 35,253</u>	<u>\$ 31,488</u>

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 (continued)**

**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, 2007 and 2006 and for the year then ended for PREPA.Net is as follows:

	<b>2007</b>	<b>2006</b>
	<i>(In thousands)</i>	
Balance sheet:		
Assets:		
Cash and cash equivalents	\$ 526	\$ 246
Receivables, net	554	191
Material and supplies	–	6
Prepayments and other assets	–	12
Utility plant, net of depreciation	<b>2,918</b>	3,304
Total assets	<b>\$ 3,998</b>	<b>\$ 3,759</b>
Liabilities:		
Accounts payable, net	<b>\$ 4,865</b>	<b>\$ 4,140</b>
Statement of revenues, expenditures and changes in net assets:		
Operating revenues	\$ 1,758	\$ 785
Operating expenses	<b>(2,244)</b>	<b>(1,166)</b>
	<b>(486)</b>	<b>(381)</b>
Net assets, beginning balance	<b>(381)</b>	–
Net assets, ending balance	<b>\$ (867)</b>	<b>\$ (381)</b>



# 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.

#### **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.

## Puerto Rico Electric Power Authority

### Notes to Audited Financial Statements (continued)

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

##### 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.
- 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.

# Puerto Rico Electric Power Authority

## Notes to Audited Financial Statements (continued)

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

#### **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, 2007 and 2006 amounted to \$22.2 million and \$12.3 million, respectively. These amounts are net of interest income earned on investments amounting to \$2.6 million and \$7.3 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 2007 and 2006.

#### **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.

## Puerto Rico Electric Power Authority

### Notes to Audited Financial Statements (continued)

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

##### **Asbestos Containment Deferred Costs**

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

##### **Pension Plan**

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

##### **Accounting for Compensated Absences**

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

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

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

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

## Puerto Rico Electric Power Authority

### Notes to Audited Financial Statements (continued)

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

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

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

##### **Municipalities**

To the extent net revenues, as defined, are available, the Authority is required under the Act to make a contribution in lieu of taxes of 11% to the Commonwealth and the Municipalities of gross electric sales.

The Authority is also 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.

Puerto Rico Electric Power Authority

Notes to Audited Financial Statements (continued)

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

**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 by third parties during recent years and local and federal agencies.

**Interest Rate Swap Agreements**

The interest rate swaps are used in the area of debt management to take advantage of favorable market interest rates and to limit interest rate risk associated with variable rate debt exposure. Under the interest rate swap programs, the Authority pays a fixed rate of interest for the term of the variable interest rate Power Revenue Bonds and receives a variable rate of interest, which is based on various indices. These indices are affected by changes in the market. The net amount received or paid under the swap agreements are recorded as an adjustment to interest accrued on the statements of balance sheets.

**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, 2007 and 2006, the carrying amount and bank balance of cash deposits held by the Authority and restricted cash deposits held by the Trustee under the 1974 Agreement are as follows (in thousands):

	<b>2007</b>		<b>2006</b>	
	<b>Carrying Amount</b>	<b>Bank Balance</b>	<b>Carrying Amount</b>	<b>Bank Balance</b>
Unrestricted	\$ 40,441	\$ 50,496	\$ 18,614	\$ 26,704
Restricted:				
Held by the Trustee	287,183	287,183	329,965	329,965
Held by the Authority	140,053	140,053	7,779	7,779
	<b>\$ 467,677</b>	<b>\$ 477,732</b>	<b>\$ 356,358</b>	<b>\$ 364,448</b>

Puerto Rico Electric Power Authority

Notes to Audited Financial Statements (continued)

**3. Cash and Cash Equivalents (continued)**

**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.

**4. Accounts Receivable**

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

	<b>2007</b>	<b>2006</b>
Electric and related services:		
Government agencies and municipalities	<b>\$ 316,620</b>	\$ 265,882
Residential, industrial, and commercial	<b>460,387</b>	428,954
Recoveries under fuel adjustment clause (over) under billed	<b>(38,989)</b>	(7,995)
Unbilled services	<b>186,077</b>	168,055
Commonwealth subsidy (fuel adjustment clause) for certain residential clients	<b>18,980</b>	18,980
Miscellaneous accounts and others	<b>23,978</b>	18,855
	<b>967,053</b>	892,731
Allowance for uncollectible accounts	<b>(88,228)</b>	(58,821)
	<b>878,825</b>	833,910
Recovery from insurance companies and other	<b>109,261</b>	-
Accrued interest on investments	<b>6,481</b>	3,449
Less other non-current receivables, mostly related to the Commonwealth	<b>(98,577)</b>	(75,006)
	<b>\$ 895,990</b>	\$ 762,353

## Puerto Rico Electric Power Authority

### Notes to Audited Financial Statements (continued)

#### 4. Accounts Receivable (continued)

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, 2007 and 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.

#### 5. Restricted Assets

At June 30, 2007 and 2006, 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.



Puerto Rico Electric Power Authority

Notes to Audited Financial Statements (continued)

**5. Restricted Assets (continued)**

*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, 2007 and 2006, cash and cash equivalents in this account amounted to \$287.2 million and \$330.0 million, respectively.

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

	2007	2006
1974 Reserve Account	\$ 273,108	\$ 258,815
1974 Self-insurance Fund	68,922	65,146
1974 Sinking Fund	5,834	–
	\$ 347,864	\$ 323,961

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. During fiscal year 2006-2007, the Authority withdrew \$9.4 million from 1974 Reserve Maintenance Fund to finance the recovery of the Palo Seco Steam Plant. In addition, the Authority deposited \$5.0 million to 1974 Reserve Maintenance Fund to replenish using the proceeds from insurance companies.

*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):

	2007		2006	
	Cash and Cash Equivalents	Investments	Cash and Cash Equivalents	Investments
1974 Construction Fund	\$ 140,005	\$ 185,921	\$ 7,668	\$ 921
Reserve Maintenance Fund	48	48,192	111	49,794
	<b>\$ 140,053</b>	<b>\$ 234,113</b>	<b>\$ 7,779</b>	<b>\$ 50,715</b>

Puerto Rico Electric Power Authority

Notes to Audited Financial Statements (continued)

**5. Restricted Assets (continued)**

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

	2007	2006
U.S. Government obligations	\$ 49,105	\$ 50,647
Certificate of deposit	185,008	68
	\$ 234,113	\$ 50,715

**Investments**

The following table provides a summary of the Authority's investments by type at June 30, 2007 (in thousands):

	Coupon Rate	Maturity Dates	Face Value	Fair Value	% of Total Portfolio
<b>1974 Reserve Maintenance Fund</b>					
Federal Home Loan Bank	4.10 to 5.30%	12/2007 to 1/2010	7,660	\$ 7,736	16.0%
Federal National Mortgage Association	5.30 to 5.75%	02/2009 to 08/2009	19,889	20,279	42.1%
Federal Farm Credit Bank	5.100%	10/1/2009	12,350	12,379	25.7%
Certificates of Deposit	5.190%	7/1/2007	7,798	7,798	16.2%
			<b>Total Portfolio</b>	<b>48,192</b>	
<b>1974 Self Insurance Reserve Fund</b>					
Federal Home Loan Bank	4.40 to 5.40%	02/2008 to 01/2010	20,770	20,926	30.4%
Federal Farm Credit Bank	5.43%	10/2009	3,045	3,066	4.4%
Certificates of Deposit	5.190%	07/2007	44,930	44,930	65.2%
			<b>Total Portfolio</b>	<b>68,922</b>	
<b>1974 Reserve Account</b>					
Federal Home Loan Mortgage Corporation	3.00 to 5.63%	11/2007 to 10/2011	31,489	31,804	11.6%
Federal Home Loan Bank	3.00 to 5.875%	01/2008 to 12/2011	124,100	123,583	45.3%
Federal National Mortgage Association	3.125 to 5.75%	09/2007 to 08/2011	62,601	62,509	22.9%
Federal Farm Credit Bank	3.375 to 3.60%	03/2009	48,622	47,797	17.5%
Certificates of Deposit	5.190%	07/2007	7,415	7,415	2.7%
			<b>Total Portfolio</b>	<b>273,108</b>	

Puerto Rico Electric Power Authority

Notes to Audited Financial Statements (continued)

**5. Restricted Assets (continued)**

	Coupon Rate	Maturity Dates	Face Value	Fair Value	% of Total Portfolio
<b>1974 Sinking Fund</b>					
Certificates of Deposit	5.26%	08/2007	5,834	5,834	100.0%
			<b>Total Portfolio</b>	<u>5,834</u>	
<b>1974 Construction Fund</b>					
Certificates of Deposit	5.41 to 5.45%	8/2007 to 01/2008	185,000	185,000	99.5%
Other - Rea Investment			921	921	.5%
			<b>Total Portfolio</b>	<u>185,921</u>	
				<u><u>\$ 581,977</u></u>	

**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.
- 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, 2007, 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.

Puerto Rico Electric Power Authority

Notes to Audited Financial Statements (continued)

**5. Restricted Assets (continued)**

**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, 2007, 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, 2007 (in thousands):

<b>Investment Type</b>	<b>Fair Value</b>	<b>Investment Maturities</b>		<b>Total</b>
		<b>Less than 1 year</b>	<b>1-5 years</b>	
Federal Home Loan Mortgage	\$ 31,804	\$ 6,507	\$ 25,297	\$ 31,804
Federal Home Loan Bank	152,245	18,513	133,732	152,245
Federal National Mortgage	82,788	29,559	53,229	82,788
Federal Farm Credit Bank	63,242	–	63,242	63,242
Certificate of Deposits	250,977	250,977	–	250,977
Other - REA Investment	921	–	921	921
<b>Total Investments</b>				<b>\$ 581,977</b>

Puerto Rico Electric Power Authority

Notes to Audited Financial Statements (continued)

**6. Utility Plant**

As of June 30, utility plant consists of:

	<b>2007</b>	<b>2006</b>
	<i>(In thousands)</i>	
Distribution	<b>\$ 2,410,780</b>	\$ 2,326,109
Transmission	<b>1,174,126</b>	1,070,258
Production	<b>1,753,574</b>	1,727,780
Other production	<b>680,850</b>	643,840
Hydroelectric	<b>102,499</b>	97,896
General	<b>1,410,763</b>	1,334,113
Irrigation systems	<b>33,880</b>	31,923
Fiber Network	<b>3,714</b>	3,313
	<b>7,570,186</b>	7,235,232
Less accumulated depreciation	<b>(4,128,229)</b>	(3,864,955)
	<b>3,441,957</b>	3,370,277
Construction in progress	<b>2,312,611</b>	2,067,384
	<b>\$ 5,754,568</b>	\$ 5,437,661

Utility plant activity for the years ended June 30, 2007 and 2006 was as follows (in thousands):

	<b>2006</b>				<b>2007</b>
	<b>Beginning Balance</b>	<b>Increases</b>	<b>Decreases</b>	<b>Transfers</b>	<b>Ending Balance</b>
Utility plant	\$ 7,235,232	\$ –	\$ (20,489)	\$ 355,443	\$ 7,570,186
Construction work in progress	2,067,384	600,670	–	(355,443)	2,312,611
Total utility plant	9,302,616	600,670	(20,489)	–	9,882,797
Less:					
Accumulated depreciation	(3,864,955)	(283,763)	20,489	–	(4,128,229)
Total utility plant, net	\$ 5,437,661	\$ 316,907	\$ –	\$ –	\$ 5,754,568

Puerto Rico Electric Power Authority

Notes to Audited Financial Statements (continued)

**6. Utility Plant (continued)**

	<b>2005</b>				<b>2006</b>
	<b>Beginning Balance</b>	<b>Increases</b>	<b>Decreases</b>	<b>Transfers</b>	<b>Ending Balance</b>
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	<u>\$ 5,089,505</u>	<u>\$ 348,156</u>	<u>\$ –</u>	<u>\$ –</u>	<u>\$ 5,437,661</u>

Construction work-in-progress at June 30, 2007 and 2006 consists principally of expansions and upgrades to the electric generation, distribution and transmission systems.

**7. 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, 2007, \$3,224 million, of Power Revenue Bonds which remain outstanding are considered defeased.

**8. 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. On December 22, 2006, this line of credit was refinanced with a term loan of \$64.2 million between the Authority and certain commercial banks. As of June 30, 2007, the balance outstanding is \$64.2 million, of which \$57 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 of 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, 2007, \$10.2 million have been drawn on this line of credit and the outstanding balance is \$7.8 million.

Puerto Rico Electric Power Authority

Notes to Audited Financial Statements (continued)

**8. Notes Payable (continued)**

On April 23, 2004, the Authority and GDB entered into an agreement for a line of credit of \$57 million for electric infrastructure projects in the Municipalities. As of June 30, 2007, the Authority had drawn \$41.7 million 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, 2007, the outstanding balance is \$32.0 million of which \$26.9 million is considered long-term.

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, 2007. The average effective interest rate during each year and at year-end was 5.52% and 5.50%, respectively, for 2007; and 4.69% and 5.43%, respectively, for 2006.

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, 2007, 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.

Short-term debt activity for the years ended June 30, 2007 and 2006 was as follows:

	<b>2007</b>	<b>2006</b>
	<i>(In thousands)</i>	
Balance at beginning of year	<b>\$ 493,316</b>	\$ 242,411
Proceeds and transfers from long-term debt	<b>114,434</b>	595,827
Payments of short-term debt	<b>(170,984)</b>	(344,922)
Balance at end of year	<b>\$ 436,766</b>	\$ 493,316



Puerto Rico Electric Power Authority

Notes to Audited Financial Statements (continued)

**9. Accounts Payable and Accrued Liabilities**

	<b>2007</b>	<b>2006</b>
	<i>(In thousands)</i>	
Accounts payable, accruals, and withholdings in process of payment	<b>\$ 515,539</b>	\$ 420,844
Additional accruals and withholdings:		
Injuries and damages and other	<b>24,931</b>	18,723
Accrued vacation and payroll benefits	<b>54,647</b>	50,773
Accrued sick leave and payroll benefits - exclusive of benefits to be liquidated after one year of approximately \$128.7 million in 2007 and \$138.3 in 2006	<b>23,639</b>	9,264
Accrued compensation	<b>17,596</b>	15,391
Accrued pension plan contribution and withholding from employees:		
Employees' Retirement System	<b>36,049</b>	67,721
Employees health plan	<b>20,815</b>	25,329
Contribution in lieu of taxes	<b>34,539</b>	1,274
Other accrued liabilities	<b>21,289</b>	36,206
	<b>\$ 749,044</b>	\$ 645,525

**10. Other Current Liabilities Payable from Restricted Assets**

	<b>2007</b>	<b>2006</b>
	<i>(In thousands)</i>	
Contract retainage	<b>\$ 29,966</b>	\$ 35,299
Other liabilities	<b>48,260</b>	54,703
	<b>\$ 78,226</b>	\$ 90,002

Puerto Rico Electric Power Authority

Notes to Audited Financial Statements (continued)

**11. Long-Term Debt**

At June 30, long-term debt consists of:

	<b>2007</b>	<b>2006</b>
	<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	<b>\$ 5,667,265</b>	\$ 5,217,470
Rural Utility Services (RUS) issues - interest rate of 5%, maturing through 2028	<b>28,175</b>	28,892
	<b>5,695,440</b>	5,246,362
Less unamortized discount and debt reacquisition costs	<b>(47,731)</b>	( 89,831)
Revenue bonds payable, net	<b>5,647,709</b>	5,156,531
Notes payable	<b>480,061</b>	104,835
	<b>6,127,770</b>	5,261,366
Less current portion of long-term debt	<b>(363,358)</b>	(391,182)
	<b>\$ 5,764,412</b>	\$ 4,870,184

Puerto Rico Electric Power Authority

Notes to Audited Financial Statements (continued)

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

Long-term debt activity for the years ended June 30, 2007 and 2006 was as follows:

	<b>2007</b>	<b>2006</b>
	<i>(In thousands)</i>	
Long-term debt excluding current portion	<b>\$ 5,261,366</b>	\$ 5,304,959
New issues:		
Power revenue bonds	<b>643,530</b>	—
Power revenue refunding bonds	<b>1,857,445</b>	—
Debt discount on new bond issues – net	<b>125,527</b>	—
Defeasance of bonds	<b>(1,860,025)</b>	—
Debt discount and excess reacquisition costs on cancelled bonds – net	<b>(95,133)</b>	—
Notes payable	<b>448,100</b>	68,000
	<b>6,380,810</b>	5,372,959
Payments:		
Power revenue bond – July 1	<b>(191,509)</b>	(118,082)
Power revenue bond – January 1	<b>(363)</b>	(345)
Notes payable	<b>(72,874)</b>	(4,750)
Total payments	<b>(264,746)</b>	(123,177)
Amortization of debt discount and excess reacquisition costs	<b>11,706</b>	11,584
Balance at end of year	<b>\$ 6,127,770</b>	\$ 5,261,366
Current portion of Notes Payable	<b>\$ 12,277</b>	\$ 13,650
Current portion of Power Revenue Bonds	<b>351,081</b>	377,532
Total current portion	<b>\$ 363,358</b>	\$ 391,182

Puerto Rico Electric Power Authority

Notes to Audited Financial Statements (continued)

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

**Power Revenue Bonds Payable**

During fiscal year 2007, the Authority issued its Power Revenue Bonds, Series TT, UU and VV. In addition, the Authority issued the Series, UU and VV Bonds pursuant to Section 210 of the 1974 Agreement to refund blocks of the following previous bond issues summarized below:

<b>Series</b>	<b>Principal Amount Refunded</b>
	<i>(In thousands)</i>
Series AA	\$ 62,335
Series DD	318,480
Series FF	24,035
Series HH	342,180
Series II	493,960
Series NN	345,780
Series RR	273,255
Total refunded	\$ 1,860,025

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 29 years is \$146,197,241. This will generate an economic gain (difference between present value of the old and new debt service payments) of \$105,563,509. The Authority deposited the net proceeds of the Series UU and VV 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.

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 TT for the purpose of paying a portion of the cost of its CIP.

Puerto Rico Electric Power Authority

Notes to Audited Financial Statements (continued)

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

**Power Revenue Bonds Payable (continued)**

A summary of the net proceeds of the Power Revenue Bonds, Series TT, Series UU, and Series VV application of the proceeds follows:

Principal amount of Series TT Bonds	\$ 643,530
Principal amount of Series UU Refunding Bonds	1,300,035
Principal amount of Series VV Refunding Bonds	557,410
Plus:	
Net original issue premium	139,202
Other available moneys	34,397
Proceeds	\$ 2,674,574

Application of net proceeds:

Deposit to Escrow Fund for Refunded Power Revenue Bonds	\$ 1,966,281
Deposit to 1974 Construction Fund	450,001
Repayment of Government Development Bank Line of credit	200,000
Capitalized interest on Series TT Bonds through January 1, 2008	20,581
Underwriting discount, municipal bond issuance premium and estimated legal, printing and other financing expenses	37,711
Costs of Issuance	\$ 2,674,574

Maturities of the Power Revenue Refunding Bonds Series TT issued during fiscal year 2007 range from July 1, 2017 to July 1, 2037. The Series TT Bonds bear fixed interest rates ranging from 4.20% to 5%. Interest on the Series TT Bonds is payable on each January 1 and July 1.

## Puerto Rico Electric Power Authority

### Notes to Audited Financial Statements (continued)

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

##### **Power Revenue Bonds Payable (continued)**

Maturities of the Power Revenue Bonds Series UU issued during fiscal year 2007 range from July 1, 2010 to July 1, 2031. The Series UU Bonds bear fixed and variable interest rates ranging from 4.00% to 5.00%. The fixed rate bonds are payable on each January 1 and July 1. The variable rate bonds are payable on each January 1, April 1, July 1 and October 1.

Maturities of the Power Revenue Refunding Bonds Series VV issued during fiscal year 2007 range from July 1, 2020 to July 1, 2035. The Series VV Bonds bear fixed interest rates ranging from 5.25% to 5.50%. Interest on the Series VV 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.

##### **Interest Rate Swap Agreements**

In order to protect against the potential of rising interest rates, the Authority entered into quarterly separate pay-fixed, receive-variable interest rate swaps at a cost anticipated to be less than what the Authority would have paid to issue fixed-rate debt.

Puerto Rico Electric Power Authority

Notes to Audited Financial Statements (continued)

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

**Interest Rate Swap Agreements (continued)**

The terms, fair values and credit ratings of the outstanding swaps as of June 30, 2007, were as follow:

Associated Power Revenue Bonds	Notional Amount	Effective Date	Maturity Date	Fixed Rate	Fair Value
LIBOR Bonds, Series UU	\$ 169,531,850	May 3, 2007	July 2, 2029	4.080%	\$ 4,967,319
LIBOR Bonds, Series UU	123,762,250	May 3, 2007	July 1, 2025	4.232%	2,978,080
LIBOR Bonds, Series UU	225,597,150	May 3, 2007	July 1, 2031	4.286%	6,325,196
LIBOR Bonds, Series UU	61,107,750	May 3, 2007	July 1, 2025	4.232%	1,447,529
LIBOR Bonds, Series UU	83,343,150	May 3, 2007	July 2, 2029	4.080%	2,403,082
LIBOR Bonds, Series UU	111,092,850	May 3, 2007	July 1, 2031	4.286%	3,071,732
Muni-BMS Bonds, Series UU	25,525,000	May 3, 2007	July 3, 2017	4.014%	374,516
Muni-BMS Bonds, Series UU	17,000,000	May 3, 2007	July 2, 2018	4.054%	252,775
Muni-BMS Bonds, Series UU	29,055,000	May 3, 2007	July 1, 2020	4.124%	441,342
Total	<u>\$ 846,015,000</u>				<u>\$ 22,261,571</u>

The notional amounts of the swaps match the principal amounts of the associated Power Revenue Bonds.

As of June 30, 2007, the swaps had a positive fair value of approximately \$22.3 million. The positive fair value of the swaps may be countered by reduction in total interest payments required on the variable-rate Power Revenue Bonds, creating higher synthetic rates.

As of June 30, 2007, the Authority was exposed to credit risk because the swaps had a positive fair value in the amount of the swaps' fair value. The swaps counterparties were rated Aa2 and Aaa as issued by Moody's Investor Services (Moody's), AA- and AA+ by Standard & Poors (S&P), and by Fitch Ratings.

The derivative contract uses the International Swaps and Derivatives Association, Inc. master agreement, which includes standard termination events, such as failure to pay bankruptcy. The Authority or the counterparties may terminate the swaps if the other party fails to perform under the terms of the contracts. Also, the swaps may be terminated by the Authority if the counterparties' credit quality rating falls below Baa1 as issued by Moody's or BBB+ s determined by S&P. If at the time of termination the swap has a negative fair value, the Authority would be liable to the counterparty for a payment equal to the swap's fair value.

Puerto Rico Electric Power Authority

Notes to Audited Financial Statements (continued)

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

**Notes Payable**

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. As of June 30, 2007, the outstanding balance of line of credit is \$200 million.

On December 22, 2006, the Authority and certain commercial banks entered into an agreement for a revolving line of credit of \$200 million to be used for operational purposes. As of June 30, 2007, the outstanding balance is \$183.9 million.

**Scheduled Maturities of Long-Term Debt**

The scheduled maturities of long-term debt with interest thereon at June 30, 2007, are as follows:

<b>Fiscal Year Ending June 30</b>	<b>Principal</b>	<b>Interest</b>	<b>Total</b>
		<i>(In thousands)</i>	
2008	\$ 373,971	\$ 428,693	\$ 802,664
2009	187,133	286,455	473,588
2010	569,309	263,084	832,393
2011	182,239	246,552	428,791
2012	194,394	237,481	431,875
2013-2017	1,098,895	1,029,568	2,128,463
2018-2022	1,149,238	754,631	1,903,869
2023-2027	1,176,185	464,776	1,640,961
2028-2032	858,517	213,586	1,072,103
2033-2037	385,619	48,915	434,534
Total	6,175,500	3,973,741	10,149,241
Less:			
Unamortized discount and premium	203,504	—	203,504
Excess reacquisition costs	(251,234)	—	(251,234)
Interest	—	(3,973,741)	(3,973,741)
Total long-term debt	6,127,770	—	6,127,770
Current portion, net of discount and excess reacquisition costs of bonds	(351,081)	—	(351,081)
Current portion of notes payable	(12,277)	—	(12,277)
Total current portion	(363,358)	—	(363,358)
Long-term debt, excluding current portion	\$ 5,764,412	\$ —	\$ 5,764,412



## Puerto Rico Electric Power Authority

### Notes to Audited Financial Statements (continued)

#### **12. Employees' Retirement Benefits**

##### **Pension Plan**

###### Plan Description

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

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, 2005 and projected to June 30, 2007, based on current year demographic data.

Puerto Rico Electric Power Authority

Notes to Audited Financial Statements (continued)

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

**Supplemental Benefits not Funded Through the System**

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

Supplemental Pension Obligations Exchanged for Forfeited Sick Leave Benefits

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

The Authority's annual pension cost for the year ended June 30, 2007 and related information for the Plan and supplemental benefits follows:

	<u>Pension Plan</u>
Contribution rates:	
Authority	21.30%
Plan members	10.00%
Annual pension cost (thousands)	\$74,603
Contributions made and accruals (thousands)	\$74,302
Actuarial valuation date	6/30/2005
Actuarial cost method	Entry age
Amortization method	Level percentage of pay, closed (4% payroll increases per year)

Puerto Rico Electric Power Authority

Notes to Audited Financial Statements (continued)

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

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

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

	<u>Pension Plan</u>
Remaining amortization period	31 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)

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

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

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

<b>Trend Information</b>			
<i>(In millions)</i>			
<b>Fiscal Year Ending</b>	<b>Annual Pension Cost (APC)</b>	<b>Percentage of APC Contributed</b>	<b>Net Pension Obligation</b>
Pension Plan			
06/30/99	\$ 28.8	100%	\$ 0.0
06/30/00	39.8	100%	0.0
06/30/01	35.0	100%	0.0
06/30/02	43.0	100%	0.0
06/30/03	50.6	100%	0.0
06/30/04	65.0	81%	12.3
06/30/05	69.9	100%	12.6
06/30/06	74.8	100%	12.9
06/30/07	74.6	100%	13.2

The annual required contribution amounted to \$74.3 million in 2007 and \$74.5 million in 2006.

**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 \$69.3 million in 2007 and \$62.1 million in 2006. Currently, 10,488 retirees meet eligibility requirements.

Puerto Rico Electric Power Authority

Notes to Audited Financial Statements (continued)

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

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

	<b>2007</b>	<b>2006</b>
	<i>(In thousands)</i>	
Governmental sector, principally instrumentalities, agencies and corporations of the Commonwealth of Puerto Rico	<b>\$ 444,410</b>	\$ 423,677
Municipalities	<b>159,912</b>	154,978
	<b>\$ 604,322</b>	\$ 578,655

**14. Net Assets**

Restricted assets at June 30, 2007 and 2006 include \$315.2 million and \$206.7 million, respectively, which have been appropriated principally to comply with long-term principal and interest debt services requirements and a reserve for damaged or destroyed property of the Authority not fully covered by insurance as required by the 1974 Agreement. Funds set aside for self-insurance purposes are deposited in the Self-Insurance Fund held by the Trustee (see Note 5).

**15. Claim for Extra Fuel Expense**

The Authority expects insurance companies to cover higher fuel price and other costs associated with alternate generation capacity in connection with two fires on the Authority's generating units (see Note 17). The Authority holds a self-insured retention of first 30 days after the date of the fires for extra expenses amounting to \$19.4 million for the fiscal year ended June 30, 2007.

**16. Contribution in Lieu of Taxes**

	<b>2007</b>	<b>2006</b>
	<i>(In thousands)</i>	
Municipalities	<b>\$ 159,912</b>	\$ 154,978
Commonwealth:		
Hotels	<b>5,634</b>	5,675
Fuel adjustment subsidy	<b>26,969</b>	19,964
Other subsidies (offset against outstanding accounts receivable and reimbursable costs)	<b>76</b>	116
	<b>\$ 192,591</b>	\$ 180,733

## 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 environmental supplemental project 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 was 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. Currently, the requirements under this program have been fulfilled. The Authority believes that the agreement enables the Authority to take additional measures that will enhance its ability to comply with the Consent Decree.

## Puerto Rico Electric Power Authority

### Notes to Audited Financial Statements (continued)

#### **17. Commitments and Contingencies (continued)**

##### **Environmental Matters (continued)**

The Authority maintains a chemical products evaluation program in which substances purchases and inventory are kept in control. This program facilitates the Authority's compliance with Sections 312 and 313 of the Emergency Planning and Community Right to Know Act.

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 led to a cooperative effort as to which alternative should be develop under a Detail Evaluation Engineer Review (DEER). Meetings have been conducted at different stages of the work plan to address and keep informed the Guayanilla Community Group. Conversations are still in progress to determine the specific route through the two corridors identified.

The Authority submitted to EPA the reports and waiver requests, pursuant to the Clean Water Act-Section 316(a) Thermal Waiver, for the San Juan and Palo Seco power plants on July 11, 1997 and November 18, 1997, respectively. EPA issue a new NPDES Permit for the San Juan Power Plant in April 2007, including the approval of the 316(a) Waiver Request.

The fieldwork of the Aguirre 316 Demonstration Study finished in May 2004 and the Final Report was submitted by May 2005.

##### **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.

## Puerto Rico Electric Power Authority

### Notes to Audited Financial Statements (continued)

#### **17. Commitments and Contingencies (continued)**

##### **Commitments to Purchase Power (continued)**

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 \$3.6 billion and \$3.4 billion at June 30, 2007 and 2006, respectively.

The net assets and restricted assets set aside in the Self-insurance Fund for self-insurance amounted to approximately \$68.9 million at June 30, 2007 and \$65.1 million at June 30, 2006.

Changes in the balances of the health insurance program and other self-insurance risks during fiscal years 2007 and 2006 were as follows:

	<b>Liability Beginning Balance</b>	<b>Expenses</b>	<b>Payments</b>	<b>Liability Ending Balance</b>
	<i>(In thousands)</i>			
<b>2006</b>	\$ 32,603	\$ 130,755	\$ 119,306	\$ 44,052
<b>2007</b>	<b>\$ 44,052</b>	<b>\$ 139,238</b>	<b>\$ 134,034</b>	<b>\$ 49,256</b>

**Contingencies**

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

## Puerto Rico Electric Power Authority

### Notes to Audited Financial Statements (continued)

#### 17. Commitments and Contingencies (continued)

##### Contingencies (continued)

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

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

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

During fiscal year ended June 30, 2003, 37 municipalities accepted this settlement, receiving an amount of \$26.1 million. During fiscal year ended June 30, 2004, 38 additional municipalities accepted the settlement as well, receiving \$37.5 million. During fiscal year ended June 30, 2006, the last two municipalities accepted the settlement offer, receiving \$4.4 million.

## Puerto Rico Electric Power Authority

### Notes to Audited Financial Statements (continued)

#### **17. Commitments and Contingencies (continued)**

##### **Contingencies (continued)**

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, 2007, the Authority had drawn \$41.7 million.

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 December 2006, two fires damaged one of the Authority's generating units and the control room, which controls all four units located at Palo Seco Plant. As a result, 602 MW of oil-fired capacity, representing 11% of the Production Plant installed dependable capacity is not currently available.

The Authority submitted claims to insurance companies of \$122.1 million, including the extra fuel expenses, and has received payments of \$5 million during the fiscal year ended June 30, 2007.

## Puerto Rico Electric Power Authority

### Notes to Audited Financial Statements (continued)

#### **17. Commitments and Contingencies (continued)**

##### **Construction and Other Commitments**

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

As of June 30, 2007, the Authority has commitments of approximately \$475.5 million on active construction, maintenance and engineering services contracts.

#### **18. Significant New Accounting Pronouncement**

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 September 2006, the GASB issued Statement No. 48, *Sales and Pledges of Receivables and Future Revenues and Intra-Entity Transfers of Assets and Future Revenues*. This Statement establishes criteria that governments will use to ascertain whether certain transactions should be regarded as a sale or a collateralized borrowing. Such transactions are likely to comprise the sale of delinquent taxes, certain mortgages, student loans, or future revenues such as those arising from tobacco settlement agreements.

In addition to clarifying guidance on accounting for sales and pledges of receivables and future revenues, the Statement:

- Requires enhanced disclosures pertaining to future revenues that have been pledged or sold,
- Provides guidance on sales of receivables and future revenues within the same financial reporting entity,
- Provides guidance on recognizing other assets and liabilities arising from the sale of specific receivables or future revenues.

The requirements of this Statement are effective for financial statements for periods beginning after December 15, 2006.

## Puerto Rico Electric Power Authority

### Notes to Audited Financial Statements (continued)

#### 18. Significant New Accounting Pronouncement (continued)

In November 2006, the GASB recently issued Statement No. 49, *Pollution Remediation Obligations*. The Statement identifies the circumstances under which a governmental entity would be required to report a liability related to pollution remediation. According to the Statement, a government would have to estimate its expected outlays for pollution remediation if it knows a site is polluted and any of the following recognition triggers occur:

- Pollution poses an imminent danger to the public or environment and a government has little or no discretion to avoid fixing the problem,
- A government has violated a pollution prevention-related permit or license,
- A regulator has identified (or evidence indicates a regulator will do so) a government as responsible (or potentially responsible) for cleaning up pollution, or for paying all or some of the cost of the clean up,
- A government is named in a lawsuit (or evidence indicates that it will be) to compel it to address the pollution,
- A government begins to clean up pollution or conducts related remediation activities (or the government legally obligates itself to do so).

Liabilities and expenses would be estimated using an "expected cash flows" measurement technique, which will be employed for the first time by governments. Statement 49 also would require governments to disclose information about their pollution remediation obligations associated with clean-up efforts in the notes to the financial statements.

Statement 49 will be effective for financial statements for periods beginning after December 15, 2007.

In May 2007, the GASB recently issued Statement No. 50, *Pension Disclosures*, which more closely aligns current pension disclosure requirements for governments with those that governments are beginning to implement for retiree health insurance and other post-employment benefits.

Specifically, Statement 50 amends GASB Statements No. 25, *Financial Reporting for Defined Benefit Pension Plans and Note Disclosures for Defined Contribution Plans*, and No. 27, *Accounting for Pensions by State and Local Governmental Employers*, by requiring:

- Disclosure in the notes to the financial statements of pension plans and certain employer governments of the current funded status of the plan—in other words, the degree to which the actuarial accrued liabilities for benefits are covered by assets that have been set aside to pay the benefits—as of the most recent actuarial valuation date.

## Puerto Rico Electric Power Authority

### Notes to Audited Financial Statements (continued)

#### 18. Significant New Accounting Pronouncement (continued)

- Governments that use the aggregate actuarial cost method to disclose the funded status and present a multi-year schedule of funding progress using the entry age actuarial cost method as a surrogate; these governments previously were not required to provide this information.
- Disclosure by governments participating in multi-employer cost-sharing pension plans of how the contractually required contribution rate is determined.

The provisions of Statement 50 generally are effective for periods beginning after June 15, 2007, with early implementation encouraged. The requirements relating to governments using the aggregate actuarial cost method are effective for financial statements and required supplementary information that contains information from actuarial valuations as of June 15, 2007, or later.

In June 2007, the GASB recently issued Statement No. 51, *Accounting and Financial Reporting for Intangible Assets*, to provide guidance regarding how to identify, account for, and report intangible assets.

The new standard characterizes an intangible asset as an asset that lacks physical substance, is nonfinancial in nature, and has an initial useful life extending beyond a single reporting period. Examples of intangible assets include easements, computer software, water rights, timber rights, patents, and trademarks.

Statement 51 requires that intangible assets be classified as capital assets (except for those explicitly excluded from the scope of the new standard, such as capital leases). Relevant authoritative guidance for capital assets should be applied to these intangible assets.

Statement 51 provides additional guidance that specifically addresses the unique nature of intangible assets, including:

- Requiring that an intangible asset be recognized in the statement of net assets only if it is considered identifiable
- Establishing a specified-conditions approach to recognizing intangible assets that are internally generated (for example, patents and copyrights)
- Providing guidance on recognizing internally generated computer software
- Establishing specific guidance for the amortization of intangible assets.

## Puerto Rico Electric Power Authority

### Notes to Audited Financial Statements (continued)

#### **18. Significant New Accounting Pronouncement (continued)**

The requirements Statement 51 are effective for financial statements for periods beginning after June 15, 2009. The GASB made significant changes to the transition provisions, based on constituent response to the proposed version of the standards, to make it easier for governments to implement.

#### **19. Subsequent Events**

On September 13, 2007, the Authority and GDB entered into an agreement for a line of credit of \$100 million to be used in the Palo Seco Steam Plant Recovery.

On December 19, 2007, the Authority and BBVA entered into an agreement for a line of credit of \$100 million to be used in the recovery of Palo Seco Plant.

For the seven-month period ended January 31, 2008, the Authority received \$69.4 million from insurance companies related to its Palo Seco Plant claim.

On September 5, 2007, the Authority entered into an interest-rate swap transaction with UBS AG and Goldman Sachs Capital Markets for two thirds and one third, respectively, of a notional amount of \$600 million in bonds to be issued by the Authority. The transaction will expire on September 1, 2008, or the date before the bonds will be issued, if earlier than September 1, 2008. The transactions fixed rate was established at 3.652 percent per annum.

The interest-rate swap transaction is subject to the terms and conditions of an ISDA Master Agreement entered between the Authority and UBS AG on April 18, 2007, and on September 5, 2007 with Goldman Sachs Capital Markets.

On January 30, 2008, the Authority and Bank of America entered into an agreement for a line of credit of \$50 million to be used for financing fuel purchases.



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, 2007, and have issued our report thereon dated February 1, 2008. 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 as a basis for designing our auditing procedures for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the Authority's internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of the Authority's internal control over financial reporting.

A control deficiency exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis. A significant deficiency is a control deficiency, or combination of control deficiencies, that adversely affects the entity's ability to initiate, authorize, record, process, or report financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the entity's financial statements that is more than inconsequential will not be prevented or detected by the entity's internal control.

A material weakness is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the financial statements will not be prevented or detected by the entity's internal control.

Our consideration of internal control over financial reporting was for the limited purpose described in the first paragraph of this section and would not necessarily identify all deficiencies in internal control that might be significant deficiencies or material weaknesses. We did not identify any deficiencies in internal control over financial reporting that we consider to be material weaknesses, as defined above.

### 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 February 1, 2008.

This report is intended solely for the information and use of the Authority's Governing Board, others with the Authority, 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.



February 1, 2008

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original of  
this report.

## Supplemental Information

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## Schedule I

### Puerto Rico Electric Power Authority Supplemental Schedule of Funding Progress

June 30, 2007

*(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>						
6/30/97	\$1,084	\$1,333	\$249	51%	\$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	866	61%	249	248%
6/30/06	1,403	2,280	877	62%	349	251%

**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, 2007 and 2006, 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.

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, 2007 and 2006

Statements of Income (GAAP) and Reconciliation of Net Income

(In thousands)

	2007			2006		
	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	\$ 3,670,966	\$ 3,680,390		\$ 3,708,938	\$ 3,716,082	
Revenues from Commonwealth for rural electrification	76	76		116	116	
Other operating revenues	11,068	11,068		11,373	11,373	
Other	5,275	5,290		11,497	11,497	
1974 agreement construction fund investment income and gain on sale of other properties	-	61,645		-	57,866	
Total revenues	<u>3,687,385</u>	<u>3,758,469</u>	71,084	<u>3,731,924</u>	<u>3,796,934</u>	65,010
Current expenses:						
As shown	3,014,983	3,025,682		3,033,924	3,041,369	
Other interest	-	1,434		-	1,946	
Total as defined	<u>3,014,983</u>	<u>3,027,116</u>	(12,133)	<u>3,033,924</u>	<u>3,043,315</u>	(9,391)
Net revenues, as defined	<u>\$ 672,402</u>			<u>\$ 698,000</u>		
Depreciation	\$ -	283,763	(283,763)	\$ -	271,694	(271,694)
Disposition of revenues: (not classified in order of payment)						
Interest on debt	257,457	262,616		257,464	270,202	
Interest on general obligation notes	38,922	38,922		11,427	11,427	
Amortization of debt discount, financing expenses	-	(5,086)		-	(4,471)	
Amortization of bond defeasance	-	20,553		-	19,960	
Allowance for funds used during construction	-	(22,230)		-	(12,322)	
Net interest on long-term debt	<u>296,379</u>	<u>294,775</u>	1,604	<u>268,891</u>	<u>284,796</u>	(15,905)
Power revenue bonds:						
Principal	197,565	-	197,565	191,854	-	191,854
Internal Funds	10,212	-	10,212	49,604	-	49,604
Contribution in lieu of taxes	168,246	192,591	(24,345)	187,651	180,733	6,918
Total expenses (GAAP)		<u>3,798,245</u>			<u>3,780,538</u>	
Net revenues, as defined	<u>\$ 672,402</u>			<u>\$ 698,000</u>		
Net income		<u>\$ (39,776)</u>	<u>\$ (39,776)</u>		<u>\$ 16,396</u>	<u>\$ 16,396</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, 2007 and 2006

*(In thousands)*

	<u>2007</u>	<u>2006</u>
Sources of net revenues:		
Revenues:		
Electric revenues	\$ 3,670,966	\$ 3,708,938
Revenues from the Commonwealth for rural electrification	76	116
Other operating revenues	11,068	11,373
Other (principally interest)	5,275	11,497
	<u>3,687,385</u>	<u>3,731,924</u>
Current expenses:		
Operations:		
Fuel	1,716,965	1,665,866
Purchased power	624,653	603,169
Fuel extra expense claimed	(114,261)	-
Other production	56,169	57,918
Transmission and distribution	157,569	162,956
Customer accounting and collection	109,361	106,927
Administrative and general	212,530	198,509
Maintenance	250,563	236,633
Other Interest	1,434	1,946
	<u>3,014,983</u>	<u>3,033,924</u>
Net revenues, as defined	<u>\$ 672,402</u>	<u>\$ 698,000</u>
Disposition of net revenues:		
Revenue fund:		
Power revenue bonds - sinking fund requirements:		
Interest	\$ 257,457	\$ 257,464
Principal	197,565	191,854
Balance available for capital improvements	10,212	49,604
	<u>465,234</u>	<u>498,922</u>
General obligation notes:		
Interest	38,922	11,427
Contribution in lieu of taxes and other	168,246	187,651
Net revenues, as defined	<u>\$ 672,402</u>	<u>\$ 698,000</u>

*See accompanying notes.*



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

Years Ended June 30, 2007 and 2006

(In thousands)

	2007				2006			
	Total	Held by Authority Other Assets	Restricted Deposits with Trustee Other Assets	Non-Current Assets	Total	Held by Authority Other Assets	Restricted Deposits with Trustee Other Assets	Non-Current Assets
<b>By Account</b>								
1974 Agreement (restricted)								
Sinking Fund - principal and interest	\$ 293,017	\$ -	\$ 287,183	\$ 5,834	\$ 329,965	\$ -	\$ 329,965	\$ -
Reserve account	273,108	-	-	273,108	258,815	-	-	258,815
Self insurance fund	68,922	-	-	68,922	65,146	-	-	65,146
Reserve maintenance fund	48,240	48,240	-	-	49,905	49,905	-	-
Construction Fund:								
Rural Utilities Services (RUS)	1,787	1,787	-	-	1,685	1,685	-	-
Other	324,139	324,139	-	-	6,904	6,904	-	-
General purpose (unrestricted):								
General	38,339	38,339	-	-	16,426	16,426	-	-
Working funds	1,576	1,576	-	-	1,942	1,942	-	-
<b>Total</b>	<b>\$ 1,049,128</b>	<b>\$ 414,081</b>	<b>\$ 287,183</b>	<b>\$ 347,864</b>	<b>\$ 730,788</b>	<b>\$ 76,862</b>	<b>\$ 329,965</b>	<b>\$ 323,961</b>
<b>By Type of Assets Held</b>								
Working funds	\$ 1,576	\$ 1,576	\$ -	\$ -	\$ 1,942	\$ 1,942	\$ -	\$ -
Cash in bank and time deposits (by depository institutions):								
Government Development Bank for Puerto Rico	1	1	-	-	1	1	-	-
Banco Popular de Puerto Rico	24,827	24,827	-	-	20,336	20,336	-	-
Citibank, N. A.	4,746	4,746	-	-	(14,474)	(14,474)	-	-
US Bank	293,017	-	287,183	5,834	329,965	-	329,965	-
Banco Bilbao Vizcaya	1,227	1,227	-	-	1	1	-	-
Banco Bilbao Vizcaya, Mayagüez, Puerto Rico	76	76	-	-	49	49	-	-
First Bank, San Juan, Puerto Rico	273	273	-	-	670	670	-	-
Banco Santander, Santurce, Puerto Rico	6,252	6,252	-	-	8,720	8,720	-	-
RG Premier Bank	21	21	-	-	-	-	-	-
Western Bank, Mayagüez, Puerto Rico	916	916	-	-	1,123	1,123	-	-
	332,932	39,915	287,183	5,834	348,333	18,368	329,965	-
Investment securities	716,196	374,166	-	342,030	382,455	58,494	-	323,961
<b>Total</b>	<b>\$ 1,049,128</b>	<b>\$ 414,081</b>	<b>\$ 287,183</b>	<b>\$ 347,864</b>	<b>\$ 730,788</b>	<b>\$ 76,862</b>	<b>\$ 329,965</b>	<b>\$ 323,961</b>

See accompanying notes.

## Puerto Rico Electric Power Authority

## Supplemental Schedule of Changes in Cash and Investments by Funds

Year Ended June 30, 2007  
(In thousands)

2006 - 2007 Activity	Total	General Purposes Funds		
		General Fund	Revenue Fund	Working Fund
<b>Balances at June 30, 2006, before interfund account</b>	\$ 730,788	\$ 137,504	\$ 16	\$ 1,942
Operations:				
Net revenues	—	(672,402)	168,246	—
Funds provided from internal operations	527,409	527,409	—	—
1974 Agreement investment income Acct 4191	—	(4,508)	—	—
Investment income and other	25,530	2,601	—	—
Unrealized gain (or loss) on market value of investment	5,909	—	—	—
Offset of current year's contribution in lieu of taxes against certain government accounts receivable	—	129,962	(129,962)	—
Offset of current year's 5% contribution in lieu of taxes against Commonwealth of Puerto Rico debt and transfers to General Obligations	—	—	—	—
Funds used for construction	(572,883)	38,284	(38,284)	—
Financing:				
Proceeds from new bond issues-net of original discounts	2,626,502	—	—	—
Proceeds from contributed capital	44,015	—	—	—
Defeased bonds-net of original discounts	(1,955,158)	—	—	—
Sinking Funds and account transfers	—	—	—	—
Notes issued for construction	400,000	—	—	—
Notes issued for improvement to Isabela Irrigation System	2,884	—	—	—
Notes issued for municipalities settlement agreement	6,791	—	—	—
Notes issued to commercial bank that are payable from accounts receivable - government	203,892	203,892	—	—
Notes re-issued to municipalities settelement agreements	64,208	64,208	—	—
Notes issued to working capital	90,000	90,000	—	—
Payment of notes	(379,727)	(179,727)	—	—
Payment of interest	(360,647)	(23,914)	—	—
Payment of current maturities of long-term debt	(191,872)	—	—	—
Payment to municipalities settlement agreement	(74,791)	(68,000)	—	—
Changes in assets and liabilities:				
Working funds	—	366	—	(366)
Accounts receivable (includes non-current)	(209,473)	(209,473)	—	—
Fuel oil	(17,391)	(17,391)	—	—
Materials and supplies	(3,599)	(3,599)	—	—
Prepayments and other	(783)	(783)	—	—
Deferred debits	590	590	—	—
Accounts payable and accrued liabilities (includes non-current)	83,196	83,196	—	—
Customer deposits	3,738	3,738	—	—
Interfund transfers, etc.	—	2,556	—	—
Total before interfund accounts	1,049,128	104,509	16	1,576
Add (deduct) Interfund accounts	—	(66,186)	—	—
<b>Balances at June 30, 2007</b>	<b>\$ 1,049,128</b>	<b>\$ 38,323</b>	<b>\$ 16</b>	<b>\$ 1,576</b>

Sinking Fund				Other Funds		
Interest 1974 Agreement	Principal 1974 Agreement	Reserve 1974 Agreement	Self Insurance Fund	Construction 1974 Agreement	Reserve Maintenance Fund	Subordinated Obligation Fund
\$ 136,522	\$ 193,443	\$ 258,815	\$ 65,146	\$ (112,505)	\$ 49,905	\$ -
257,457	197,565	-	-	10,212	-	38,922
-	-	-	-	-	-	-
-	-	-	-	4,508	-	-
2,940	5,107	9,654	2,987	-	2,241	-
-	-	4,639	789	-	481	-
-	-	-	-	-	-	-
-	-	-	-	-	-	-
-	-	-	-	(572,883)	-	-
-	-	-	-	2,626,502	-	-
-	-	-	-	44,015	-	-
-	-	-	-	(1,955,158)	-	-
-	-	-	-	-	-	-
-	-	-	-	400,000	-	-
-	-	-	-	2,884	-	-
-	-	-	-	6,791	-	-
-	-	-	-	-	-	-
-	-	-	-	-	-	-
-	-	-	-	-	-	-
-	-	-	-	(200,000)	-	-
(297,811)	-	-	-	-	-	(38,922)
-	(191,872)	-	-	-	-	-
-	-	-	-	(6,791)	-	-
-	-	-	-	-	-	-
-	-	-	-	-	-	-
-	-	-	-	-	-	-
-	-	-	-	-	-	-
-	-	-	-	-	-	-
-	-	-	-	-	-	-
-	-	-	-	-	-	-
-	-	-	-	-	-	-
-	-	-	-	-	-	-
(8,404)	(1,930)	-	-	12,165	(4,387)	-
90,704	202,313	273,108	68,922	259,740	48,240	-
				66,186		-
<b>\$ 90,704</b>	<b>\$ 202,313</b>	<b>\$ 273,108</b>	<b>\$ 68,922</b>	<b>\$ 325,926</b>	<b>\$ 48,240</b>	<b>\$ -</b>

## 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)	—	—
<b>Balances at June 30, 2006</b>	<b>\$ 730,788</b>	<b>\$ 16,410</b>	<b>\$ 16</b>	<b>\$ 1,942</b>

See accompanying notes.

Sinking Fund				Other Funds	
Interest 1974 Agreement	Principal 1974 Agreement	Reserve 1974 Agreement	Self Insurance Fund	Construction 1974 Agreement	Reserve Maintenance Fund
\$ 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

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

Years Ended June 30, 2007 and 2006

*(In thousands)*

	<u>2007</u>	<u>2006</u>
<b>Long-term debt excluding current portion</b>		
Balance at the beginning of year	\$ 4,870,184	\$ 5,001,857
Transfers to current liabilities:		
Power revenue bonds	(165,992)	(199,673)
Payment of general obligation notes:		
Note payable	(59,224)	—
Remainder	<u>4,644,968</u>	<u>4,802,184</u>
 New issues:		
Power revenue bonds	643,530	—
Power revenue refunding bonds	1,857,445	—
Debt discount on new bond issues - net	125,527	—
Defeasance of bonds	(1,860,025)	—
Debt discount and excess reacquisition costs on cancelled bonds - net	(95,133)	—
Note payable	448,100	68,000
Balance at the end of year	<u>\$ 5,764,412</u>	<u>\$ 4,870,184</u>
 <b>Current portion of long-term debt</b>		
Balance at beginning of year	\$ 391,182	\$ 303,102
Transfer from long-term debt	165,992	199,673
Payments to bondholders:		
Power revenue- July 1	(191,509)	(118,082)
Power revenue- January 1	(363)	(345)
General obligation notes	(13,650)	(4,750)
Total payments	<u>(205,522)</u>	<u>(123,177)</u>
 Amortization of debt discount and excess reacquisition costs	 11,706	 11,584
Balance at end of year	<u>\$ 363,358</u>	<u>\$ 391,182</u>

*See accompanying notes.*

## **APPENDIX III**

Letter of the Consulting Engineers

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June 18, 2008

Puerto Rico Electric Power Authority  
San Juan, Puerto Rico

Dear Sirs:

Washington Division of URS Corporation (“Washington Division”) 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 annual report provided to the Authority and the Trustee was dated as of June 2007.

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 Division 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 Division 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 Division without it having conducted an independent investigation thereof. In addition, Washington Division 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 beyond the limited scope of the Economic Incentives Act as described in the Recent Developments section of this Official Statement, nor will there be unforeseen technological developments;
9. that the demographic, statistical, economic and other information regarding Puerto Rico obtained by Washington Division 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 revenue and generation 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;
2. 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;
3. 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;

4. 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 Units 3 & 4, which are being restored to service following the destruction of the central controls by two separate fires on consecutive days in late December 2006;

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.

Sincerely,

WASHINGTON DIVISION OF URS CORPORATION



George W. Romano, Jr.  
Manager,  
Utility Management  
Services Department

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**PROPOSED FORM OF BOND COUNSEL OPINION**

*Upon delivery of the Bonds and 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:*

June \_\_, 2008

Puerto Rico Electric Power Authority  
San Juan, Puerto Rico

Re: \$697,345,000 Puerto Rico Electric Power Authority Power Revenue Bonds, Series WW

Ladies and 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 \$697,345,000 aggregate principal amount of Power Revenue Bonds, Series WW (the "Bonds"). The Bonds are dated, mature on July 1 of the years and in such principal amounts and bear interest at the rates, all as set forth in the Resolution referred to hereinbelow. The Bonds are issuable as fully registered bonds without coupons, in authorized denominations and are subject to redemption prior to maturity, 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, (i) 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"); (ii) 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; (iii) Resolution No. 3517, duly adopted by the Authority on June 18, 2008 (the "Resolution"); and (iv) 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 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 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 2008 and 2009, including, without limitation, the repayment of a loan the proceeds of which were used to finance such Improvements.

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 the 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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