

**Supplement, dated October 16, 2007, to Official Statement,
dated October 3, 2007, relating to:**

**\$926,570,000
COMMONWEALTH OF PUERTO RICO
Public Improvement Refunding Bonds, Series 2007A
(General Obligation Bonds)
Base CUSIP 74514L**

Please note the following changes to the Official Statement, dated October 3, 2007, relating to the above bonds (all terms used below having the same meanings given to them in said Official Statement, dated October 3, 2007):

1. The third and fourth sentences of the first paragraph on **the cover page** of said Official Statement below the **“Dated: Date of Delivery”** line are deleted and in their place the following sentence is added to read as follows: “The Bonds offered hereby will be available to purchasers only under the book-entry system maintained by DTC through brokers and dealers who are, or act through, DTC Participants in denominations of: (1) \$5,000 and multiples thereof in respect of the Bonds maturing before July 1, 2023, (2) \$100,000 or any multiple of \$5,000 in excess thereof in respect of the Variable Rate Demand Obligations and (3) \$25,000 and any multiple thereof in respect of the Auction Rate Securities.”
2. In both paragraphs on **page 15** under the heading *“The Bonds – Purchase of the Variable Rate Bonds – During Daily Interest Rate Period”*, the time for the delivery of an optional tender notice by any Bondholder owning Variable Rate Demand Obligations in the Daily Interest Rate Period is changed from “12 noon, New York City time” to “10:00 a.m., New York City time”.
3. Clause (a) on **page 25** under the heading *“The Bonds – Initial Liquidity Facilities – Events of Termination and Events of Default”* is deleted and in its place the following clause is added to read as follows: “(a) (i) Any principal or interest due on the Variable Rate Demand Obligations is not paid when due and such principal or interest is not paid by the applicable Bond Insurer when, as, and in the amounts required to be paid pursuant to the terms of the applicable Insurance Policy or (ii) the Commonwealth provides notice that the applicable Bond Insurer shall be substituted as insurer of the Variable Rate Demand Obligations, or the applicable Insurance Policy is surrendered, cancelled, terminated, or modified in any material respect, without the applicable Liquidity Facility Provider’s prior written consent; or”
4. The third sentence on **page 32 and 33** under the heading *“The Bonds – Book-Entry Only System”* is deleted and in its place the following sentence is added to read as follows: “One fully registered bond will be issued for each maturity (and within a maturity of two subseries, each subseries) of the Bonds, in the aggregate principal amount of such maturity or subseries, as the case may be, and will be deposited with DTC.”

5. The third sentence on **page 35** under the heading “*The Bonds – Discontinuance of the Book-Entry Only System*” is deleted and in its place the following sentence is added to read as follows: “The Bonds offered by virtue of this Official Statement will be issued only as registered bonds without coupons in denominations of: (1) \$5,000 or any multiple thereof in respect of the Bonds maturing before July 1, 2023, (2) \$100,000 or any multiple of \$5,000 in excess thereof in respect of the Variable Rate Demand Obligations and (3) \$25,000 and any multiple thereof in respect of the Auction Rate Securities.”

6. In addition to the ratings for the Bonds set forth set forth on **page 59** under the heading “*Ratings*”, the Variable Rate Demand Obligations have been given the ratings of VMIG 1 and A-1+, respectively, from Moody’s and S&P on the strength of the issuance concurrently with the delivery of the Bonds of the respective Initial Liquidity Facilities by Dexia and JPMorgan.

This Supplement will be filed with each NRMSIR and with the MSRB.

COMMONWEALTH OF PUERTO RICO

By: /s/ Juan Carlos Mendez Torres
Secretary of the Treasury

Dated: October 16, 2007

NEW ISSUE - BOOK-ENTRY ONLY
See “Book-Entry Only System” under *The Bonds*

In the opinion of Squire, Sanders & Dempsey L.L.P., Bond Counsel, under existing law (i) assuming continuing compliance with certain covenants and the accuracy of certain representations, interest on the Bonds is excluded from gross income for federal income tax purposes and is not an item of tax preference for purposes of the federal alternative minimum tax imposed on individuals and corporations, and (ii) the Bonds and the interest thereon are exempt from state, Commonwealth of Puerto Rico and local income taxation. Interest on the Bonds may be subject to certain federal taxes imposed only on certain corporations, including the corporate alternative minimum tax on a portion of that interest. For a more complete discussion of the tax aspects of the Bonds, see “Tax Matters” herein.

\$926,570,000
COMMONWEALTH OF PUERTO RICO
Public Improvement Refunding Bonds, Series 2007A
(General Obligation Bonds)

Dated: Date of Delivery

Due: July 1, as shown on the inside cover

The Bonds are issuable as registered bonds without coupons and will be initially registered only in the name of Cede & Co., as nominee of The Depository Trust Company, New York, New York (“DTC”), which will act as securities depository for the Bonds. The Commonwealth will initially issue a portion of the Bonds with interest rates that will be periodically reset by one or more remarketing agents (the “Variable Rate Demand Obligations”) and a portion of the Bonds with interest rates that will be periodically reset through auction procedures (the “Auction Rate Securities” and, together with the Variable Rate Demand Obligations, the “Variable Rate Bonds”), as described therein. Bonds offered hereby (other than Auction Rate Securities) will be available to purchasers in denominations of \$100,000 and multiples of \$5,000 in excess thereof only under the book-entry system maintained by DTC through brokers and dealers who are, or act through, DTC Participants. Auction Rate Securities will be available to purchasers in denominations of \$25,000 and multiples thereof also only under said DTC book-entry system. **Purchasers will not receive delivery of the Bonds. So long as any purchaser is the beneficial owner of a Bond, he must maintain an account with a broker or dealer who is, or acts through, a DTC Participant to receive payment of principal and interest on such Bond.** See “Book-Entry Only System” under *The Bonds*. Interest on the Bonds will accrue from their date of issuance at the annual rates described on the inside front cover, and in the case of Bonds maturing before July 1, 2023 will be payable semi-annually on each January 1 and July 1, commencing on January 1, 2008, and in the case of the remaining Bonds offered hereby will be payable initially monthly or after every auction date, as applicable, as further described herein. The Bonds are subject to redemption prior to maturity as set forth herein.

THE BONDS ARE GENERAL OBLIGATIONS OF THE COMMONWEALTH. THE GOOD FAITH, CREDIT AND TAXING POWER OF THE COMMONWEALTH ARE IRREVOCABLY PLEDGED FOR THE PROMPT PAYMENT OF THE PRINCIPAL OF AND INTEREST ON THE BONDS. THE CONSTITUTION OF PUERTO RICO PROVIDES THAT PUBLIC DEBT OF THE COMMONWEALTH, WHICH INCLUDES THE BONDS, CONSTITUTES A FIRST CLAIM ON AVAILABLE COMMONWEALTH RESOURCES.

The scheduled payment of principal of and interest on a portion of the Bonds when due will be guaranteed under certain financial guaranty or similar insurance policies for such Bonds, to be issued concurrently with the delivery of the Bonds, by recognized insurance companies as set forth on the inside front cover and as further described herein. See Bond Insurance herein.

In connection with the Variable Rate Demand Obligations, the Commonwealth has obtained from JPMorgan Chase Bank, National Association, and Dexia Credit Local, acting through its New York Branch (the “Initial Liquidity Facility Providers”) written agreements to purchase Variable Rate Demand Obligations that are tendered and not remarketed, except under certain circumstances described herein, under separate Standby Bond Purchase Agreements, which Agreements will expire, subject to earlier termination under certain circumstances or extension, prior to the final maturity of said Demand Obligations. **As more fully described herein, the rights of the owners of Variable Rate Demand Obligations to tender their Variable Rate Demand Obligations may be immediately terminated or suspended without notice to any person or without mandatory tender of the Variable Rate Demand Obligations.**

The Bonds are offered for delivery when, as and if issued and accepted by the Underwriters subject to the approval of legality by Squire, Sanders & Dempsey L.L.P., Miami, Florida, Bond Counsel, and certain other conditions. Certain legal matters will be passed upon for the Underwriters by Sidley Austin LLP, New York, New York. It is expected that the Bonds will be available for delivery through the facilities of DTC on or about October 16, 2007.

UBS Investment Bank

Banc of America Securities LLC
Citi
JPMorgan
Oriental Financial Services
Samuel A. Ramírez & Co., Inc.

Lehman Brothers

BBVAPR MSD
DEPFA First Albany Securities LLC
Loop Capital
Popular Securities
Santander Securities

Morgan Stanley

Bear, Stearns & Co., Inc.
Goldman, Sachs & Co.
Merrill Lynch & Co.
RBC Capital Markets
Scotia Capital

Wachovia Bank, National Association

\$926,570,000
COMMONWEALTH OF PUERTO RICO
Public Improvement Refunding Bonds, Series 2007A
(General Obligation Bonds)

Sub Series	Maturity July 1,	Amount	Interest Rate	Price or Yield	CUSIP
2007A-1	2011	\$ 4,000,000	5¼%	3.87%	74514L MU 8
2007A-1	2012	4,000,000	5¼%	3.95	74514L MV 6
2007A-1	2013	7,645,000	5%	4.00	74514L MW 4
2007A-1	2014	20,885,000	5¼%	4.08	74514L MX 2
2007A-1	2015	26,925,000	5¼%	4.15	74514L MY 0
2007A-1	2016	10,925,000	5¼%	4.22	74514L MZ 7
2007A-1	2017	34,970,000	5½%	4.29	74514L NB 9
2007A-1	2017 ¹	24,940,000	5%	3.97	74514L NA 1
2007A-1	2018	30,965,000	5½%	4.36	74514L NC 7
2007A-1	2019 ²	53,215,000	5½%	4.07	74514L ND 5
2007A-1	2020 ²	39,290,000	5½%	4.13	74514L NE 3
2007A-1	2021 ³	36,205,000	5½%	4.18	74514L NF 0
2007A-1	2022 ³	36,830,000	5½%	4.22	74514L NG 8
2007A-2	2029	99,450,000	4	100	74514L NK 9
2007A-3	2029	99,500,000	5	100	74514L NL 7
2007A-4	2031	96,825,000	6	100	74514L NM 5
2007A-5	2032	100,000,000	7	100	74514L NN 3
2007A-6	2033	50,000,000	8	100	74514L NP 8
2007A-7	2033	50,000,000	9	100	74514L NQ 6
2007A-8	2034	50,000,000	10	100	74514L NR 4
2007A-9	2034	50,000,000	11	100	74514L NS 2

¹ Insured by Assured Guaranty Corp.

² Insured by MBIA Insurance Corporation

³ Insured by Financial Guaranty Insurance Corporation (“FGIC”)

⁴ Term Variable Rate Bonds; insured by Financial Security Assurance Inc. (“FSA”); JPMorgan Chase Bank, National Association (“JPMorgan”), Initial Liquidity Facility Provider; Lehman Brothers Inc. (“Lehman”), Remarketing Agent

⁵ Term Variable Rate Bonds; insured by FSA; Dexia Credit Local, New York Branch (“Dexia”), Initial Liquidity Facility Provider; UBS Securities LLC (“UBS”), Remarketing Agent

⁶ Term Variable Rate Bonds; insured by FSA; Dexia, Initial Liquidity Facility Provider; UBS, Remarketing Agent

⁷ Term Variable Rate Bonds; insured by FGIC; JPMorgan, Initial Liquidity Facility Provider; Morgan Stanley & Co. Incorporated (“Morgan Stanley”), Remarketing Agent

⁸ Term Auction Rate Securities; insured by Assured; UBS, Broker-Dealer

⁹ Auction Rate Securities; insured by Assured; UBS, Broker-Dealer

¹⁰ Term Auction Rate Securities; insured by Assured; Lehman, Broker-Dealer

¹¹ Auction Rate Securities; insured by Assured; Morgan Stanley, Broker-Dealer

The interest rates on the Bonds maturing July 1 of the years 2029, 2031 and 2032 (collectively, the “Variable Rate Demand Obligations”) will be determined by the Underwriters shown on the cover of this Official Statement on October 15, 2007 (October 16, 2007 in respect of subseries 2007A-3 and 2007A-4), and effective on the Variable Rate Bonds on October 16, 2007, and such rates shall be the lowest rates that in the sole judgment of the Underwriters would be necessary to market the respective Variable Rate Bonds at par on October 16, 2007 for the period ending October 16, 2007 (October 24, 2007 in respect of subseries 2007A-2 and 2007A-5). The interest rate on the Bonds maturing July 1 of the years 2033 and 2034 (collectively, the “Auction Rate Securities”) will be determined by the Underwriters on October 15, 2007, and such rate shall be the lowest rate that in the sole judgment of the Underwriters would be necessary to market the Auction Rate Securities at par for the period ending October 22, 2007 in respect of subseries 2007A-6 above, October 25, 2007 in respect of subseries 2007A-7 above, October 24, 2007 in respect of subseries 2007A-8 above and October 23, 2007 in respect of subseries 2007A-9 above.

Commonwealth of Puerto Rico

Governor

ANÍBAL ACEVEDO VILÁ

Members of the Cabinet

JORGE P. SILVA-PURAS
Chief of Staff

FERNANDO J. BONILLA
Secretary of State

ROBERTO J. SÁNCHEZ RAMOS
Secretary of Justice

JUAN C. MÉNDEZ TORRES
Secretary of the Treasury

RAFAEL ARAGUNDE TORRES
Secretary of Education

ROMÁN M. VELASCO GONZÁLEZ
*Secretary of Labor and
Human Resources*

ROSA PÉREZ PERDOMO
Secretary of Health

SALVADOR RODRÍGUEZ
Acting Secretary of Agriculture

CARLOS GONZÁLEZ MIRANDA
*Secretary of Transportation
and Public Works*

RICARDO RIVERA CARDONA
*Secretary of Economic
Development and Commerce*

FÉLIX MATOS
Secretary of Family Affairs

JORGE RIVERA JIMÉNEZ
Secretary of Housing

JAVIER VÉLEZ AROCHO
*Secretary of Natural and
Environmental Resources*

VÍCTOR SUÁREZ
*Acting Secretary of
Consumer Affairs*

DAVID E. BERNIER RIVERA
Secretary of Sports and Recreation

MIGUEL A. PEREIRA
*Secretary of Corrections
and Rehabilitation*

Legislative Officers

KENNETH D. MCCLINTOCK
President, Senate

JOSÉ F. APONTE
Speaker, House of
Representatives

Fiscal Officers

JOSÉ GUILLERMO DÁVILA
Director, Office of
Management and Budget

JORGE IRIZARRY HERRÁNS
Acting President,
Government Development
Bank for Puerto Rico

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No dealer, broker, sales representative or other person has been authorized by the Commonwealth 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 Commonwealth. 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, by any person in any jurisdiction in which it is unlawful for such person to make such an offer, solicitation or sale. The information set forth herein has been obtained from the Commonwealth and other official sources that are believed to be reliable. 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 Commonwealth since the date hereof. 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 THE OFFERING OF THE BONDS, THE UNDERWRITERS MAY EFFECT TRANSACTIONS WHICH STABILIZE OR MAINTAIN THE MARKET PRICES OF THE BONDS, AS WELL AS THE OUTSTANDING GENERAL OBLIGATION BONDS OF THE COMMONWEALTH, 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 COMMONWEALTH OF PUERTO RICO. IN THIS RESPECT, THE WORDS “ESTIMATES”, “PROJECTS”, “ANTICIPATES”, “EXPECTS”, “INTENDS”, “BELIEVES” AND SIMILAR EXPRESSIONS ARE INTENDED TO IDENTIFY FORWARD-LOOKING STATEMENTS. ALL PROJECTIONS, FORECASTS, ASSUMPTIONS, EXPRESSIONS OF OPINIONS, ESTIMATES AND OTHER FORWARD-LOOKING STATEMENTS ARE EXPRESSLY QUALIFIED IN THEIR ENTIRETY BY THIS CAUTIONARY STATEMENT: ACTUAL RESULTS MAY DIFFER MATERIALLY FROM THOSE EXPRESSED OR IMPLIED BY FORWARD-LOOKING STATEMENTS.

Other than with respect to information concerning Financial Security Assurance Inc. (“FSA”) contained under the caption *Bond Insurance* and *Appendix VI* specimen “Municipal Bond Insurance Policy” herein, none of the information in this Official Statement has been supplied or verified by FSA and FSA makes no representation or warranty, express or implied, as to (i) the accuracy or completeness of such information; (ii) the validity of the Bonds; or (iii) the tax exempt status of the interest on the Bonds.

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\$926,570,000
COMMONWEALTH OF PUERTO RICO
Public Improvement Refunding Bonds, Series 2007A
(General Obligation Bonds)

INTRODUCTORY STATEMENT

This Official Statement of the Commonwealth of Puerto Rico (the “Commonwealth” or “Puerto Rico”), which includes the cover page, the inside cover page, the table of contents and the appendices, provides certain information in connection with the sale of \$926,570,000 Commonwealth of Puerto Rico Public Improvement Refunding Bonds, Series 2007A (the “Bonds”).

The Bonds are being issued under the provisions of Act No. 2 of the Legislature of Puerto Rico, approved October 10, 1985, and Joint Resolution No. 57 of the Legislature of Puerto Rico, approved July 12, 1993 (collectively, the “Act”), and pursuant to a resolution authorizing the issuance of the Bonds (the “Bond Resolution”) adopted in accordance with the Act by the Secretary of the Treasury of the Commonwealth of Puerto Rico (the “Secretary” or the “Secretary of the Treasury”) and approved by the Governor of Puerto Rico on October 3, 2007. Concurrently with the issuance of the Bonds, the Commonwealth is issuing its \$60,545,000 Commonwealth of Puerto Rico Public Improvement Refunding Bonds, Series 2007B (the “2007B Bonds”), under the provisions of the Act.

Bond Insurance. The Bonds maturing July 1, 2017 in the principal amount of \$24,940,000 and the Bonds maturing July 1 of the years 2033 and 2034 (the “Assured Insured Bonds”) are insured under a financial guaranty insurance policy (the “Assured Insurance Policy”) issued by Assured Guaranty Corp. (“Assured”). The Bonds maturing July 1 of the years 2019 and 2020 (the “MBIA Insured Bonds”) are insured under a financial guaranty insurance policy (the “MBIA Insurance Policy”) issued by MBIA Insurance Corporation (“MBIA”). The Bonds maturing July 1 of the years 2021, 2022 and 2032 (the “FGIC Insured Bonds”) are insured under a municipal bond new issue insurance policy (the “FGIC Insurance Policy”) issued by Financial Guaranty Insurance Company (“FGIC”). The Bonds maturing July 1 of the years 2029 and 2031 (the “FSA Insured Bonds; and together with the Assured Insured Bonds, the MBIA Insured Bonds and the FGIC Insured Bonds, the “Insured Bonds”) are insured under a municipal bond insurance policy (the “FSA Insurance Policy”; and together with the Assured Insurance Policy, the MBIA Insurance Policy and the FGIC Insurance Policy, the “Insurance Policies” or the “Policies”) issued by Financial Security Assurance Inc. (“FSA”; and together with Assured, MBIA, FGIC, the “Insurers” or the “Bond Insurers”).

Variable Rate Demand Obligations, Auction Rate Securities and Interest Rate Swaps. The Bonds maturing after July 1, 2022 (subseries 2007A-2 through 2007A-9 as listed on the inside cover page of this Official Statement) are herein collectively called the “Variable Rate Bonds”, the Variable Rate Bonds maturing on July 1 of the years 2029, 2031 and 2032 (subseries 2007A-2 through 2007A-5 similarly listed) are herein collectively called the “Variable Rate Demand Obligations” and the Variable Rate Bonds maturing July 1 of the years 2033 and 2034 (subseries 2007A-6 through 2007A-9 as similarly listed) are herein collectively called the

“Auction Rate Securities”. Banco Popular de Puerto Rico, San Juan, Puerto Rico, will serve as tender agent for the Variable Rate Demand Obligations (the “Tender Agent”) and Wells Fargo Bank, National Association will serve as auction agent for the Auction Rate Securities (the “Auction Agent”).

In connection with the Variable Rate Demand Obligations maturing July 1, 2029 in the principal amount of \$99,450,000 and the Variable Rate Demand Obligations maturing July 1, 2032, the Commonwealth and JPMorgan Chase Bank, National Association (“JPMorgan”) will enter into separate standby bond purchase agreements (collectively, the “JPMorgan Liquidity Agreement”), and in connection with the remaining Variable Rate Demand Obligations, the Commonwealth and Dexia Credit Local, acting through its New York Branch (“Dexia” and together with JPMorgan, the “Initial Liquidity Facility Providers” and individually, an “Initial Liquidity Facility Provider”), will enter into separate standby bond purchase agreements (collectively, the “Dexia Liquidity Agreement” and together with the JPMorgan Liquidity Agreement, the “Initial Liquidity Facilities”). Dexia is an affiliate of FSA.

Also in connection with the Variable Rate Demand Obligations, Lehman Brothers Inc. (“Lehman”) will serve as remarketing agent for the Variable Rate Demand Obligations maturing July 1, 2029 in the principal amount of \$99,450,000 under a remarketing agreement with the Commonwealth (the “Lehman Remarketing Agreement”), UBS Securities LLC (“UBS”) will serve as remarketing agent for the Variable Rate Demand Obligations maturing July 1, 2029 in the principal amount of \$99,500,000 and July 1, 2031 under a remarketing agreement with the Commonwealth (the “UBS Remarketing Agreement”) and Morgan Stanley & Co. Incorporated (“Morgan Stanley”) will serve as remarketing agent for the Variable Rate Demand Obligations maturing July 1, 2032 under a remarketing agreement with the Commonwealth (the “Morgan Remarketing Agreement”; and together with the Lehman Remarketing Agreement and the UBS Remarketing Agreement, the “Remarketing Agreements” and Lehman, Morgan Stanley and UBS in such context together, the “Remarketing Agents” and individually, a “Remarketing Agent”), and in order effectively to fix the interest cost to the Commonwealth of said Variable Rate Demand Obligations, the Commonwealth has signed confirmations under master interest rate exchange agreements (collectively the “Master Agreements” and individually, a “Master Agreement”) evidencing interest rate swaps with affiliates of each of Lehman, Morgan Stanley and UBS (collectively, the “VRDO Interest Rate Swaps”).

The Auction Rate Securities are being issued with interest rates that will be established through the implementation of periodic auction procedures. UBS will serve as broker-dealer for subseries 2007A-6 and 2007A-7 of the Auction Rate Securities, Lehman will serve as broker-dealer for subseries 2007A-8 of the Auction Rate Securities and Morgan Stanley will serve as broker-dealer for subseries 2007A-9 of the Auction Rate Securities (collectively, the “Broker-Dealers”), and each will execute separate broker-dealer agreements (individually a “Broker-Dealer Agreement” and collectively, the “Broker-Dealer Agreements”) with the Commonwealth in connection therewith. In order effectively to fix the interest cost to the Commonwealth of said Auction Rate Securities, the Commonwealth has signed confirmations under the Master Agreements evidencing interest rate swaps with affiliates of each of Lehman, Morgan Stanley and UBS (collectively, the “ARS Interest Rate Swaps” and together with the VRDO Interest Rate Swaps, the “Interest Rate Swaps” and in reference to the Interest Rate Swaps, Lehman,

Morgan Stanley and UBS are collectively referred to as the “Swap Providers” and individually, as a “Swap Provider”).

Reference is made to the Bond Resolution for the complete terms of the Bonds (including the terms of the Variable Rate Demand Obligations and Auction Rate Securities, each as defined herein), and terms used in this Official Statement and not defined herein have the respective meanings given to them in the Bond Resolution, copies of which may be obtained by contacting Director – New York Office, Government Development Bank for Puerto Rico, 666 Fifth Avenue, 15th Floor, New York, New York 10103-1599, telephone number (212) 422-6420, or to Director – General Obligations Division, Government Development Bank for Puerto Rico, P.O. Box 42001, San Juan, Puerto Rico 00940, telephone number (787) 722-7060.

Security. Under the Act, the good faith, credit and taxing power of the Commonwealth are irrevocably pledged for the prompt payment of the principal of and interest on the Bonds. The Constitution of Puerto Rico provides that public debt of the Commonwealth, which includes the Bonds, constitutes a first claim on available Commonwealth resources.

Additional Documents. This Official Statement includes the Commonwealth’s Financial Information and Operating Data Report, dated July 1, 2007 (the “Commonwealth Report”), attached hereto as *Appendix I*, and incorporates by reference 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 the Commonwealth (the “Commonwealth’s Annual Financial Report”). The Commonwealth Report attached hereto as *Appendix I* includes important operating and financial information about the Commonwealth, including information about its economy, historical revenues and expenditures of its General Fund, the estimated year-end results of fiscal year 2007, the budget for fiscal years 2007 and 2008, and the debt of the Commonwealth’s public sector, and should be read in its entirety and in conjunction with the *Recent Developments* herein. The Commonwealth’s Annual Financial Report includes the basic financial statements of the Commonwealth as of and for the fiscal year ended June 30, 2006, together with the independent auditor’s report thereon, dated August 1, 2007, of KPMG LLP, certified public accountants. KPMG LLP did not audit the financial statements of the Public Buildings Authority capital project fund or the Children’s Trust special revenue funds (major funds), and certain activities, funds and component units separately identified in its report. Those financial statements were audited by other auditors whose reports have been furnished to KPMG LLP, and its opinion as to the basic financial statements, insofar as it relates to the amounts included in the basic financial statements pertaining to such activities, funds and component units, is based solely on the reports of the other auditors. The report of KPMG LLP contains an emphasis paragraph for the adoption of Governmental Accounting Standards Board (“GASB”) Statement No. 42, *Accounting and Financial Reporting for Impairment of Capital Assets and for Insurance Recoveries*, as of June 30, 2006. The Commonwealth’s Annual Financial Report has been filed by the Commonwealth with each nationally recognized municipal securities information repository (“NRMSIR”).

Any appendix of an Official Statement of the Commonwealth or of any instrumentality of the Commonwealth containing any revision to the Commonwealth Report or to the Commonwealth’s Annual Financial Report that is filed with each NRMSIR and the Municipal Securities Rulemaking Board, or any new or revised Commonwealth Report or Commonwealth

Annual Financial Report or other document containing information that modifies or supersedes the information contained in the Commonwealth Report or in the Commonwealth's Annual Financial Report that is filed with each NRMSIR, in each case after the date hereof and prior to the termination of the offering of the Bonds, shall be deemed to be incorporated by reference into this Official Statement and to be part of this Official Statement from the date of filing of such document. Any statement contained in the Commonwealth's Annual Financial Report 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 such subsequently filed document modifies or supersedes such statement. Any statement contained in the Commonwealth Report or elsewhere herein shall also be deemed to be modified or superseded to the extent that a statement contained in any such 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.

Under its existing continuing disclosure agreements, the Commonwealth is obligated to file on or before May 1 in each year updates of its financial and demographic information through the end of the prior fiscal year, including the Commonwealth's Annual Financial Report. In the recent past, the Commonwealth has been unable, due to accounting rules changes and other reasons (mostly related to delays in receipt of component units' audited financial statements), to file the Commonwealth's Annual Financial Report by the May 1 continuing disclosure update filing deadline. Due to the fact that the Aqueduct and Sewer Authority did not complete and deliver to the Commonwealth's independent auditors in a timely manner said component unit's audited financial statements for the fiscal year ended June 30, 2006, this year the Commonwealth was unable to meet its May 1 deadline in respect of the Commonwealth's Annual Financial Report. The Commonwealth's Annual Financial Report was filed with each NRMSIR on August 16, 2007, and an amended and restated version thereof was filed with each NRMSIR on September 13, 2007.

The Commonwealth will provide without charge to any person to whom this Official Statement is delivered, on the written or oral request of such person, a copy of the Commonwealth's Annual Financial Report incorporated herein by reference. Requests should be directed to Director – New York Office, Government Development Bank for Puerto Rico, 666 Fifth Avenue, 15th Floor, New York, New York 10103-1599, telephone number (212) 422-6420, or to Director – General Obligations Division, Government Development Bank for Puerto Rico, P.O. Box 42001, San Juan, Puerto Rico 00940, telephone number (787) 722-7060.

A copy of the Commonwealth's Annual Financial Report may also be obtained by contacting a NRMSIR. The address of each NRMSIR is set forth in *Continuing Disclosure* below.

OVERVIEW

Puerto Rico is located approximately 1,600 miles southeast of New York City. According to the United States Census Bureau, its population was 3,808,610 in 2000. Puerto Rico's political status is that of a commonwealth. The United States and the Commonwealth share a common defense, market, currency and citizenship. The Commonwealth government exercises virtually the same control over its internal affairs as is exercised by the state

governments of each of the fifty states over their respective internal affairs, with similar separation of powers among the executive, legislative and judicial branches. It differs from the states, however, in its relationship with the federal government. The people of Puerto Rico are citizens of the United States but do not vote in national elections. They are represented in Congress by a Resident Commissioner who has a voice in the House of Representatives but no vote. Most federal taxes, except those such as Social Security taxes, which are imposed by mutual consent, are not levied in Puerto Rico. No federal income tax is collected from Puerto Rico residents on income earned in Puerto Rico, except for certain federal employees who are subject to taxes on their salaries. The official languages of Puerto Rico are Spanish and English.

Puerto Rico has a diversified economy with manufacturing and services comprising its principal sectors. Puerto Rico's economy is closely linked to the United States economy. In fiscal year 2006 (which ended on June 30, 2006), the Commonwealth's gross product (preliminary, in current dollars) was \$56.688 billion, and personal income per capita (preliminary, in current dollars) was \$12,997.

The Constitution of Puerto Rico limits the amount of general obligation debt that the Commonwealth can issue. The Commonwealth's policy has been and continues to be to maintain the level of such debt within a prudent range below the constitutional limitation.

Fiscal responsibility for the Commonwealth is shared among the Department of the Treasury, the Office of Management and Budget ("OMB") and Government Development Bank for Puerto Rico ("Government Development Bank" or the "Bank"). The Department of the Treasury is responsible for collecting most of the Commonwealth's revenues, overseeing preparation of its financial statements and contributing to the preparation of the budget. OMB prepares the Commonwealth's budget and is responsible for monitoring expenditures. Government Development Bank is the fiscal agent and financial advisor to the Commonwealth and its agencies, public corporations and municipalities and coordinates the management of public finances.

Additional information about the Commonwealth can be found in the Commonwealth Report attached hereto as *Appendix I*, including information about the economy, historical revenues and expenditures of the Commonwealth's General Fund, the year-end results of fiscal year 2006, the estimated year-end results for fiscal year 2007 and the approved budget for fiscal year 2008, and the debt of the Commonwealth's public sector. The Commonwealth Report should be read in its entirety.

RECENT DEVELOPMENTS

This section supplements the information appearing in the Commonwealth Report and should be read in conjunction therewith.

Under Act No. 117 of the Legislature of Puerto Rico, approved on July 4, 2006, as amended (the "Sales Tax Act"), a general sale and use tax of 5½% is imposed by the central government (the "Central Government Sales Tax") and of 1½% is imposed by each municipality (the "Municipal Sales Tax" and, together with the Central Government Sales Tax, the "Sales Tax"). In general, the Municipal Sales Tax has the same tax base, exemptions (except for

unprocessed foods) and limitations as those contained in the Central Government Sales Tax. The Sales Tax Act also provides certain income tax reductions to address the regressive effect of the Sales Tax on taxpayers in lower income brackets.

Pursuant to Act No. 91 of the Legislature of Puerto Rico, approved on May 13, 2006, as amended (the “Sales Tax Financing Corporation Act”), Puerto Rico Sales Tax Financing Corporation (the “Sales Tax Financing Corporation”) was created for the purpose of refinancing certain debt obligations of the Commonwealth outstanding as of June 30, 2006, which obligations are payable solely from Commonwealth budgetary appropriations and are generally referred to as “extra constitutional debt”. Under the Sales Tax Financing Corporation Act, 1% of the 5 ½% Central Government Sales Tax (subject to an annually inflated minimum amount, if greater) is deposited by the Secretary of the Treasury upon receipt into the dedicated sales tax fund (the “Sales Tax Fund”), which is held and owned by the Sales Tax Financing Corporation separate and apart from the Commonwealth’s General Fund. Amounts on deposit in the Sales Tax Fund are applied to the payment of debt issued by the Sales Tax Financing Corporation to refinance the aforementioned extra constitutional debt outstanding. On July 31, 2007, the Sales Tax Financing Corporation issued \$2,667,603,572.60 Sales Tax Revenue Bonds, Series 2007A and \$1,333,101,779.90 Sales Tax Revenue Bonds, Series 2007B (collectively, the “Sales Tax Bonds”), the proceeds of which were used as the first installment in the refinancing of the Commonwealth’s extra constitutional debt.

The Commonwealth expects to issue on or about October 4, 2007, \$408,800,000 of its Public Improvement Bonds of 2007, Series A, and \$91,200,000 of its Public Improvement Bonds of 2007, Series B. The proceeds of these bonds will be used by the Commonwealth to defray a portion of the cost of various public works throughout the Commonwealth.

PLAN OF FINANCING

The Bonds, together with the 2007B Bonds, are being issued for the purpose of refunding the following general obligation bonds of the Commonwealth (the “Refunded Bonds”):

Public Improvement Bonds	Principal Amount to be Refunded	Interest Rate	Maturity Date July 1,	Redemption Date July 1,	Redemption Price (% of Par)
Series 1993*	\$12,070,000	9 %	2008	NA	NA
1995	8,975,000	6¼	2008	NA	NA
1995	830,000	6¼	2009	NA	NA
1996	8,815,000	6½	2008	NA	NA
1997	9,870,000	6¼	2008	NA	NA
1997	5,450,000	5.70	2009	NA	NA
1998	11,845,000	5¾	2008	NA	NA
1998	12,525,000	5¾	2009	NA	NA
1998	19,775,000	5	2017	2008	101
1998	20,765,000	5	2018	2008	101
1998	119,175,000	4⅞	2023	2008	101
Series 1998B*	9,710,000	5¾	2008	N/A	N/A
1999	11,005,000	5	2008	NA	NA
1999	19,295,000	4¾	2023	2008	101
1999	19,485,000	5	2028	2008	101
2000	3,855,000	5	2008	NA	NA
2000	10,760,000	5	2009	NA	NA
2001 Series B	11,700,000	4.70	2014	2011	100
2001 Series B	6,625,000	4.80	2015	2011	100
2001 Series B	2,525,000	4.90	2016	2011	100
2001 Series B	4,245,000	4.95	2017	2011	100
2001 Series B	9,255,000	5	2018	2011	100
2001 Series B	2,200,000	5.05	2019	2011	100
2001 Series B	365,000	5.05	2020	2011	100
2001 Series B	530,000	5.05	2021	2011	100
2001 Series B	770,000	5	2021	2011	100
Series 2002*	53,105,000	5	2008	N/A	N/A
Series 2002 A*	1,835,000	3¾	2009	NA	NA
2003 Series A	9,255,000	5¼	2008	NA	NA
2003 Series A	9,740,000	5¼	2009	NA	NA
2003 Series A	10,250,000	4¾	2010	NA	NA
2003 Series A	12,550,000	5½	2014	NA	NA
2003 Series A	12,315,000	5½	2015	NA	NA
2004 Series A	4,725,000	5	2008	NA	NA
2004 Series A	6,040,000	5	2009	NA	NA
2004 Series A	12,825,000	5¼	2017	2013	100
2004 Series A	12,005,000	5¼	2019	2013	100
2004 Series A	3,000,000	2½	2008	NA	NA
2004 Series A	2,000,000	2⅞	2009	NA	NA
2004 Series A	3,000,000	4	2014	2013	100
2004 Series A	81,590,000	5	2033	2013	100
2005 Series A	14,275,000	5	2017	2014	100
2005 Series A	94,655,000	5	2034	2014	100
2006 Series A	19,670,000	5¼	2027	2016	100

Public Improvement Bonds	Principal Amount to be Refunded	Interest Rate	Maturity Date July 1,	Redemption Date July 1,	Redemption Price (% of Par)
2006 Series A	79,410,000	5¼	2030	2016	100
Series 2006 B*	86,075,000	5¼	2032	2016	100
Series 2006 B*	121,340,000	5	2035	2016	100

* Public Improvement Refunding Bonds

The Secretary of the Treasury will deposit the net proceeds of the Bonds and the 2007B Bonds and certain other available moneys into two escrow funds (collectively, the “Escrow Fund”) with Banco Popular de Puerto Rico (the “Escrow Agent”). Said net proceeds and other available moneys will be invested in noncallable direct obligations of the United States, the principal of and interest on which will be sufficient to pay the principal of and premium, if any, on the Refunded Bonds on the redemption or maturity dates mentioned above, which dates will be irrevocably designated by the Secretary of the Treasury, and to pay the interest thereon to such redemption or maturity dates.

Upon the deposit with the Escrow Agent referred to above, the Refunded Bonds will cease to be outstanding under the terms of their respective authorizing resolutions. Under the Act, once the above deposit of cash and noncallable direct obligations of the United States has been made, all the Refunded Bonds will be deemed not to be outstanding for the purpose of applying the debt limitation under Section 2 of Article VI of the Commonwealth’s Constitution.

The sufficiency of the amount so deposited, with investment earnings thereon, to accomplish the refunding of the Refunded Bonds referred to above, will be verified by Causey Demgen & Moore Inc. (the “Verification Agent”).

Sources and Uses of Funds[†]

Sources:

Principal amount of the Bonds	\$ 926,570,000
Principal amount of the 2007B Bonds.....	\$ 60,545,000
Net original issue premium.....	35,711,612
Moneys from Redemption Fund.....	49,400,192
Total sources	<u>\$1,072,226,804</u>

Uses:

Deposit into the Escrow Fund for Refunded Bonds	\$1,043,875,393
Underwriting discount, bond insurance premiums, legal, printing, and other financing expenses	28,351,411
Total uses.....	<u>\$1,072,226,804</u>

[†] Amounts rounded to nearest dollar.

Standby Bond Purchase Agreements

In connection with the Variable Rate Demand Obligations, the Commonwealth will enter into the Initial Liquidity Facilities, whereby, unless certain events have occurred, each of the Initial Liquidity Facility Providers will be required to purchase the Variable Rate Demand Obligations to which its Initial Liquidity Facility relates which Demand Obligations are optionally or mandatorily tendered by their Owners and are not remarketed. THE INITIAL LIQUIDITY FACILITY PROVIDER'S OBLIGATION TO PURCHASE VARIABLE RATE DEMAND OBLIGATIONS IS TERMINATED OR SUSPENDED AUTOMATICALLY UNDER CERTAIN CIRCUMSTANCES WITH NO OPPORTUNITY FOR THE HOLDERS OF SUCH DEMAND OBLIGATIONS TO TENDER THEM PRIOR TO SUCH TERMINATION OR SUSPENSION. If the obligation of an Initial Liquidity Facility Provider to purchase Variable Rate Demand Obligations under its Initial Liquidity Facility has been terminated or suspended prior to, or the conditions to such obligation are not satisfied as of, the date on which the payment of the purchase price of such Demand Obligations is required, funds to pay such purchase price will not be available under such Initial Liquidity Facility. See "THE BONDS – Purchase of the Variable Rate Demand Obligations". THE COMMONWEALTH IS NOT OBLIGATED TO PURCHASE VARIABLE RATE DEMAND OBLIGATIONS IN THE EVENT THAT PAYMENTS ARE NOT MADE UNDER A LIQUIDITY FACILITY. See "Liquidity Facility" under *The Bonds*.

Interest Rate Swaps

The Commonwealth will enter into the Interest Rate Swaps with the Swap Providers in accordance with and meeting the requirements of Act No. 39 of the Legislature of Puerto Rico, approved August 1, 2005 as amended ("Act No. 39 of 2005"), pursuant to each of which (i) the Commonwealth will pay a fixed amount to the applicable Swap Provider at an effective rate that approximates a fixed rate borrowing with respect to the Variable Rate Bonds to which its Interest Rate Swap relates, and (ii) such Swap Provider will pay a variable amount to the Commonwealth based on LIBOR and an aggregate notional amount equal to the corresponding principal amount of the related Variable Rate Bonds. The notional amounts of the Interest Rate Swaps will amortize in accordance with the principal amortization of the Variable Rate Bonds to which such Swaps relate.

Under the terms of the Interest Rate Swaps, which are expected to terminate on the maturity of the applicable Variable Rate Bonds, they may be terminated by the Commonwealth at any time at their then current market value(s). The underlying Master Agreements may also be terminated upon the occurrence of certain credit events. If a termination event occurs due to a credit event, the Commonwealth may be obligated to pay to the applicable Swap Provider an amount based on the terminating Swap's market value that may be substantial.

The Commonwealth's obligations under the Interest Rate Swaps will be insured by FSA in respect of a portion of the Interest Rate Swaps relating to the Variable Rate Bonds of subseries 2007A-2 through 2007A-4, and Assured in respect of a portion of the Interest Rate Swaps relating to the Auction Rate Securities subseries 2007A-8 and 2007A-9, and the obligations of the Commonwealth under the Interest Rate Swaps are also secured, by virtue of the provisions of Act No. 39 of 2005, by the full faith, credit and taxing power of the Commonwealth.

THE BONDS

General

The Bonds will be dated, bear interest at such rates, and mature on the dates and in the principal amounts set forth on the cover and inside cover page of this Official Statement. Interest on the Bonds maturing before July 1, 2023 will be payable semi-annually on January 1 and July 1, beginning on January 1, 2008, and interest on the Variable Rate Bonds will initially be payable monthly as described under “Description of the Variable Rate Bonds.” The Bonds are subject to redemption at the times and at the prices set forth below in “Redemption”. Banco Popular de Puerto Rico will serve as paying agent and registrar (the “Registrar”) for the Bonds.

Description of the Variable Rate Bonds

The following is a summary of certain provisions of the Variable Rate Bonds. Reference is made to the Variable Rate Bonds for their complete text and to the Bond Resolution for a more detailed description of the provisions of the Variable Rate Bonds.

General. As more fully described below, the Variable Rate Bonds maturing July 1, 2029 (subseries 2007A-3) and 2031 (subseries 2007A-4) will be issued initially to bear interest at the Daily Interest Rate (the “Daily Interest Rate”) for a Daily Interest Rate Period (a “Daily Interest Rate Period”), the Variable Rate Bonds maturing July 1, 2029 (subseries 2007A-2) and 2032 (subseries 2007A-5) will be issued initially to bear interest at the Weekly Interest Rate (the “Weekly Interest Rate”) for a Weekly Interest Rate Period (a “Weekly Interest Rate Period”) and the remaining Variable Rate Bonds (subseries 2007A-6 through 2007A-9) will be issued initially as Auction Rate Securities, all in the respective aggregate principal amounts specified on the inside cover page of this Official Statement. At the direction of the Commonwealth, from time to time, a subseries of the Variable Rate Bonds may be converted in whole, from an Interest Rate Period to another Interest Rate Period, including the Daily Interest Rate Period, the Weekly Interest Rate Period, the Long-Term Interest Rate Period (the “Long-Term Interest Rate Period”), the Short-Term Interest Rate Period (the “Short-Term Interest Rate Period”), the ARS Rate Period (the “ARS Rate Period”) and the Indexed Put Interest Rate Period (the “Indexed Put Interest Rate Period”). *This Official Statement provides information concerning the Variable Rate Bonds while bearing interest at a Daily Interest Rate, a Weekly Interest Rate (“Weekly Interest Rate”) or an Auction Period Rate (“Auction Period Rate”). There are significant differences in the terms of the Variable Rate Bonds if they are bearing interest at a Long-Term Interest Rate (the “Long-Term Interest Rate”), a Bond Interest Term Rate during each Bond Interest Term in a Short-Term Interest Rate Period (the “Bond Interest Term Rate”), or the Indexed Put Rate (the “Indexed Put Rate”). This Official Statement does not provide information with respect to the Variable Rate Bonds other than Variable Rate Bonds in a Daily Interest Rate Period, a Weekly Interest Rate Period or an ARS Rate Period.*

The Variable Rate Bonds are issuable initially in the form of fully registered bonds without coupons in the denomination of \$100,000 or multiples of \$5,000 in excess thereof, except that the Auction Rate Securities will be in the denomination of \$25,000 or any multiple thereof. As described below under the caption “Book-Entry Only System”, when issued, the

Variable Rate Bonds will be registered in the name of Cede & Co., as Bondholder and nominee of The Depository Trust Company (“DTC”), New York, New York, which will act as securities depository for the Variable Rate Bonds.

Interest Payment. All Variable Rate Bonds of a subseries shall initially bear interest at the same interest rate. Variable Rate Bonds bearing interest at the Daily Interest Rate, Weekly Interest Rate or Auction Period Rate shall not, at any time, bear interest in excess of 12% per annum (the “Maximum Bond Interest Rate”). Interest on the Variable Rate Bonds shall be paid on each Interest Payment Date, any redemption date and on the Maturity Date. Variable Rate Bonds in the Daily Interest Rate Period and Weekly Interest Rate Period shall accrue interest on the basis of the actual number of days elapsed during the Interest Rate Period and a year of 365 days (366 in a leap year). The initial Interest Payment Date for interest accrued on the Variable Rate Demand Obligations will be November 1, 2007. Thereafter, the Interest Payment Date for Variable Rate Bonds in the Daily Interest Rate Period and the Weekly Interest Rate Period will be the first Business Day of each calendar month. Interest Payment Dates and Auction Dates for the Auction Rate Securities will generally occur on the days as described in and subject to adjustment pursuant to the provisions of the Bond Resolution and as described in *Appendix III*.

Place of Payment. The principal and Tender Price of and premium, if any, and interest on the Variable Rate Bonds in the Daily Interest Rate Period, Weekly Interest Rate Period or ARS Rate Period shall be paid by the Registrar by wire transfer of immediately available funds to the respective Holders thereof on the applicable Record Date to an account specified by the Holder thereof in a writing delivered to the Registrar.

Remarketing Agents; Tender Agent; Auction Agent. Lehman, Morgan Stanley and UBS have been appointed Remarketing Agents for the Variable Rate Demand Obligations (UBS will serve as Remarketing Agent in respect of subseries 2007A-3 and 2007A-4 of the Variable Rate Bonds, Lehman will serve as Remarketing Agent in respect of subseries 2007A-2 of the Variable Rate Bonds, and Morgan Stanley will serve as Remarketing Agent in respect of subseries 2007A-5 of the Variable Rate Bonds), Banco Popular de Puerto Rico will serve as Tender Agent for such four subseries, and Wells Fargo Bank, National Association will serve as Auction Agent for the Auction Rate Securities (subseries 2007A-6 through 2007A-9 of the Variable Rate Bonds). All determinations for the Variable Rate Bonds of interest rates shall be conclusive and binding upon the Commonwealth, the Registrar, the Tender Agent, the Auction Agent, the Remarketing Agents, the Liquidity Facility Providers and the Variable Rate Bondholders, as applicable. At the direction of the Commonwealth a subseries of Variable Rate Bonds may be converted, in whole, from one Interest Rate Period to another Interest Rate Period.

Daily Interest Rate and Daily Interest Rate Period. During each Daily Interest Rate Period, the Variable Rate Bonds or any subseries of Variable Rate Bonds shall bear interest at the Daily Interest Rate, which shall be determined by the applicable Remarketing Agent on each Business Day for such Business Day.

The Daily Interest Rate shall be the rate of interest per annum determined by such Remarketing Agent (based on an examination of tax-exempt obligations comparable, in the judgment of the Remarketing Agent, to the Variable Rate Bonds and known by such Remarketing Agent to have been priced or traded under then-prevailing market conditions) on or

before 10:30 a.m., New York City time, on a Business Day to be the minimum interest rate which, if borne by such Bonds, would enable such Remarketing Agent to sell all of such Bonds on such Business Day at a price (without regard to accrued interest) equal to the principal amount thereof. The Daily Interest Rate for any day which is not a Business Day shall be the same as the Daily Interest Rate for the immediately preceding Business Day. If for any reason a Daily Interest Rate for the Variable Rate Bonds or any subseries of the Variable Rate Bonds is not so established for any Business Day by the applicable Remarketing Agent, the Daily Interest Rate for such Business Day shall be equal to the Index.

Weekly Interest Rate and Weekly Interest Rate Period. During each Weekly Interest Rate Period, the Variable Rate Bonds or any subseries of the Variable Rate Bonds shall bear interest at the Weekly Interest Rate, which shall be determined by the applicable Remarketing Agents by 5:00 p.m., New York City time, on Wednesday of each week during the Weekly Interest Rate Period, or if such day is not a Business Day, then on the next succeeding Business Day. The first Weekly Interest Rate for each Weekly Interest Rate Period shall be determined on or prior to the first day of such Weekly Interest Rate Period and shall apply to the period commencing on the first day of such Weekly Interest Rate Period and ending on and including the next succeeding Wednesday. Thereafter, each Weekly Interest Rate shall apply to the period commencing on and including Thursday and ending on and including the next succeeding Wednesday, unless such Weekly Interest Rate Period ends on a day other than Wednesday, in which event the last Weekly Interest Rate for such Weekly Interest Rate Period shall apply to the period commencing on and including the Thursday preceding the last day of such Weekly Interest Rate Period and ending on and including the last day of such Weekly Interest Rate Period.

Each Weekly Interest Rate with respect to the Variable Rate Bonds shall be the rate of interest per annum determined by each of such Remarketing Agents (based on an examination of tax-exempt obligations comparable, in the judgment of the Remarketing Agent, to the Variable Rate Bonds and known by them to have been priced or traded under then-prevailing market conditions) to be the minimum interest rate which, if borne by such Variable Rate Bonds, would enable the applicable Remarketing Agents to sell all of such Variable Rate Bonds on the effective date of that rate at a price (without regard to accrued interest) equal to the principal amount thereof.

If a Remarketing Agent fails to establish a Weekly Interest Rate for any week with respect to the applicable Variable Rate Bonds bearing interest at such rate, then the Weekly Interest Rate for such week with respect to such Variable Rate Bonds shall be equal to the Index. The Registrar shall give notice by first-class mail of a Conversion to a Weekly Interest Rate Period to the Holders of the Variable Rate Bonds or any subseries of Variable Rate Bonds not less than 30 days prior to the proposed effective date of such Weekly Interest Rate Period, in accordance with requirements under the Bond Resolution.

Auction Period Rate and ARS Rate Period. Auction Rate Securities will bear interest at the Auction Period Rate established from time to time for each applicable subseries of the Variable Rate Bonds, as set forth in the Bond Resolution and summarized in *Appendix III – “Definitions and Auction Procedures.”* The Auction Rate Securities shall initially bear interest at the initial rate to be determined immediately prior to the initial delivery of the Auction Rate Securities for the respective initial periods set forth on the inside cover page of this Official

Statement and will then bear interest at an Auction Period Rate for seven-day Auction Periods commencing on October 23, 2007 in respect of the subseries 2007A-6 Auction Rate Securities, on October 26, 2007 in respect of the subseries 2007A-7 Auction Rate Securities, on October 25, 2007 in respect of the subseries 2007A-8 Auction Rate Securities, and on October 24, 2007 in respect of the subseries 2007A-9 Auction Rate Securities.

Conversion Provisions

General. If the Secretary elects to convert the interest rate of a subseries of Variable Rate Bonds, the written direction furnished by the Secretary to the Registrar, the Tender Agent, the applicable Liquidity Facility Providers and Remarketing Agents, the Auction Agent and the applicable Bond Insurers and Broker-Dealers as required shall be made by registered or certified mail, or by telecopy confirmed by registered or certified mail. In connection with any Conversion of the Interest Rate Period for any subseries of Variable Rate Bonds, the Secretary shall have the right to deliver to the Registrar, the Tender Agent, the Auction Agent and the applicable Bond Insurer, Remarketing Agent, Liquidity Facility Provider and Broker-Dealer on or prior to 11:00 a.m., New York City time, on the second Business Day preceding the effective date of any such Conversion a notice to the effect that the Secretary elects to rescind its election to make such Conversion. If such election to convert is rescinded, then the applicable subseries shall bear interest at a Weekly Interest Rate commencing on the date which would have been the effective date of the Conversion, but if such subseries were in a Daily Interest Rate Period immediately prior to such proposed Conversion, then the Variable Rate Bonds of such subseries shall continue to bear interest at the Daily Interest Rate as in effect immediately prior to such proposed Conversion. In any event, if notice of a Conversion has been mailed to the Holders of such Bonds and the Secretary rescinds its election to make such Conversion, then the Variable Rate Bonds of such subseries shall continue to be subject to mandatory tender for purchase on the date which would have been the effective date of the Conversion.

No Conversion from one Interest Rate Period to another shall take effect unless each of the following conditions, to the extent applicable, shall have first been satisfied:

(1) With respect to the new Interest Rate Period, there shall be in effect a Liquidity Facility if and as required under the Bond Resolution.

(2) The Registrar shall have received a Favorable Opinion of Bond Counsel with respect to such Conversion dated the effective date of such Conversion.

(3) In the case of any Conversion with respect to which there shall be no Liquidity Facility in effect to provide funds for the purchase of Variable Rate Bonds or any subseries of Variable Rate Bonds on the Conversion Date, the remarketing proceeds available on the Conversion Date shall not be less than the amount required to purchase all of the Variable Rate Bonds or any subseries of Variable Rate Bonds at the Tender Price (not including any premium).

(4) In the case of any Conversion of any subseries of Variable Rate Bonds from any ARS Rate Period to any other Interest Rate Period (except a Long-Term Interest Rate Period effective to the maturity date of the applicable Variable Rate Bonds or to an Indexed Put Interest Rate Period), prior to the Conversion Date the Secretary shall have appointed a Tender Agent, a

Remarketing Agent and a Liquidity Facility Provider (if a Liquidity Facility meeting the requirements of the Bond Resolution in the Long-Term Interest Rate Period is provided) and there shall have been executed and delivered a Tender Agent Agreement, a Remarketing Agreement and a Liquidity Facility (if a Liquidity Facility meeting the requirements of the Bond Resolution in the Long-Term Interest Rate Period is provided).

(5) In the case of any Conversion of any subseries of Variable Rate Bonds from any Weekly Interest Rate Period, Daily Interest Rate Period, Long-Term Interest Rate Period, Short-Term Interest Rate Period or Indexed Put Interest Rate Period to an ARS Rate Period, prior to the Conversion Date the Secretary shall have appointed an Auction Agent, and one or more Broker-Dealers and there shall have been executed and delivered an Auction Agreement and one or more Broker-Dealer Agreements.

(6) In the case of any Conversion of any subseries of Variable Rate Bonds to any Indexed Put Interest Rate Period, prior to the Conversion Date, the Secretary shall have appointed a Tender Agent and a Remarketing Agent.

In the case of failure to meet these conditions: (1) the Variable Rate Bonds or any subseries of Variable Rate Bonds shall bear interest at a Weekly Interest Rate commencing on the date which would have been the effective date of the Conversion, unless they were Auction Rate Securities right before the proposed conversion in which case they will remain as Auction Rate Securities and shall bear interest and be in an Auction Period as provided in *Appendix III*; and (2) the Variable Rate Bonds or any subseries of Variable Rate Bonds shall continue to be subject to mandatory tender for purchase on the date which would have been the effective date of the Conversion.

Conversion to Daily Interest Rate. The Secretary may, from time to time, by written direction to the Registrar, the Tender Agent, the Auction Agent and the applicable Liquidity Facility Provider, Remarketing Agent, Bond Insurer and Broker-Dealer, elect that a subseries of the Variable Rate Bonds shall bear interest at a Daily Interest Rate. Such direction shall specify, among other things, (1) the proposed effective date of such Conversion to a Daily Interest Rate, which shall be a Business Day not earlier than the 30th day following the second Business Day after receipt by the Registrar of such direction and (2) the Tender Date for the Variable Rate Bonds to be purchased, which shall be such proposed effective date. In addition, such direction shall be accompanied by a form of notice to be mailed to the Holders of the applicable Variable Rate Bonds or any subseries by the Registrar. During each Daily Interest Rate Period for the applicable Variable Rate Bonds commencing on a date so specified and ending on the day immediately preceding the effective date of the next succeeding Interest Rate Period, the interest rate borne by such Bonds shall be a Daily Interest Rate.

Conversion to Weekly Interest Rate. The Secretary may, from time to time, by written direction to the Registrar, the Tender Agent, the Auction Agent and the applicable Liquidity Facility Provider, Remarketing Agent, Bond Insurer and Broker-Dealer, elect that a subseries of Variable Rate Bonds shall bear interest at a Weekly Interest Rate. Such direction shall specify, among other things, (1) the proposed effective date of the Conversion to a Weekly Interest Rate, which shall be a Business Day not earlier than the 30th day following the second Business Day after receipt by the Registrar of such direction and (2) the Tender Date for the Variable Rate

Bonds to be purchased, which shall be such proposed effective date. In addition, such direction shall be accompanied by a form of notice to be mailed to the Holders of the applicable Variable Rate Bonds or any subseries by the Registrar. During each Weekly Interest Rate Period for the applicable Variable Rate Bonds commencing on a date so specified and ending on the day immediately preceding the effective date of the next succeeding Interest Rate Period, the interest rate borne by such Bonds shall be a Weekly Interest Rate.

Conversion to Auction Rate. The Secretary may, from time to time, by written direction to the Registrar, the Tender Agent, the Auction Agent and the applicable Liquidity Facility Provider, Remarketing Agent, Bond Insurer and Broker-Dealer, elect that a subseries of Variable Rate Bonds shall bear interest at an Auction Rate. Such direction shall specify, among other things, the proposed ARS Conversion Date, the length of the Initial Period, the first Auction Date, the first Interest Payment Date following such Conversion Date and the initial Auction Period. During each ARS Rate Period for the applicable Variable Rate Bonds commencing on a date so specified and ending on the day immediately preceding the effective date of the next succeeding Interest Rate Period, the interest rate borne by such Bonds shall be an Auction Period Rate.

Purchase of the Variable Rate Bonds

During Daily Interest Rate Period. Any Variable Rate Bond (other than a Bank Bond) bearing interest at a Daily Interest Rate shall be purchased in an Authorized Denomination from its Bondholder at the option of the Bondholder on any Business Day at a purchase price equal to the Tender Price, payable in immediately available funds, upon delivery to the Tender Agent at its principal office for delivery of applicable Variable Rate Bonds, to the Registrar at its corporate trust office and to the Remarketing Agent, by no later than 12:00 noon, New York City time, on such Business Day, of an irrevocable notice by Electronic Means, which states the principal amount of such Bonds to be purchased and the date of purchase. For payment of such purchase price on the date specified in such notice, such Bonds must be delivered, at or prior to 12:00 noon, New York City time, on such Business Day, to the Tender Agent at its principal office for delivery of applicable Variable Rate Bonds, accompanied by an instrument of transfer thereof, in form satisfactory to such Tender Agent, executed in blank by the Bondholder thereof or its duly-authorized attorney, with such signature guaranteed by a commercial bank, trust company or member firm of the New York Stock Exchange.

During any Daily Interest Rate Period for which the book-entry-only system (see “Book-Entry Only System” herein) is in effect, any Bonds bearing interest at the Daily Interest Rate or portion thereof in an Authorized Denomination shall be purchased on the date specified in the notice referred to below at the Tender Price. The irrevocable notice by Electronic Means by the Participant shall be delivered on any Business Day by the Participant for such Bonds to the Tender Agent at its principal office for the delivery of such Bonds, to the Registrar at its corporate trust office and to the Remarketing Agent prior to 12:00 noon, New York City time. That notice shall state the principal amount of such Bonds or portion thereof to be purchased and the date on which the same shall be purchased. Upon confirmation by the Securities Depository to the Registrar that such Participant has an ownership interest in the applicable Variable Rate Bonds at least equal to the amount of Bonds specified in such irrevocable written notice, payment of the Tender Price of such Bonds shall be made by 4:00 p.m., New York City time, or

as soon as practicably possible thereafter, upon the receipt by the Registrar of the Tender Price on the Business Day specified in the notice upon the transfer on the registration books of the Securities Depository of the beneficial ownership interest in such Bonds tendered for purchase to the account of the Tender Agent, or a Participant acting on behalf of such Tender Agent, at or prior to 2:30 p.m., New York City time, on the date specified in such notice.

During Weekly Interest Rate Period. Any Variable Rate Bond (other than a Bank Bond) bearing interest at a Weekly Interest Rate shall be purchased in Authorized Denominations from its Bondholder at the option of the Bondholder on any Business Day at a purchase price equal to the Tender Price, payable in immediately available funds, upon delivery to the Tender Agent at its principal office for delivery of the Variable Rate Bonds, to the Registrar at its corporate trust office and to the applicable Remarketing Agent of an irrevocable notice by Electronic Means which states the principal amount of such Bonds, the principal amount thereof to be purchased and the date on which the same shall be purchased, which date shall be a Business Day not prior to the seventh day after the date of the delivery of such notice to the Tender Agent. Any notice delivered to the Tender Agent after 5:00 p.m., New York City time, shall be deemed to have been received on the next succeeding Business Day. Bank Bonds may not be tendered for purchase at the option of the Holder thereof. For payment of the Tender Price on the Tender Date, such Bonds must be delivered at or prior to 11:00 a.m., New York City time, on the Tender Date to the Tender Agent at its principal office for delivery of the applicable Variable Rate Bonds accompanied by an instrument of transfer, in form satisfactory to the Tender Agent executed in blank by the Bondholder or its duly-authorized attorney, with such signature guaranteed by a commercial bank, trust company, or member firm of the New York Stock Exchange.

During any Weekly Interest Rate Period for which the book-entry-only system (see “Book-Entry Only System” herein) is in effect, any Variable Rate Bonds bearing interest at the Weekly Interest Rate or portion thereof in an Authorized Denomination shall be purchased on the date specified in the notice referred to below at the Tender Price. The irrevocable notice by Electronic Means by the Participant shall be delivered on any Business Day by the Participant for such Bonds to the Tender Agent at its principal office for the delivery of such Bonds, to the Registrar at its corporate trust office and to the applicable Remarketing Agent. That notice shall state the principal amount of such Bonds or portion thereof to be purchased and the date on which the same shall be purchased, which date shall be a Business Day at least seven days after the date of delivery of such notice to the Registrar. Upon confirmation by the Securities Depository to the Registrar that such Participant has an ownership interest in the applicable Variable Rate Bonds at least equal to the amount of Variable Rate Bonds specified in such irrevocable written notice, payment of the Tender Price of such Bonds shall be made by 4:00 p.m., New York City time, or as soon as practicably possible thereafter, upon the receipt by the Registrar of the Tender Price on the Business Day specified in the notice upon the transfer on the registration books of the Securities Depository of the beneficial ownership interest in such Bonds tendered for purchase to the account of the Tender Agent, or a Participant acting on behalf of such Tender Agent, at or prior to 11:00 a.m., New York City time, on the date specified in such notice.

Mandatory Tender for Purchase on First Day of Each Interest Rate Period. The applicable Variable Rate Bonds shall be subject to mandatory tender for purchase on the first day

of each Interest Rate Period at the Tender Price, payable in immediately available funds. For payment of the Tender Price on the Tender Date, Variable Rate Bonds must be delivered at or prior to 11:00 a.m., New York City time, on the Tender Date. If delivered after that time, the Tender Price shall be paid on the next succeeding Business Day.

Mandatory Tender for Purchase upon Termination, Replacement or Expiration of Liquidity Facility or on Bond Insurance Substitution Date; Mandatory Standby Tender. If at any time the Registrar gives notice that the Tender Price on applicable Variable Rate Bonds tendered for purchase shall cease to be subject to purchase pursuant to the Liquidity Facility then in effect with respect to said Bonds as a result of (i) the termination, replacement or expiration of the term, as extended, of such Liquidity Facility, including but not limited to termination at the option of the Secretary in accordance with the terms of such Liquidity Facility, or (ii) the occurrence of a Mandatory Standby Tender (as hereinafter defined), then each such Variable Rate Bond shall be purchased or deemed purchased at the Tender Price. Any purchase of such Variable Rate Bonds pursuant to the foregoing events shall occur: (1) on the fifth Business Day preceding any such termination, replacement or expiration of such Liquidity Facility without replacement by an Alternate Liquidity Facility or upon any termination thereof as a result of a Mandatory Standby Tender, and (2) on the date of the replacement of such Liquidity Facility, in any case where an Alternate Liquidity Facility has been delivered to the Tender Agent. In the case of any replacement, the existing Liquidity Facility will be drawn to pay the Tender Price, if necessary, rather than the Alternate Liquidity Facility. No such mandatory tender will be effected upon the replacement of a Liquidity Facility in the case where such Liquidity Facility is failing to honor conforming draws. “Mandatory Standby Tender” means the mandatory tender of the applicable Variable Rate Bonds upon receipt by the Registrar of written notice from the applicable Liquidity Facility Provider that an event with respect to its Liquidity Facility has occurred which gives such Liquidity Facility Provider the option to terminate its Liquidity Facility upon notice. Mandatory Standby Tender shall not include circumstances where a Liquidity Facility Provider may suspend or terminate its obligations to purchase applicable Variable Rate Bonds without notice, in which case there will be no mandatory tender.

If at any time the Registrar receives notice that a substitute bond insurance policy will be delivered, then each applicable Variable Rate Bond shall be purchased or deemed purchased at the Tender Price. Any purchase of such Bond shall occur on the Business Day preceding the delivery of a substitute bond insurance policy.

Payment of the Tender Price of any such Bonds shall be made in immediately available funds by 4:00 p.m., New York City time, on the Tender Date upon delivery of such Bonds to the Tender Agent at its principal office for delivery of applicable Variable Rate Bonds, accompanied by an instrument of transfer, in form satisfactory to the Tender Agent, executed in blank by the Bondholder with the signature of such Bondholder guaranteed by a commercial bank, trust company or member firm of the New York Stock Exchange, at or prior to 12:00 noon, New York City time, on the Tender Date. If, as a result of any such Mandatory Standby Tender, expiration, termination with notice or replacement of a Liquidity Facility, any applicable Variable Rate Bonds are no longer subject to purchase pursuant to such Liquidity Facility, the Tender Agent (upon receipt from the Holder thereof in exchange for payment of the Tender Price thereof) shall present such Bonds to the Registrar for notation of such fact thereon.

Consent and Notice. The Secretary may not enter into any agreement or consent to or participate in any arrangement pursuant to which applicable Variable Rate Bonds are tendered or purchased for any purpose other than the redemption and cancellation of such Bonds without the prior written consent of the applicable Bond Insurer. In connection with any mandatory tender for purchase of applicable Variable Rate Bonds, the Registrar shall give the notice in accordance with the Bond Resolution.

Such notice shall state (i) in the case of a mandatory tender for purchase on the first day of each Interest Rate Period, the type of Interest Rate Period to commence on such mandatory purchase date; (ii) in the case of a mandatory tender for purchase upon termination, replacement or expiration of a Liquidity Facility, on a bond insurance substitution date or Mandatory Standby Tender, that the applicable Liquidity Facility will expire, terminate or be replaced and that the applicable Variable Rate Bonds will no longer be payable from that Liquidity Facility and that any rating applicable to such Bonds may be reduced or withdrawn; (iii) that the Tender Price of any Variable Rate Bonds subject to mandatory tender for purchase shall be payable only upon surrender of that Variable Rate Bond or Bonds to the Tender Agent at its principal office for delivery of applicable Variable Rate Bonds, accompanied by an instrument of transfer, in form satisfactory to the Tender Agent, executed in blank by the Bondholder or its duly-authorized attorney, with such signature guaranteed by a commercial bank, trust company or member firm of the New York Stock Exchange; (iv) that, provided that moneys sufficient to effect such purchase shall have been provided through the remarketing of such Bonds by the applicable Remarketing Agent, through said Liquidity Facility or funds provided by the Commonwealth, all Variable Rate Bonds subject to mandatory tender for purchase shall be purchased on the mandatory Tender Date; and (v) that if any Holder of a Variable Rate Bond subject to mandatory tender for purchase does not surrender that Bond to the Tender Agent for purchase on the mandatory Tender Date, then that Bond shall be deemed to be an Undelivered Bond, no interest shall accrue on that Bond on and after the mandatory Tender Date and such Holder shall have no rights under the Bond Resolution other than to receive payment of the Tender Price.

Payment of Tender Price by Secretary. If all or a portion of the applicable Variable Rate Bonds tendered for purchase cannot be remarketed and the applicable Liquidity Facility Provider fails to purchase all or any part of the unremarketed portion of such tendered Bonds in accordance with its Liquidity Facility on a Tender Date, the Secretary may at its option, but shall not be obligated to, pay to the Tender Agent as soon as practicable on a Tender Date immediately available funds (together with any remarketing proceeds and any funds provided under said Liquidity Facility) sufficient to pay the Tender Price on the Variable Rate Bonds tendered for purchase. The Tender Agent shall deposit the amount paid by the Secretary, if any, in the Commonwealth Purchase Account of the Bond Purchase Fund pending application of the money to the payment of the Tender Price.

Special Considerations relating to the Auction Rate Securities

The financial institutions named in footnotes 8 through 11 on the inside cover page of this Official Statement have been appointed as the initial Broker-Dealers for the Auction Rate Securities, and Wells Fargo Bank, National Association, serves as the Auction Agent.

Role of the Broker-Dealers. Each Broker-Dealer has been appointed by issuers or obligors of various auction rate securities to serve as a dealer in the auctions for those securities and is paid by the issuers or obligors for its services. Each Broker-Dealer receives broker-dealer fees from such issuers or obligors at an agreed-upon annual rate that is applied to the principal amount of securities sold or successfully placed through such Broker-Dealer in such auctions.

Each Broker-Dealer is designated in a Broker-Dealer Agreement as a Broker-Dealer to contact Existing Owners and Potential Owners and solicit Bids for the Auction Rate Securities. Each Broker-Dealer will receive Broker-Dealer Fees from the Commonwealth with respect to the Auction Rate Securities sold or successfully placed through such Broker-Dealer in auctions for the Auction Rate Securities. Each Broker-Dealer may share a portion of such fees with other broker-dealers that submit Orders through such Broker-Dealer that are filled in the auction for the Auction Rate Securities.

Bidding by Broker-Dealers. Each Broker-Dealer is permitted, but not obligated, to submit Orders in Auctions for its own account either as a buyer or a seller and routinely does so in the auction rate securities market in its sole discretion. If a Broker-Dealer submits an Order for its own account, it would have an advantage over other Bidders because such Broker-Dealer would have knowledge of some or all of the other Orders placed through such Broker-Dealer in that Auction and, thus, could determine the rate and size of its Order so as to increase the likelihood that (i) its Order will be accepted in the Auction and (ii) the Auction will clear at a particular rate. For this reason, and because each Broker-Dealer is appointed and paid by the Commonwealth to serve as a Broker-Dealer in the Auctions, a Broker-Dealer's interests in serving as Broker-Dealer in an Auction may differ from those of Existing Owners and Potential Owners who participate in Auctions. See "Role of the Broker-Dealers" herein. A Broker-Dealer would not have knowledge of Orders submitted to the Auction Agent by any other firm that is, or may in the future be appointed to accept Orders pursuant to a Broker-Dealer Agreement.

Each Broker-Dealer routinely places bids in auctions generally for its own account to acquire securities for its inventory, to prevent an "Auction Failure" (which occurs if there are insufficient clearing bids and results in the auction rate being set at the maximum rate) or to prevent an auction from clearing at a rate that such Broker-Dealer believes does not reflect the market for such securities. Each Broker-Dealer may place one or more Bids in an Auction for its own account to acquire Auction Rate Securities for its inventory, to prevent an Auction Failure or to prevent Auctions for Auction Rate Securities from clearing at a rate that the Broker-Dealer believes does not reflect the market for such Securities. Each Broker-Dealer may place such Bids even after obtaining knowledge of some or all of the other Orders submitted through it. When Bidding in an Auction for its own account, each Broker-Dealer also may Bid inside or outside the range of rates that it posts in its Price Talk. See "Price Talk" herein.

Each Broker-Dealer routinely encourages bidding by others in auctions generally for which it serves as broker-dealer. Each Broker-Dealer also may encourage Bidding by others in Auctions for the Auction Rate Securities, including to prevent an Auction Failure or to prevent an Auction for the Auction Rate Securities from clearing at a rate that such Broker-Dealer believes does not reflect the market for the Auction Rate Securities. A Broker-Dealer may encourage such Bids even after obtaining knowledge of some or all of the other Orders submitted through it.

Bids by a Broker-Dealer or by those it may encourage to place Bids are likely to affect (i) the Auction Rate – including preventing the Auction Rate from being set at the Maximum Rate or otherwise causing Bidders to receive a lower rate than they might have received had such Broker-Dealer not Bid or encouraged others to Bid and (ii) the allocation of Auction Rate Securities being auctioned – including displacing some Bidders who may have their Bids rejected or receive fewer Auction Rate Securities than they would have received if such Broker-Dealer had not Bid or encouraged others to Bid. Because of these practices, the fact that an Auction clears successfully does not mean that an investment in the Auction Rate Securities involves no significant liquidity or credit risk. No Broker-Dealer is obligated to continue to place such Bids or to continue to encourage other Bidders to do so in any particular Auction to prevent an Auction Failure or an Auction from clearing at a rate such Broker-Dealer believes does not reflect the market for the Auction Rate Securities. Investors should not assume that the Broker-Dealer will place Bids or encourage others to do so or that “Auction Failures” will not occur. Investors should also be aware that Bids by a Broker-Dealer or by those it may encourage to place Bids may cause lower Auction Rates to occur.

The statements herein regarding Bidding by a Broker-Dealer apply only to a Broker-Dealer’s auction desk and any other business units of the Broker-Dealer that are not separated from the auction desk by an information barrier designed to limit inappropriate dissemination of bidding information.

In any particular Auction, if all outstanding Auction Rate Securities are the subject of Submitted Hold Orders, the Auction Rate for the next succeeding auction period will be the All Hold Rate (such a situation is called an “All Hold Auction”). If a Broker-Dealer holds any Auction Rate Securities for its own account on an Auction Date, it is such Broker-Dealer’s practice to submit a Sell Order into the Auction for such Auction Rate Securities with respect to such Auction Rate Securities, which would prevent that Auction from being an All Hold Auction. The Broker-Dealer may, but is not obligated to, submit Bids for its own account in that same Auction for the Auction Rate Securities, as set forth herein.

Price Talk. Before the start of an Auction, each Broker-Dealer may, in its discretion, make available to its customers who are Existing Owners and Potential Owners such Broker-Dealer’s good faith judgment of the range of likely clearing rates for the Auction based on market and other information. This is known as “Price Talk.” Price Talk is not a guarantee that the Auction Rate established through the Auction will be within the Price Talk, and Existing Owners and Potential Owners are free to use it or ignore it. A Broker-Dealer may occasionally update and change the Price Talk based on changes in the Commonwealth or Bond Insurer’s credit quality or macroeconomic factors that are likely to result in a change in interest rate levels, such as an announcement by the Federal Reserve Board of a change in the Federal Funds rate or an announcement by the Bureau of Labor Statistics of unemployment numbers. Each Broker-Dealer will use its best efforts to communicate this information in a manner reasonably designed to make it available to all Existing Owners and Potential Owners that were given the original Price Talk. Existing Owners and Potential Owners should confirm with the respective Broker-Dealer the manner by which that Broker-Dealer will communicate Price Talk and any changes to Price Talk.

“All-or-Nothing” Bids. None of the Broker-Dealers accepts “all-or-nothing” Bids (i.e., Bids whereby the Bidder proposes to reject an allocation smaller than the entire quantity Bid) or any other type of Bid that allows the Bidder to avoid Auction Procedures that require the pro rata allocation of Bonds when there are not sufficient Sell Orders to fill all Bids at the Winning Bid Rate.

No Assurances Regarding Auction Outcomes. The Broker-Dealers provide no assurance as to the outcome of any Auction. Nor will a Broker-Dealer provide any assurance that any Bid will be successful, in whole or in part, or that the Auction will clear at a rate that a Bidder considers acceptable. Bids may be only partially filled, or not filled at all, and the Auction Rate on any Auction Rate Securities purchased or retained in any Auction may be lower than the market rate for similar investments.

The Broker-Dealers will not agree before an Auction to buy Auction Rate Securities from or sell Auction Rate Securities to a customer after the Auction.

Deadlines. Each particular Auction has a formal deadline by which all Bids must be submitted by each Broker-Dealer to the Auction Agent. This deadline is called the “Submission Deadline.” To provide sufficient time to process and submit customer Bids to the Auction Agent before the Submission Deadline, each Broker-Dealer imposes an earlier deadline for all customers – called the “Broker-Dealer Deadline” – by which Bidders must submit Bids to such Broker-Dealer. The Broker-Dealer Deadline is subject to change by such Broker-Dealer. The Broker-Dealer will use its best efforts to make this information available by means reasonably expected to reach Existing Owners and Potential Owners. Existing Owners and Potential Owners should consult with each Broker-Dealer as to its Broker-Dealer Deadline. Each Broker-Dealer may correct Clerical Errors by such Broker-Dealer after its Broker-Dealer Deadline and prior to the Submission Deadline. A Broker-Dealer may submit Bids for its own account at any time until the Submission Deadline and may change Bids it has submitted for its own account at any time until the Submission Deadline. The Auction Procedures provide that until one hour after the Auction Agent completes the dissemination of the results of an Auction, new Orders can be submitted to the Auction Agent if such Orders were received by a Broker-Dealer or generated by such Broker-Dealer for its own account prior to the Submission Deadline and the failure to submit such Orders prior to the Submission Deadline was the result of force majeure, a technological failure or a Clerical Error. In addition until one hour after the Auction Agent completes the dissemination of the results of an Auction, a Broker-Dealer may modify or withdraw an Order submitted to the Auction Agent prior to the Submission Deadline if the Broker-Dealer determines that such Order contained a Clerical Error. In the event of such a submission, modification or withdrawal the Auction Agent will rerun the Auction, if necessary, taking into account such submission, modification or withdrawal.

Existing Owner’s Ability to Resell Auction Rate Securities May Be Limited. An Existing Owner may sell, transfer or dispose of an Auction Rate Securities (i) in an Auction, only pursuant to a Bid or Sell Order in accordance with the Auction Procedures, or (ii) outside an Auction, only to or through a Broker-Dealer.

Existing Owners will be able to sell all of the Auction Rate Securities that are the subject of their Submitted Sell Orders only if there are Bidders willing to purchase all the Auction Rate

Securities offered for sale in the Auction. If Sufficient Clearing Bids have not been made, Existing Owners that have submitted Sell Orders will not be able to sell in the Auction all, and may not be able to sell any, of the Bonds subject to such submitted Sell Orders. As discussed above (see “Bidding by Broker-Dealers”), a Broker-Dealer may submit a Bid in an Auction to avoid an Auction Failure, but it is not obligated to do so. There may not always be enough Bidders to prevent an Auction Failure in the absence of a Broker-Dealer Bidding in the Auction for its own account or encouraging others to Bid. Therefore, “Auction Failures” are possible, especially if the Commonwealth’s or the Bond Insurers’ credit were to deteriorate, if a market disruption were to occur or if, for any reason, each Broker-Dealer were unable or unwilling to Bid.

Between Auctions, there can be no assurance that a secondary market for the Auction Rate Securities will develop or, if it does develop, that it will provide Existing Owners the ability to resell the Auction Rate Securities on the terms or at the times desired by an Existing Owner. Each Broker-Dealer may, in its own discretion, decide to buy or sell the Auction Rate Securities in the secondary market for its account to or from investors at any time and at any price, including at prices equivalent to, below, or above the par value of the Auction Rate Securities. However, no Broker-Dealer is obligated to make a market in the Auction Rate Securities, and either Broker-Dealer may discontinue trading in the Auction Rate Securities without notice for any reason at any time. Existing Owners who resell between Auctions may receive less than par value, depending on market conditions.

If an Existing Owner purchased an Auction Rate Security through a dealer which is not a Broker-Dealer for the Auction Rate Securities, such Existing Owner’s ability to sell its Auction Rate Security may be affected by the continued ability of its dealer to transact trades for the Auction Rate Securities through a Broker-Dealer.

The ability to resell the Auction Rate Securities will depend on various factors affecting the market for the Auction Rate Securities, including news relating to the Bond Insurer(s) and the Commonwealth, the attractiveness of alternative investments, investor demand for short term securities, the perceived risk of owning the Auction Rate Securities (whether related to credit, liquidity or any other risk), the tax or accounting treatment accorded the Auction Rate Securities (including U.S. generally accepted accounting principles as they apply to the accounting treatment of auction rate securities), reactions of market participants to regulatory actions (such as those described in “Securities and Exchange Commission Settlements,” below) or press reports, financial reporting cycles and market conditions generally. Demand for the Auction Rate Securities may change without warning, and declines in demand may be short-lived or continue for longer periods.

Resignation of the Auction Agent or the Broker-Dealer Could Affect the Ability to Hold Auctions. The Auction Agent may resign from its duties under the Auction Agreement upon written notice to the Registrar, the Commonwealth, the Bond Insurer and each Broker-Dealer on the date specified in such notice, which date shall be no earlier than sixty (60) days after the date of delivery of such notice (30 days’ prior notice if the Auction Agent resigns because it has not received payment for its auction agent services). The Auction Agreement does not require, as a condition to the effectiveness of such resignation, that a replacement Auction Agent be in place.

Each Broker-Dealer Agreement provides that the Broker-Dealer thereunder may resign upon five (5) days' notice, or suspend its duties immediately, in certain circumstances, and does not require, as a condition to the effectiveness of such resignation or suspension, that a replacement Broker-Dealer be in place. Any successor Broker-Dealer shall be selected by the Secretary, and shall be a member of the National Association of Securities Dealers, Inc., shall have a capitalization of at least fifteen million dollars (\$15,000,000) and shall be authorized by law to perform all the duties set forth in the Bond Resolution. The Secretary's delivery to the Registrar of a certificate setting forth the effective date of the appointment of a successor or additional Broker-Dealer and the name of such successor or additional Broker-Dealer shall be conclusive evidence that: (i) if applicable, the predecessor Broker-Dealer has been removed in accordance with the provisions of the Bond Resolution; and (ii) such successor or additional Broker-Dealer has been appointed and is qualified to act as Broker-Dealer under the terms of the Bond Resolution. For any auction period during which there is no duly appointed Auction Agent, or during which there is no duly appointed Broker-Dealer, it will not be possible to hold Auctions, with the result that the interest rate on the Auction Rate Securities will be determined as described in Section 2.04(c) of the Auction Procedures. See *Appendix III – "Definitions and Auction Procedures"*.

Securities and Exchange Commission Settlements. On May 31, 2006, the U.S. Securities and Exchange Commission (the "SEC") announced that it had settled its investigation of fifteen firms, including Lehman and Morgan Stanley who will each serve as a Broker-Dealer (the "Settling Broker-Dealers"), that participate in the auction rate securities market, regarding their respective practices and procedures in this market. The SEC alleged in the settlement that the firms had managed auctions for auction rate securities in which they participated in ways that were not adequately disclosed or that did not conform to disclosed auction procedures. As part of the settlement, the Settling Broker-Dealers agreed to pay civil penalties. In addition, each Settling Broker-Dealer, without admitting or denying the SEC's allegations, agreed to provide to customers written descriptions of its material auction practices and procedures and to implement procedures reasonably designed to detect and prevent any failures by that Settling Broker-Dealer to conduct the auction process in accordance with disclosed procedures. No action was taken by the SEC against UBS, and UBS is not aware of any ongoing inquiries on this matter related to it.

In addition on January 9, 2007, the SEC announced that it had settled its investigation of three banks (the "Settling Auction Agents"), that participate as auction agents in the auction rate securities market, regarding their respective practices and procedures in this market. The SEC alleged that the Settling Auction Agents allowed broker-dealers in auctions to submit bids or revise bids after the submission deadlines and allowed broker-dealers to intervene in auctions in ways that affected the rates paid on the auction rate securities. As part of the settlement, the Settling Auction Agents agreed to pay civil penalties. In addition, each Settling Auction Agent, without admitting or denying the SEC's allegations, agreed to provide to broker-dealers and issuers written descriptions of its material auction practices and procedures and to implement procedures reasonably designed to detect and prevent any failures by that Settling Auction Agent to conduct the auction process in accordance with disclosed procedures. Wells Fargo is not one of the Settling Auction Agents.

Initial Liquidity Facilities

General. The Commonwealth has initially arranged for JPMorgan and Dexia to provide their respective Initial Liquidity Facilities, each in the form of separate Standby Bond Purchase Agreements (one for each subseries of the Variable Rate Demand Obligations), to be all dated as of October 16, 2007, by and among such Initial Liquidity Facility Provider, the Tender Agent, and the Commonwealth (each, a “Standby Purchase Agreement” and together, the “Standby Purchase Agreements”). The obligation of the applicable Initial Liquidity Facility Provider to purchase Variable Rate Demand Obligations under its Standby Purchase Agreement will expire on October 18, 2010 in respect of the Standby Purchase Agreements relating to subseries 2007A-2 (JPMorgan) and 2007A-3 (Dexia) and on October 14, 2008 in respect of the Standby Purchase Agreements relating to subseries 2007A-5 (JPMorgan) and 2007A-4 (Dexia), prior to the final maturity of those Variable Rate Demand Obligations, unless extended or terminated in accordance with its terms.

During the term of the Standby Purchase Agreements, they will provide liquidity for the purchase of the Variable Rate Demand Obligations to which they relate, which Variable Rate Demand Obligations are delivered to the Tender Agent pursuant to an optional or mandatory tender but not remarketed by the applicable Remarketing Agent. In addition, each Standby Purchase Agreement will provide liquidity for the mandatory purchase of applicable Tendered Bonds (i) upon certain changes in interest rate periods, (ii) upon the expiration (without extension) of such Standby Purchase Agreement, (iii) except as otherwise provided in the Bond Resolution, upon the replacement of such Standby Purchase Agreement with an Alternate Liquidity Facility and (iv) at the direction of the applicable Initial Liquidity Facility Provider following the occurrence of certain Events of Termination or Events of Default. The Commonwealth has the right and may elect to terminate a Standby Purchase Agreement in its discretion. Unless otherwise noted, all capitalized terms in this summary of the Standby Purchase Agreements shall have the respective meanings ascribed to such terms in each such Standby Purchase Agreement.

UNDER CERTAIN CIRCUMSTANCES THE OBLIGATION OF AN INITIAL LIQUIDITY FACILITY PROVIDER TO PURCHASE VARIABLE RATE DEMAND OBLIGATIONS TENDERED BY THE OWNERS THEREOF OR SUBJECT TO MANDATORY TENDER MAY BE TERMINATED OR SUSPENDED WITHOUT A PURCHASE BY THE APPLICABLE INITIAL LIQUIDITY FACILITY PROVIDER. IN SUCH EVENT, SUFFICIENT FUNDS MAY NOT BE AVAILABLE TO PURCHASE VARIABLE RATE DEMAND OBLIGATIONS TENDERED BY THE OWNERS THEREOF OR SUBJECT TO MANDATORY PURCHASE. IN ADDITION, NEITHER STANDBY PURCHASE AGREEMENT PROVIDES SECURITY FOR THE PAYMENT OF PRINCIPAL OF OR INTEREST OR PREMIUMS, IF ANY, ON THE BONDS. THE STANDBY PURCHASE AGREEMENTS PROVIDE FOR THE PURCHASE OF APPLICABLE TENDERED BONDS ONLY.

Purchase of Tendered Bonds by Provider. Each Initial Liquidity Facility Provider has agreed to purchase during the Purchase Period, Eligible Bonds which have been tendered for optional purchase or which are tendered for mandatory purchase and which are not remarketed as provided in the Bond Resolution. The Purchase Period begins on the date of initial delivery of

the Variable Rate Demand Obligations (expected to be October 16, 2007) and ends on the earliest of (a) the respective dates set forth in the first paragraph under “General” above or the last day of any extension of such date pursuant to the terms of the applicable Standby Purchase Agreement (the “Stated Expiration Date”); (b) the date of receipt by the applicable Liquidity Facility Provider of a certificate signed by the Tender Agent stating that the applicable Standby Purchase Agreement has been terminated pursuant to the terms of the Bond Resolution because (i) an Alternate Liquidity Facility has become effective under the Bond Resolution; (ii) no Variable Rate Demand Obligations are outstanding under the Bond Resolution; or (iii) all of the Variable Rate Demand Obligations have been converted to a Non-Covered Interest Rate; (c) the date specified in a written notice delivered by the Commonwealth to the applicable Liquidity Facility Provider and the Tender Agent that the Commonwealth has elected to terminate such Provider’s Standby Purchase Agreement pursuant to its terms; (d) the occurrence of an Event of Termination (as further described below); and (e) the date on which the applicable Liquidity Facility Provider’s commitment has been terminated in its entirety and such Provider is no longer obligated to purchase Variable Rate Demand Obligations. The price to be paid by such Provider for such Bonds will be equal to the aggregate principal amount on such Bonds without premium, plus interest accrued thereon on the Purchase Date, unless, in the case of interest, the Purchase Date is an Interest Payment Date. As described below, under certain circumstances the obligation of such Provider to purchase Tendered Bonds will be automatically suspended or terminated, without prior notice or demand, and the Tender Agent will be unable to require the purchase of Variable Rate Demand Obligations under the corresponding Standby Purchase Agreement.

Events of Termination and Events of Default. The remedies upon the occurrence of an Event of Termination or an Event of Default under each Standby Purchase Agreement differ significantly and depend upon the nature of the particular Event of Termination or Event of Default. See “Remedies Upon an Event of Termination or an Event of Default” below.

Each of the following is an “Event of Termination” under the Standby Purchase Agreements:

(a) (i) Any principal or interest due on the Variable Rate Demand Obligations or any payment under an applicable VRDO Interest Rate Swap (other than a termination payment or any other amount not insured by the applicable Bond Insurer) is not paid when due and such principal or interest is not paid by the applicable Bond Insurer when, as, and in the amounts required to be paid pursuant to the terms of the applicable Insurance Policy or (ii) the Commonwealth provides notice that the applicable Bond Insurer shall be substituted as insurer of the Variable Rate Demand Obligations, or the applicable Insurance Policy is surrendered, cancelled, terminated, or modified in any material respect, without the applicable Liquidity Facility Provider’s prior written consent; or

(b) The applicable Bond Insurer shall in writing claim that its Insurance Policy with respect to the payment of principal of or interest on the Variable Rate Demand Obligations is not valid and binding on it, and repudiate its obligations under such Policy, or it shall initiate any legal proceedings to seek an adjudication that such Policy, with respect to the payment of principal or interest, is not valid and binding, or

any court or Governmental Authority with jurisdiction to rule on the validity of such Insurance Policy shall find or rule that such Insurance Policy is not so valid and binding; or

(c) The occurrence of a Bond Insurer Event of Insolvency (as defined in the respective Standby Bond Purchase Agreements); or

(d) The withdrawal or suspension by S&P, Moody's and Fitch of the financial strength rating of the applicable Bond Insurer or the reduction of such rating below BBB- in the case of S&P, Baa3 in the case of Moody's, and BBB- in the case of Fitch; or

(e) Any default by the applicable Bond Insurer in making payment when, as, and in the amounts required to be made pursuant to the express terms and provisions of any other financial guaranty insurance policy issued by it insuring publicly-rated bonds and such failure shall continue for thirty (30) days unless its obligation to pay is being contested by such Bond Insurer in good faith by appropriate proceedings; or

(f) The applicable Bond Insurer shall fail to maintain a financial strength or claims paying ability rating by Moody's of A1 (or its equivalent) or higher or by S&P of A+ (or its equivalent) or higher or by Fitch of A+ (or its equivalent) or higher for a period of thirty (30) consecutive days.

Each of the following is an "Event of Default" under the Standby Purchase Agreements:

(a) Any material representation or warranty made by the Commonwealth under or in connection with the applicable Standby Purchase Agreement shall prove to be untrue in any material respect on the date as of which it was made; or

(b) Non-payment of any commitment fees and certain other amounts payable under the applicable Standby Purchase Agreement (together with interest thereon at the Default Rate) within ten (10) days after the Tender Agent, the applicable Bond Insurer and the Commonwealth have received written notice from the Liquidity Facility Provider of such Agreement that the same were not paid when due; or

(c) Non-payment of any other fees or amounts payable under the applicable Standby Purchase Agreement (together with interest thereon at the Default Rate) within twenty (20) days after the Tender Agent, the applicable Bond Insurer and the Commonwealth have received written notice thereof from the Liquidity Facility Provider of such Agreement that the same were not paid when due; or

(d) The breach by the Commonwealth of certain covenants under the applicable Standby Purchase Agreement; or

(e) The breach by the Commonwealth of any terms or provisions of the applicable Standby Purchase Agreement for which no cure period is otherwise specifically provided with respect thereto which is not remedied within thirty (30) days after the applicable Bond Insurer and the Commonwealth have received written notice thereof from the Liquidity Facility Provider of such Agreement; or

(f) (i) The Commonwealth shall commence any case, proceeding or other action under any existing or future applicable law, (A) relating to bankruptcy, insolvency, reorganization or relief of debtors, seeking to have an order for relief entered with respect to it, or seeking to adjudicate it a bankrupt or insolvent, or seeking reorganization, arrangement, adjustment, winding-up, liquidation, dissolution, composition or other relief with respect to it or its debts, or (B) seeking appointment of a receiver, trustee, custodian or other similar official for it or for all or any substantial part of its assets, or the Commonwealth shall make a general assignment for the benefit of its creditors; or (ii) there shall be commenced against the Commonwealth any case, proceeding or other action of a nature referred to in clause (i) above which (A) results in an order for such relief or in the appointment of a receiver or similar official or (B) remains undismissed, undischarged or unbonded for a period of sixty (60) days; or (iii) there shall be commenced against the Commonwealth any case, proceeding or other action seeking issuance of a warrant of attachment, execution, distraint or similar process against all or any substantial part of its assets, which results in the entry of an order for any such relief which shall not have been vacated, discharged, or stayed or bonded pending appeal within sixty (60) days from the entry thereof; or (iv) the Commonwealth shall take any action in furtherance of, or indicating its consent to, approval of, or acquiescence in, any of the acts set forth in clause (i), (ii) or (iii) above; or (v) the Commonwealth shall generally not, or shall be unable to, or shall admit in writing its inability to, pay its debts; or

(g) Any material provision of the applicable Standby Purchase Agreement or any Related Document (other than the applicable Insurance Policy) shall at any time for any reason cease to be valid and binding on the Commonwealth or shall be declared to be null and void, or the validity or enforceability thereof shall be contested by the Commonwealth or by any Governmental Authority having jurisdiction, or the Commonwealth shall deny that it has any further liability or obligation under any such document, or such document is cancelled or terminated without the applicable Liquidity Facility Provider's prior written consent; or

(h) The occurrence of any "event of default" as defined in any of the Related Documents, which occurrence is not waived pursuant to the terms thereof and which occurrence is not otherwise described in the applicable Standby Purchase Agreement, other than the failure of the applicable Liquidity Facility Provider to provide funds for the purchase of Tendered Bonds when required by the terms and conditions of such Standby Purchase Agreement; or

(i) The Commonwealth shall have defaulted in the payment or performance of any obligation of a principal amount of \$5,000,000 or more, which constitutes Debt, and such default permits the acceleration of the payment of moneys; or

(j) The rating assigned by S&P or Moody's to the Commonwealth's long-term debt (without taking into account third party credit enhancement) is withdrawn, suspended or reduced below BBB- (or its equivalent rating) by S&P or Baa3 (or its equivalent rating) by Moody's; or

(k) One or more judgments or orders for the payment of money in an aggregate amount in excess of \$10,000,000 shall be rendered against the Commonwealth and such judgments or orders shall remain undischarged or unstayed for a period of thirty (30) days, or any action shall be taken by a judgment creditor to levy upon assets or properties of the Commonwealth to enforce any such judgment or order.

Remedies Upon an Event of Termination or an Event of Default. If any Event of Termination or Event of Default occurs and is continuing, the applicable Liquidity Facility Provider has the following remedies under its Standby Purchase Agreement:

In the case of an Event of Termination specified in paragraphs (a), (c), (d), or (e) above, the Available Commitment, the Purchase Period and the obligation of the applicable Liquidity Facility Provider to purchase Variable Rate Demand Obligations shall immediately terminate without notice or demand (a “Termination Event”), and thereafter such Provider shall be under no obligation to purchase such Bonds. Promptly upon the applicable Liquidity Facility Provider’s obtaining knowledge of any such Event of Termination, such Provider shall give written notice of the same to the Tender Agent, the Commonwealth and the applicable Remarketing Agent and Bond Insurer, and such Provider shall incur no liability or responsibility whatsoever by reason of its failure to give such notice and such failure shall in no manner affect the immediate termination of its Available Commitment and of its obligation to purchase Variable Rate Demand Obligations pursuant to its Standby Purchase Agreement.

In the case of an Event of Termination specified in paragraph (f) above, or an Event of Default specified in paragraphs (b) or (c) above, such Provider may terminate its Available Commitment and Purchase Period by giving written notice to the Tender Agent, the Commonwealth and the applicable Remarketing Agent and Bond Insurer, specifying the date on which such Available Commitment and Purchase Period shall terminate, which shall be not less than thirty (30) days from the date of receipt of such notice by the Tender Agent (the “Purchase Termination Date”). On and after the Purchase Termination Date, such Provider shall be under no further obligation to purchase Variable Rate Demand Obligations under its Standby Purchase Agreement.

In the case of an Event of Termination specified in paragraph (b) above, the applicable Liquidity Facility Provider’s obligation to purchase Variable Rate Demand Obligations to which its Facility relates shall be immediately suspended without notice or demand and thereafter such Provider shall be under no obligation to purchase Variable Rate Demand Obligations until the Available Commitment is reinstated as described in its Standby Purchase Agreement. Promptly upon such Provider’s obtaining knowledge of any such Event of Termination, it shall give written notice of the same to the Commonwealth, the Tender Agent and the applicable Remarketing Agent and Bond Insurer, and such Provider shall incur no liability or responsibility whatsoever by reason of its failure to give such notice and such failure shall in no way affect the suspension of such Provider’s obligation to purchase Variable Rate Demand Obligations. If a court with jurisdiction to rule on the validity of the applicable Insurance Policy shall thereafter enter a final, nonappealable judgment that it is not valid and binding on the applicable Bond Insurer, then such Provider’s obligation to purchase Variable Rate Demand

Obligations shall immediately terminate. If such court shall find or rule that such Policy is valid and binding, such Provider's obligation to purchase Variable Rate Demand Obligations shall be automatically reinstated and the terms of its Standby Purchase Agreement will continue in full force and effect (unless otherwise terminated or suspended by its terms). Notwithstanding the foregoing, if, upon the earlier of the Stated Expiration Date and the date which is three (3) years after the effective date of suspension of such Provider's obligation, litigation is still pending and a judgment regarding the validity of the applicable Insurance Policy as is the subject of such Event of Termination has not been obtained, then the corresponding Available Commitment and the obligation of such Provider to purchase Variable Rate Demand Obligations shall at such time immediately terminate, and thereafter such Provider shall be under no obligation to purchase such Bonds.

During the pendency of an Event of Termination pursuant to paragraphs (c) (with respect to an order described in clause (i) of paragraph (c), and prior to the expiration of the specified period) or (e) (prior to the expiration of the specified period) above (each a "Potential Event of Termination"), the applicable Liquidity Facility Provider's obligation to purchase Variable Rate Demand Obligations shall be immediately suspended without notice or demand and thereafter such Provider shall be under no obligation to purchase Variable Rate Demand Obligations until the applicable Available Commitment is reinstated as described hereafter. Promptly upon such Provider obtaining knowledge of any such Potential Event of Termination, it shall give written notice of the same to the Commonwealth, the Tender Agent and the applicable Remarketing Agent and Bond Insurer, and it shall incur no liability or responsibility whatsoever by reason of its failure to give such notice and such failure shall in no way affect the suspension of its obligations under its Standby Purchase Agreement. In the event such Potential Event of Termination is cured prior to becoming a Termination Event, such Provider's obligations shall be automatically reinstated and the terms of its Standby Purchase Agreement will continue in full force and effect (unless it is otherwise terminated or suspended by its terms).

In addition to the rights and remedies set forth in the preceding paragraphs, in the case of any Event of Termination or Event of Default, upon the election of the applicable Liquidity Facility Provider: (i) all amounts payable under its Standby Purchase Agreement (other than payments of principal and redemption price of and interest on the applicable Variable Rate Demand Obligations or payments of Excess Bond Interest related thereto) shall upon notice to the Commonwealth become immediately due and payable without presentment, demand, protest or further notice of any kind, all of which are expressly waived by the Commonwealth; and (ii) the applicable Liquidity Facility Provider shall have all the rights and remedies available to it under its Standby Purchase Agreement, the Related Documents, the applicable Insurance Policy or otherwise pursuant to law or equity, but it shall not have the right to terminate its obligation to purchase Variable Rate Demand Obligations or to declare any amount due hereunder due and payable except as expressly provided, or to accelerate the maturity date of any such Bonds except as provided in the Bond Resolution. Without limiting the generality of the foregoing, the applicable Liquidity Facility Provider agrees to purchase Variable Rate Demand Obligations on the terms and conditions of its Standby Purchase Agreement

notwithstanding the institution or pendency of any bankruptcy, insolvency or similar proceeding with respect to the Commonwealth. The applicable Liquidity Facility Provider will not assert as a defense to its obligation to purchase Variable Rate Demand Obligations under its Standby Purchase Agreement (A) the institution or pendency of a bankruptcy, insolvency or similar proceeding with respect to the Commonwealth, or (B) a determination by a court of competent jurisdiction in a bankruptcy, insolvency or similar proceeding with respect to the Commonwealth that its Standby Purchase Agreement is not enforceable against the Commonwealth under applicable bankruptcy, insolvency or similar laws. This paragraph shall not limit the exercise of its remedies expressly provided for above.

Extension, Reduction, Adjustment or Termination of the Standby Purchase Agreements. Each Standby Purchase Agreement will expire on the respective dates set forth under “General” above unless earlier terminated or, with the consent of the applicable Liquidity Facility Provider in its sole and absolute discretion, extended for an additional period or periods, in each case in accordance with the provisions of its Standby Purchase Agreement.

Upon (i) any redemption, defeasance or other payment of all or any portion of the principal amount of the Variable Rate Demand Obligations or (ii) any purchase by the applicable Liquidity Facility Provider of Variable Rate Demand Obligations tendered or deemed tendered in accordance with the terms of the Bond Resolution, such Provider’s purchase commitment under its Standby Purchase Agreement with respect to principal of Variable Rate Demand Obligations shall automatically be reduced by the principal amount of such Bonds so redeemed, defeased or otherwise paid or purchased, as the case may be. JPMorgan’s commitment with respect to interest initially shall be equal to \$1,144,357 with respect to interest on subseries 2007A-2 of the Variable Rate Demand Obligations and \$1,150,685 with respect to interest on subseries 2007A-5 of the Variable Rate Demand Obligations (each an amount equal to thirty-five (35) days’ interest on the Variable Rate Demand Obligations to which its corresponding Standby Purchase Agreements relate, computed as if such Bonds bore interest at the rate of twelve percent (12%) per annum), based on a year of 365 days. Dexia’s commitment (similarly computed) is \$1,144,932 with respect to interest on subseries 2007A-3 of the Variable Rate Demand Obligations and \$1,114,151 with respect to interest on subseries 2007A-4 of the Variable Rate Demand Obligations to which its corresponding Standby Purchase Agreements relate. The commitment with respect to interest will be adjusted downward by an amount in proportion to the reduction of the commitment as to principal because of the redemption, defeasance or other payment of Variable Rate Demand Obligations or the purchase by the applicable Liquidity Facility Provider of Variable Rate Demand Obligations tendered or deemed tendered in accordance with the terms of the Bond Resolution.

Limitations of the Standby Purchase Agreements. The ability to obtain funds under a Standby Purchase Agreement in accordance with its terms may be limited by federal or state law. Bankruptcy, conservatorship, receivership and similar laws governing financial institutions or any issuer of a standby purchase agreement may prevent or restrict payment under such Standby Purchase Agreement. To the extent the short-term rating on the Variable Rate Demand Obligations depends on the rating of the applicable Liquidity Facility Provider, the short-term ratings on such Bonds could be downgraded or withdrawn if such Provider were to be

downgraded, placed on credit watch or have its ratings suspended or withdrawn or were to refuse to perform under its Standby Purchase Agreement.

The obligation of the applicable Liquidity Facility Provider to purchase unremarketed Variable Rate Demand Obligations pursuant to its Standby Purchase Agreement is subject to the conditions and limitations set forth therein, and is also subject to all rights and defenses available to contracting parties generally. Each Standby Purchase Agreement is not a guaranty to pay the purchase price of Variable Rate Demand Obligations tendered for purchase. Each Standby Purchase Agreement is a general contract, subject to certain conditions and limitations, but is not a letter of credit. Purchasers of the Variable Rate Demand Obligations should consult their legal counsel for an explanation of the differences between a general contract and a letter of credit or guaranty.

Initial Liquidity Facility Providers

Dexia Credit Local. Dexia Credit Local (“Dexia”) is a subsidiary of the Dexia Group, which was created in 1996. The Dexia Group is a major European banking organization that is the product of several cross-border mergers. Dexia is an authentically European bank in terms of both its management organization and the scope of its different lines of business. The Dexia Group is listed on the Brussels, Paris and Luxembourg stock exchanges. With a stock market capitalization of over 24 billion euros as of December 31, 2006, the Dexia Group ranks in the top third of the Euronext 100 companies.

Dexia specializes in the Dexia Group’s first line of business – public and project finance and financial services for the public sector. Dexia has recognized expertise in local public sector financing and project finance. It is backed by a network of specialized banks, which employ over 3,500 professionals. Through this network of subsidiaries, affiliates and branches, Dexia is present in almost all of the countries of the European Union as well as Central Europe, the United States of America and Canada. Dexia also has operations in Latin America, the Asian-Pacific Region including Australia, and the countries around the Mediterranean.

Dexia is a bank with its principal office located in Paris, France. In issuing its Initial Liquidity Facility, Dexia will act through its New York Branch, which is licensed by the Banking Department of the State of New York as an unincorporated branch of Dexia Credit Local, Paris. Dexia is the leading local authority lender in Europe, funding its lending activities in 2006 primarily through the issuance of euro and U.S. dollar-denominated bonds. In 2006, total funding raised by Dexia and Dexia Municipal Agency was 15.7 billion euros.

The Dexia Group is the owner of Financial Security Assurance Holdings Ltd. (“FSA Holdings”), the holding company for FSA.

As of December 31, 2006, Dexia had total consolidated assets of 304 billion euros, outstanding medium and long-term loans to customers of 241 billion euros and shareholders’ equity of over 7.98 billion euros (Tier I plus Tier II), and for the year then ended had consolidated net income of 1.082 billion euros. These figures were determined in accordance with generally accepted accounting principles in France. Dexia maintains its records and

prepares its financial statements in euros. At December 31, 2006, the exchange rate was 1.0000 euro equals 1.317 United States dollar. Such exchange rate fluctuates from time to time.

Dexia is rated Aa1 long-term and P-1 short-term by Moody's, AA long-term and A-1+ short-term by S&P, and AA+ long-term and F1+ short-term by Fitch.

Dexia will provide without charge a copy of its most recent publicly available annual report. Written requests should be directed to: Dexia Credit Local, New York Branch, 445 Park Avenue, 7th Floor, New York, New York 10022, Attention: General Manager. The delivery of this information shall not create any implication that the information contained or referred to herein is correct as of any time subsequent to its date.

JPMorgan Chase Bank, N.A. JPMorgan, is a wholly owned bank subsidiary of JPMorgan Chase & Co., a Delaware corporation, whose principal office is located in New York, New York. JPMorgan offers a wide range of banking services to its customers, both domestically and internationally. It is chartered and its business is subject to examination and regulation by the Office of the Comptroller of the Currency.

As of June 30, 2007, JPMorgan had total assets of \$1,252.4 billion, total net loans of \$438.3 billion, total deposits of \$664.1 billion, and total stockholder's equity of \$98.4 billion. These figures are extracted from JPMorgan's unaudited Consolidated Reports of Condition and Income as at June 30, 2007, prepared in accordance with regulatory instructions that do not in all cases follow U.S. generally accepted accounting principles, which Reports are filed with the Federal Deposit Insurance Corporation.

Additional information, including the most recent Form 10-K for the year ended December 31, 2006, of JPMorgan Chase & Co., the 2006 Annual Report of JPMorgan Chase & Co., and additional annual, quarterly and current reports filed with or furnished to the Securities and Exchange Commission by JPMorgan Chase & Co., as they become available, may be obtained without charge by each person to whom this Official Statement is delivered upon the written request of any such person to the Office of the Secretary, JPMorgan Chase & Co., 270 Park Avenue, New York, New York 10017.

The information contained in the preceding three paragraphs relates to and has been obtained from JPMorgan. The delivery of this Official Statement shall not create any implication that there has been no change in the affairs of JPMorgan since the date hereof, or that the information contained or referred to above is correct as of any time subsequent to its date.

Book-Entry Only System

The following information concerning DTC and DTC's book-entry system has been obtained from DTC. The Commonwealth does not take any responsibility for the accuracy thereof.

DTC will act as securities depository for the Bonds. The Bonds will be issued as fully registered bonds registered in the name of Cede & Co. (DTC's partnership nominee) or such other nominee as may be requested by an authorized representative of DTC. One fully registered

bond will be issued for each maturity of the Bonds, each in the aggregate principal amount of such maturity, and will be deposited with DTC.

DTC, the world's largest depository, is a limited-purpose trust company organized under the New York Banking Law, a "banking organization" within the meaning of the New York Banking Law, a member of the Federal Reserve System, a "clearing corporation" within the meaning of the New York Uniform Commercial Code, and a "clearing agency" registered pursuant to the provisions of Section 17A of the Securities Exchange Act of 1934, as amended. DTC holds and provides asset servicing for over 2.2 million issues of U.S. and non-U.S. equity, corporate and municipal debt, 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, in turn, is owned by a number of Direct Participants of DTC and Members of the National Securities Clearing Corporation, Fixed Income Clearing Corporation, and Emerging Markets Clearing Corporation (NSCC, FICC, and EMCC, also subsidiaries of DTCC), as well as by the New York Stock Exchange, Inc., the American Stock Exchange LLC, and the National Association of Securities Dealers, Inc. Access to the DTC system is also available to others such as both U.S. and non-U.S. securities brokers and dealers, banks, trust companies, and clearing corporations that clear through or maintain a custodial relationship with a Direct Participant, either directly or indirectly ("Indirect Participants"). DTC has the highest rating issued by S&P: "AAA". The DTC Rules applicable to its Participants are on file with the Securities and Exchange Commission. More information about DTC can be found at www.dtcc.com and www.dtc.org.

Purchases of the 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 a Bond ("Beneficial Owner") will in turn be recorded on the Direct and Indirect Participants' records. Beneficial Owners will not receive written confirmation from DTC of their purchases. Beneficial Owners are, however, expected to receive written confirmations providing details of their transactions, 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 on the books of Direct and Indirect Participants acting on behalf of Beneficial Owners. Beneficial Owners will not receive certificates representing their ownership interests in the Bonds, except in the event that use of the book-entry system for the Bonds is discontinued.

To facilitate subsequent transfers, all Bonds deposited by Direct Participants with DTC are registered in the name of DTC's partnership nominee, Cede & Co, or such other nominee 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 and 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 may wish to take certain steps to augment the transmission to them of notices of significant events with respect to the Bonds, such as redemptions, tenders, defaults, and proposed amendments to the bond documents. For example, Beneficial Owners 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 Registrar and request that copies of notices be provided directly to them.

Redemption notices shall 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 such maturity to be redeemed.

Neither DTC nor Cede & Co. (nor such other DTC nominee) will consent or vote with respect to the Bonds unless authorized by a Direct Participant in accordance with DTC's procedures. Under its usual procedures, DTC mails an Omnibus Proxy to the Commonwealth 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 such record date (identified in a listing attached to the Omnibus Proxy).

Redemption proceeds 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 Commonwealth, 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, its nominee, or the Commonwealth, subject to any statutory or regulatory requirements as may be in effect from time to time. Payment of principal, redemption premium, if any, and interest to Cede & Co. (or such other nominee as may be requested by an authorized representative of DTC) is the responsibility of the Commonwealth, 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.

A Beneficial Owner shall give notice to elect to have its Bonds purchased or tendered, through its Participant, to the Registrar, and shall effect delivery of such Bonds by causing the Direct Participant to transfer the Participant's interest in the Bonds, on DTC's records, to the Registrar. The requirement for physical delivery of Bonds in connection with an optional tender or a mandatory purchase will be deemed satisfied when the ownership rights in the Bonds are transferred by Direct Participants on DTC's records and followed by a book-entry credit of tendered Bonds to the Registrar's DTC account.

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

The Commonwealth may decide to discontinue use of the system of book-entry only transfers through DTC (or a successor depository). In that event, definitive Bonds will be printed and delivered.

Payments and Transfers

No assurance can be given by the Commonwealth that DTC will make prompt transfer of payments to the Participants or that Participants will make prompt transfer of payments to Beneficial Owners. The Commonwealth is not responsible or liable for payment by DTC or Participants or for sending transaction statements or for maintaining, supervising or reviewing records maintained by DTC or Participants.

For every transfer and exchange of the Bonds, the Beneficial Owners may be charged a sum sufficient to cover any tax, fee or other charge that may be imposed in relation thereto.

Discontinuance of the Book-Entry Only System

In the event that the book-entry only system is discontinued, the following provisions will apply: principal of and redemption premium, if any, on the Bonds shall be payable in lawful money of the United States of America at the principal office of the Registrar in San Juan, Puerto Rico. Interest on the Bonds will be payable by check mailed to the respective addresses of the registered owners determined as of the 15th day of the month preceding the interest payment date as shown on the registration books of the Commonwealth maintained by the Registrar. The Bonds offered by virtue of this Official Statement will be issued only as registered bonds without coupons in denominations of \$100,000 or any multiple \$5,000 in excess thereof except for the Auction Rate Securities, which will be issued only as registered bonds without coupons in denominations of \$25,000 and any multiple thereof. The transfer of the Bonds will be registrable and they may be exchanged at the corporate trust office of the Registrar in San Juan, Puerto Rico, upon the payment of any taxes or other governmental charges required to be paid with respect to such transfer or exchange.

Authorization

Section 2 of Article VI of the Constitution of the Commonwealth provides that the power of the Commonwealth to contract and to authorize the contracting of debts shall be exercised as determined by the Legislative Assembly. Pursuant to this power, the Legislative Assembly enacted the Act, which authorizes the Secretary of the Treasury to issue the Bonds pursuant to one or more resolutions adopted by the Secretary of the Treasury and approved by the Governor. In accordance with the Act, the Secretary of the Treasury adopted and the Governor approved the Bond Resolution.

Redemption

The Bonds maturing prior to July 1, 2023 are not subject to redemption prior to maturity.

Mandatory Redemption. The Variable Rate Bonds (excluding subseries 2007A-7 and 2007A-9 which subseries have no amortization requirements) are subject to redemption to the extent of the respective amortization requirements therefor (and corresponding to the subseries) set forth below (less the amount applied to the purchase of any such Bonds and otherwise subject to adjustment as described below), upon at least 30 days' notice, on July 1, 2023, 2030, 2031, 2032 and 2033, respectively, and on July 1 in each year thereafter at a redemption price of par plus accrued interest to the dates fixed for redemption:

Amortization Requirements (subseries in parenthesis) for Variable Rate Bonds due July 1,

Year	2029(A-2)	2029(A-3)	2031(A-4)	2032(A-5)	2033(A-6)	2034(A-8)
2023	\$17,925,000	\$17,925,000				
2024	14,625,000	14,625,000				
2025	4,975,000	4,975,000				
2026	5,175,000	5,175,000				
2027	15,200,000	15,225,000				
2028	20,375,000	20,375,000				
2029	21,175,000*	21,200,000*				
2030			\$44,050,000			
2031			52,775,000*	\$18,925,000		
2032				81,075,000*	\$23,525,000	
2033					26,475,000*	\$32,350,000
2034						17,650,000*
Average Life						

* Maturity

If the amount of such Bonds purchased or redeemed in a fiscal year exceeds the amount of the amortization requirement for such Bonds for such fiscal year, the amortization requirement for such Bonds may be decreased for such subsequent fiscal years and in such amounts aggregating the amount of such excess as the Secretary of the Treasury shall determine.

Optional Redemption of the Variable Rate Bonds

Variable Rate Bonds bearing interest at a Daily Interest Rate or a Weekly Interest Rate shall be subject to redemption at the option of the Secretary, in whole or in part (and if in part, such order of maturity and subseries as the Secretary shall determine), at a redemption price of 100% of the principal amount thereof at any time.

Auction Rate Securities are subject to redemption at the option of the Secretary on the Interest Payment Date immediately following an Auction Period, in whole or in part (and if in part, in such order of maturity and subseries as the Secretary shall determine), at a redemption

price equal to the principal amount thereof to be redeemed, plus accrued but unpaid interest to the redemption date, without premium, as long as after any such optional redemption, there shall remain not less than \$10,000,000 in aggregate principal amount of each subseries of Variable Rate Bonds bearing interest at an Auction Period Rate unless otherwise consented to by the applicable Broker-Dealer.

Notice of Redemption; Effect of Redemption

Any redemption of the Bonds, either in whole or in part, shall be made upon at least a 30-day prior notice by mail to DTC or, if the book-entry only system described above has been discontinued, by registered or certified mail, postage prepaid, to all registered owners of the Bonds to be redeemed in the manner and under the terms and conditions provided in the Bond Resolution. On the date designated for redemption, notice having been given as provided in the Bond Resolution and moneys for payment of the principal of and accrued interest on the Bonds or portions thereof so called for redemption being held by the Registrar, interest on the Bonds or portions thereof so called for redemption shall cease to accrue.

Each notice of redemption shall contain, among other things, the particular Bonds (or portions thereof) being called for redemption, the redemption date and price and the address at which such Bonds are to be surrendered for payment of the redemption price. Any defect in such notice or the failure so to mail any such notice to DTC in respect of, or the registered owner of, any Bond will not affect the validity of the proceedings for the redemption of any other Bond.

If less than all of a subseries of Bonds are called for redemption, Bank Bonds of such subseries shall be selected for redemption by the Registrar by such method as it deems proper, before any other Bonds of such subseries shall be selected. All other Bonds of such subseries so called for redemption shall be selected (in Authorized Denominations) by the Registrar by such method as it deems fair and appropriate.

If any Auction Rate Securities are to be redeemed and are held by the Securities Depository, the Registrar shall include in the notice of the call for redemption delivered to the Securities Depository: (i) under an item entitled "Publication Date for Securities Depository Purposes", the Securities Depository lottery publication date applicable to such Auction Rate Securities, which date shall be two (2) Business Days after the second Auction Date that immediately precedes the date specified in such notice as the date fixed for the redemption or defeasance of such Auction Rate Securities (the "Redemption/Defeasance Date") (three (3) Business Days immediately preceding such Redemption/Defeasance Date in the case of Auction Rate Securities in the daily Auction Period). Prior to the giving of such notice of redemption or defeasance to the Securities Depository, the Registrar shall confirm the lottery publication date with the Auction Agent. The Registrar shall, at least two (2) Business Days prior to the Redemption/Defeasance Date specified in any such notice of redemption or defeasance of such Auction Rate Securities, as the case may be, request the Securities Depository to disclose to the Auction Agent the Participant number of each Securities Depository's participant in whose account at the Securities Depository any of such Auction Rate Securities have been called for redemption or defeasance (and the principal amount of the Auction Rate Securities held in the account that have been so called) and, at least one (1) Business Day prior to such Business Day the Auction Agent shall request each Broker-Dealer to disclose on a best efforts basis to the

Auction Agent (upon selection by such participant of the Existing Owner or Existing Owners whose Auction Rate Securities are to be so redeemed or defeased and the principal amount of each thereof to be so redeemed or defeased) the aggregate principal amount of such Auction Rate Securities of each such Existing Owner, if any, to be redeemed or defeased. The Auction Agent shall forward to the applicable Broker-Dealer by Electronic Means any notice received by the Auction Agent pursuant to this paragraph by the close of business on the day received by the Auction Agent.

Security

Provision for Payment of Public Debt

The Act provides that the good faith, credit and taxing power of the Commonwealth are irrevocably pledged for the prompt payment of the principal of and interest on the bonds issued under the provisions of the Act. The Secretary of the Treasury is authorized and directed under the Act to pay the principal of and interest on the Bonds as the same become due and payable from any funds available for such purpose at the Department of the Treasury in the fiscal year in which such payment is due. The Act provides that the provisions contained therein with respect to the payment of the principal of and interest on the Bonds shall be considered to be a continuous appropriation for the Secretary of the Treasury to make such payments, even though no specific appropriations are made for such purposes. The payments under the Act are required to be made pursuant to the provisions of the laws of the Commonwealth that regulate the disbursement of public funds.

The Constitution of Puerto Rico provides that public debt of the Commonwealth will constitute a first claim on available Commonwealth resources. Public debt includes general obligation bonds and notes of the Commonwealth and any payments required to be made by the Commonwealth under its guarantees of bonds and notes issued by its public instrumentalities.

The Commonwealth has allocated certain motor vehicle fuel taxes, crude oil and derivative products excise taxes and license fees to Puerto Rico Highway and Transportation Authority (the "Highway Authority"). The amounts so allocated, however, are subject to first being applied to payment of the principal of and interest on the Commonwealth public debt, but only if and to the extent that all other available revenues of the Commonwealth are insufficient for that purpose. The Commonwealth has never had to apply such amounts to the payment of its public debt.

Since fiscal year 1989, the Commonwealth has pledged to Puerto Rico Infrastructure Financing Authority certain federal excise taxes imposed on alcoholic beverages and tobacco products produced in Puerto Rico and sold in the United States, which taxes are returned to the Commonwealth. The amounts so pledged, however, are subject to first being applied to payment of the principal of and interest on the Commonwealth public debt, but only if and to the extent that all other available revenues of the Commonwealth are insufficient for that purpose. The Commonwealth has never had to apply such amounts to the payment of its public debt.

In 2006, the Commonwealth allocated a portion of the sales tax to service the bonds issued by Sales Tax Financing Corporation to refinance a portion of the Commonwealth's

outstanding extra constitutional debt (including the Sales Tax Bonds). The legislation making such allocation provides that the portion so set aside is not “available Commonwealth revenues” for purposes of the above Constitutional provision. No ruling from the Puerto Rico Supreme Court has been solicited as to the validity of such “set aside” vis-a-vis the Constitutional provision referred to above, and the Commonwealth cannot give any assurance that the Puerto Rico Supreme Court when faced with this issue in a properly briefed and litigated proceeding would agree that such segregated sales tax revenues are “unavailable”.

The Constitution expressly empowers a holder of bonds and notes evidencing public debt to bring suit against the Secretary of the Treasury to require application of available resources, including surplus, to the payment of principal of and interest on public debt when due.

Special Fund for the Bonds (General Obligation) Debt Service

Act No. 83 of the Legislature of Puerto Rico, approved on August 30, 1991, as amended, provides for the levy of an annual special tax of 1.03% of the assessed value of all real and personal property not exempt from taxation. The proceeds of said tax are credited to the Commonwealth Debt Redemption Fund (the “Redemption Fund”), for application to the payment of general obligation bonds and notes of the Commonwealth.

Act No. 39 of the Legislature of Puerto Rico, approved on May 13, 1976, as amended (“Act No. 39”), requires the Secretary of the Treasury to transfer each month from available funds of the Commonwealth to the Redemption Fund such amounts which, together with certain other funds deposited therein, will be equal to the sum of one-sixth of the interest to be paid in the next six months and one-twelfth of the principal to be paid or required to be amortized within the next twelve months on all bonds and notes of the Commonwealth for which its full faith and credit are pledged as the same become due and all bonds and notes of the Commonwealth for which the guaranty of the Commonwealth has been exercised. Moneys in the Redemption Fund are held in trust by Government Development Bank. Act No. 39 provides that the obligation of the Secretary of the Treasury to make the above transfers is cumulative, and the amount of any deficiency in any month shall be added to the amount of transfers required in future months until such deficiency has been fully paid.

Act No. 39 expressly relates to direct obligations of the Commonwealth. It may also apply to the payment of Commonwealth guaranteed obligations of public corporations outstanding prior to the date of its adoption but not to the payment of bonds and other obligations of such public corporations guaranteed by the Commonwealth issued after the date of its adoption.

Payment Record

The Commonwealth has never defaulted on the payment of principal of or interest on any of its debt.

Debt Limitation

Section 2 of Article VI of the Constitution of Puerto Rico provides that direct obligations of the Commonwealth evidenced by full faith and credit bonds or notes shall not be issued if the

amount of the principal of and interest on such bonds and notes and on all such bonds and notes theretofore issued which is payable in any fiscal year, together with any amount paid by the Commonwealth in the preceding fiscal year on account of bonds or notes guaranteed by the Commonwealth, exceeds 15% of the average annual revenues raised under the provisions of Commonwealth legislation and covered into the Treasury of Puerto Rico (hereinafter “internal revenues”) in the two fiscal years preceding the then current fiscal year. Section 2 of Article VI does not limit the amount of debt that the Commonwealth may guarantee so long as the 15% limitation is not exceeded. Internal revenues consist principally of income taxes, property taxes and excise taxes. Certain revenues, such as federal excise taxes on offshore shipments of alcoholic beverages and tobacco products and customs duties, which are collected by the United States Government and returned to the Treasury of Puerto Rico and motor vehicle fuel taxes and license fees, which are allocated to the Highway Authority, are not included as internal revenues for the purpose of calculating the debt limit, although some of these revenues may be available for the payment of debt service. In addition, the portion of the sales tax allocated to the Sales Tax Financing Corporation is also not included as internal revenues consistent with the legislation creating the Sales Tax Financing Corporation, which legislation provides that such portion is not “available resources” under the Constitutional provisions relating to the Bonds.

All or a portion of the proceeds of certain refunding bonds issued by the Commonwealth were invested in guaranteed investment contracts or federal agency securities (in each case rated in the highest rating category by Moody’s and S&P), none of which is eligible to be used for legal defeasance under Puerto Rico law (“non-eligible investments”). Since bonds refunded with proceeds invested in non-eligible investments are not legally defeased, such bonds are treated as outstanding for purposes of the 15% debt limitation.

Joint Resolution No. 2104 of September 30, 2004 (“Joint Resolution No. 2104”), authorized the Commonwealth to enter into interest rate exchange agreements with respect to the Commonwealth’s \$447,875,000 Public Improvement Refunding Bonds, Series 2004 B (the “Series 2004 B Bonds”), which were issued as variable rate bonds. Joint Resolution No. 2104 allows the Commonwealth to calculate the constitutional debt limitation using (i) the fixed rate it is required to pay under any interest rate exchange agreement entered into by the Commonwealth in connection with the Series 2004 B Bonds, and (ii) the lesser of (A) the maximum interest rate allowed by law, and (B) the maximum interest rate set forth in the resolution approving the bonds, if any, in connection with the Commonwealth’s \$279,240,000 Public Improvement Refunding Bonds, Series 2004 A (the “Series 2004 A Bonds”) and any Series 2004 B Bonds for which no interest rate exchange agreement is executed. In November 2004, the Commonwealth entered into two interest rate exchange agreements with respect to the Series 2004 B Bonds.

Act No. 39 of 2005 authorizes the Commonwealth to enter into interest rate exchange agreements with respect to its general obligation bonds, subject to certain conditions, including that the agreements are entered into to reduce certain financial risks associated with issuing variable rate obligations. In August 2006, the Commonwealth issued its \$500,000,000 Public Improvement Bonds of 2006, Series A, a portion of which bonds bear interest at a rate that will change periodically based on changes in the United States consumer price index, and in connection with such consumer price index floating rate bonds (said portion, the “2006 CPI Bonds”) entered into an interest rate exchange agreement, the effect of which will economically enable the Commonwealth to pay a fixed rate of interest in respect thereof. Act No. 39 of 2005

allows the Commonwealth to calculate the constitutional debt limit in a manner identical to that utilized in Joint Resolution No. 2104. In addition, the Commonwealth has also executed under the authority granted in Act No. 39 of 2005, interest rate exchange agreements in which the Commonwealth is making payments (1) on \$1,698,370,000 notional amount of public improvement bonds based on a short-term interest rate index published by Securities Industry and Financial Markets Association (“SIFMA”) and is receiving from its counterparties payments on the same notional amount based on the published three-month London Interbank Offered Rate index (the “basis swap”) and (2) on \$850,000,000 notional amount of public improvement bonds based on the published short-term SIFMA municipal swap rate and is receiving from its counterparties payments on the same notional amount based on a published index of municipal bonds having a maturity of 10 years (the “constant maturity swap”). Finally, in connection with the issuance of the Variable Rate Bonds, the Commonwealth is entering into the Interest Rate Swaps.

After giving effect to the issuance of the Bonds, the 2007B Bonds and the refunding of the Refunded Bonds, future maximum annual debt service for the Commonwealth’s outstanding general obligation debt is \$859,632,840 in the fiscal year ending June 30, 2020 (based on the assumption that (i) the bonds refunded with non-eligible investments are treated as being outstanding, (ii) the Series 2004 A Bonds bear interest at their actual rate per annum through July 1, 2012 and thereafter at 12% per annum, (iii) the Series 2004 B Bonds, the 2006 CPI Bonds and the Variable Rate Bonds bear interest at 12% per annum and (iv) the public improvement bonds to which the basis swap and the constant maturity swap relate bear interest at their stated interest rates rather than the rates set forth in said swaps). This amount (\$859,632,840) is equal to 10.30% of \$8,344,210,500, which is the average of the adjusted internal revenues for the fiscal year ended June 30, 2006 and the currently estimated adjusted internal revenues for the fiscal year ended June 30, 2007. If the bonds refunded with non-eligible investments were treated as not being outstanding, and the interest on the Series 2004 B Bonds, the 2006 CPI Bonds and the Variable Rate Bonds is calculated using the fixed rate paid by the Commonwealth under the interest rate exchange agreements executed in connection with such bonds, the percentage referred to in the preceding sentence would be 8.63%.

Debt service for the Puerto Rico Aqueduct and Sewer Authority (“PRASA”) guaranteed bonds of approximately \$30 million was paid by PRASA during the last two fiscal years and, thus, is not included in the calculation of the 15% debt limitation. See “Other Public Corporations – Aqueduct and Sewer Authority” under *Public Corporations* in *Appendix I*. In the event PRASA is unable to make any portion of the future debt service payments on its guaranteed bonds, the Commonwealth would be required to make such payments under its guarantee from the General Fund and such debt service would to the extent to be paid by the Commonwealth be included in the calculation of the 15% debt limitation.

Maturity Limitation

The Constitution provides that no bonds or notes of the Commonwealth shall mature later than 30 years from their date of issue, except bonds or notes for housing facilities, which shall mature in no more than 40 years.

BOND INSURANCE

The Assured Insurance Policy

The following information is not complete and reference is made to *Appendix IV* for a specimen of Assured's Insurance Policy.

Assured has made a commitment to issue the Assured Insurance Policy relating to the Assured Insured Bonds, effective as of the date of issuance of the Assured Insured Bonds. Under the terms of the Assured Insurance Policy, Assured will unconditionally and irrevocably guarantee to pay that portion of principal of and interest on the Assured Insured Bonds that becomes Due for Payment but shall be unpaid by reason of Nonpayment by the Commonwealth (the "Insured Payments"). Insured Payments shall not include any additional amounts owing by the Commonwealth solely as a result of the failure by the Registrar to pay such amount when due and payable, including without limitation any such additional amounts as may be attributable to penalties or to interest accruing at a default rate, to amounts payable in respect of indemnification, or to any other additional amounts payable by the Registrar by reason of such failure. The Assured Insurance Policy is non-cancelable for any reason, including without limitation the non-payment of premium.

"Due for Payment" means, when referring to the principal of the Assured Insured Bonds, the stated maturity date thereof, or the date on which the Assured Insured Bonds shall have been duly called for mandatory sinking fund redemption, and does not refer to any earlier date on which payment is due by reason of a call for redemption (other than by mandatory sinking fund redemption), acceleration or other advancement of maturity (unless Assured in its sole discretion elects to make any principal payment, in whole or in part, on such earlier date) and, when referring to interest on the Assured Insured Bonds, means the stated dates for payment of interest.

"Nonpayment" means, in respect of the Assured Insured Bonds, the failure of the Commonwealth to have provided sufficient funds to the Registrar for payment in full of all principal and interest Due for Payment on the Assured Insured Bonds. The term Nonpayment in respect of an Assured Insured Bond also includes any amount previously distributed to the holder of such Assured Insured Bond in respect of any Insured Payment by or on behalf of the Commonwealth which amount has been recovered from such holder pursuant to the United States Bankruptcy Code in accordance with a final, nonappealable order of a court having competent jurisdiction that such payment constitutes an avoidable preference with respect to such holder. Nonpayment does not include nonpayment of principal or interest caused by the failure of the Registrar to pay such amount when due and payable.

Assured will pay each portion of an Insured Payment that is Due for Payment and unpaid by reason of Nonpayment, on the later to occur of (i) the date such principal or interest becomes Due for Payment, or (ii) the business day next following the day on which Assured shall have received a completed notice of Nonpayment therefor in accordance with the terms of the Assured Insurance Policy.

Assured shall be fully subrogated to the rights of the holders of the Assured Insured Bonds to receive payments in respect of the Insured Payments to the extent of any payment by Assured under the Assured Insurance Policy.

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

Assured. Assured is a Maryland-domiciled insurance company regulated by the Maryland Insurance Administration and licensed to conduct financial guaranty insurance business in forty-nine states, the District of Columbia and Puerto Rico. Assured commenced operations in 1988. Assured is a wholly owned, indirect subsidiary of Assured Guaranty Ltd. (“AGL”), a Bermuda-based holding company whose shares are publicly traded and are listed on the New York Stock Exchange under the symbol “AGO.” AGL, through its operating subsidiaries, provides credit enhancement products to the U.S. and global public finance, structured finance and mortgage markets. Neither AGL nor any of its shareholders is obligated to pay any debts of Assured or any claims under any insurance policy issued by Assured

Assured is subject to insurance laws and regulations in Maryland and in New York (and in other jurisdictions in which it is licensed) that, among other things, (i) limit Assured’s business to financial guaranty insurance and related lines, (ii) prescribe minimum solvency requirements, including capital and surplus requirements, (iii) limit classes and concentrations of investments, (iv) regulate the amount of both the aggregate and individual risks that may be insured, (v) limit the payment of dividends by Assured, (vi) require the maintenance of contingency reserves, and (vii) govern changes in control and transactions among affiliates. Certain state laws to which Assured is subject also require the approval of policy rates and forms.

Assured’s financial strength is rated “AAA” by S&P, “AAA” by Fitch, Inc. and “Aaa” by Moody’s. Each rating of Assured should be evaluated independently. An explanation of the significance of the above ratings may be obtained from the applicable rating agency. The above ratings are not recommendations to buy, sell or hold any security, and such ratings are subject to revision or withdrawal at any time by the rating agencies. Any downward revision or withdrawal of any of the above ratings may have an adverse effect on the market price of any security guaranteed by Assured. Assured does not guaranty the market prices of the securities it guarantees, nor does it guaranty that the ratings on such securities will not be revised or withdrawn.

As of December 31, 2006, Assured had total admitted assets of \$1,248,270,663 (audited), total liabilities of \$962,316,898 (audited), total surplus of \$285,953,765 (audited) and total statutory capital (surplus plus contingency reserves) of \$916,827,559 (audited) determined in accordance with statutory accounting practices prescribed or permitted by insurance regulatory authorities. As of June 30, 2007, Assured had total admitted assets of \$1,274,707,293 (unaudited), total liabilities of \$1,032,077,892 (unaudited), total surplus of \$242,629,401 (unaudited) and total statutory capital (surplus plus contingency reserves) of \$933,783,902 (unaudited) determined in accordance with statutory accounting practices prescribed or permitted by insurance regulatory authorities. The Maryland Insurance Administration recognizes only statutory accounting practices for determining and reporting the financial condition and results of

operations of an insurance company, for determining its solvency under the Maryland Insurance Code, and for determining whether its financial condition warrants the payment of a dividend to its stockholders. No consideration is given by the Maryland Insurance Administration to financial statements prepared in accordance with accounting principles generally accepted in the United States (“GAAP”) in making such determinations.

The following documents are hereby incorporated by reference into this Official Statement and shall be deemed to be a part hereof:

- The consolidated balance sheets of Assured as of December 31, 2006 and December 31, 2005 and the related consolidated statements of operations and comprehensive income, of shareholder’s equity and of cash flows for each of the three years in the period ended December 31, 2006, prepared in accordance with GAAP, included as Exhibit 99.1 to the Annual Report on Form 10-K of AGL for the fiscal year ended December 31, 2006 (which was filed by AGL with the Securities and Exchange Commission (the “SEC”) on February 28, 2007), as amended by the Form 10-K/A filed by AGL on March 1, 2007;
- The unaudited consolidated balance sheet and statement of shareholder’s equity of Assured as of and for the period ended March 31, 2007, respectively, and the related consolidated statements of operations and comprehensive income and cash flows for the three months ended March 31, 2007 and March 31, 2006, prepared in accordance with GAAP, included as Exhibit 99.1 to the Quarterly Report on Form 10-Q for the quarterly period ended March 31, 2007 (which was filed by AGL with the SEC on May 7, 2007);
- The unaudited consolidated balance sheet and statement of shareholder’s equity of Assured as of and for the period ended June 30, 2007, respectively, and the related consolidated statements of operations and comprehensive income for the three and six months ended June 30, 2007 and June 30, 2006, and the statements of cash flows for the six months ended June 30, 2007 and June 30, 2006, prepared in accordance with GAAP, included as Exhibit 99.1 to the Quarterly Report on Form 10-Q for the quarterly period ended June 30, 2007 (which was filed by AGL with the SEC on August 9, 2007); and
- The Current Reports on Form 8-K filed by AGL with the SEC, as they relate to Assured.

Any statement contained in a document incorporated herein by reference or contained herein under this heading “The Assured Insurance Policy” shall be modified or superseded for purposes of this Official Statement to the extent that a statement contained under this heading or in any subsequently filed document which is incorporated by reference under this heading also modifies or supersedes such statement. Any statement so modified or superseded shall not be deemed, except as so modified or superseded, to constitute a part of this Official Statement.

All consolidated financial statements of Assured included in documents filed by AGL with the SEC pursuant to Section 13(a), 13(c), 14 or 15(d) of the Securities Exchange Act of

1934, as amended, subsequent to the date of this Official Statement and prior to the termination of the offering of the Bonds shall be deemed to be incorporated by reference into this Official Statement and to be a part hereof from the respective dates of filing such consolidated financial statements.

Copies of the consolidated financial statements of Assured incorporated by reference under this heading and of the statutory financial statements filed by Assured with the Maryland Insurance Administration are available upon request by contacting Assured at 1325 Avenue of the Americas, New York, New York 10019 or by calling Assured at (212) 974-0100.

Assured makes no representation regarding the Bonds or the advisability of investing in the Bonds. In addition, Assured makes no representation regarding, nor does it accept any responsibility for the accuracy or completeness of this Official Statement or any information or disclosure contained herein, or omitted herefrom, other than with respect to the accuracy of the information regarding Assured and AGL supplied by Assured and presented under this heading.

The FGIC Insurance Policy

The following information has been furnished by FGIC for use in this Official Statement. Reference is made to *Appendix V* for a specimen of FGIC's Insurance Policy.

Concurrently with the issuance of the FGIC Insured Bonds, FGIC will issue its FGIC Insurance Policy for the FGIC Insured Bonds. The FGIC Insurance Policy unconditionally guarantees the payment of that portion of the principal or accreted value (if applicable) of and interest on the FGIC Insured Bonds which has become due for payment, but shall be unpaid by reason of nonpayment by the Commonwealth. FGIC will make such payments to U.S. Bank Trust National Association, or its successor as its agent (the "Fiscal Agent"), on the later of the date on which such principal, accreted value or interest (as applicable) is due or on the business day next following the day on which FGIC shall have received notice (in accordance with the terms of the FGIC Insurance Policy) from an owner of a FGIC Insured Bond or the Registrar of the nonpayment of such amount by the Commonwealth. The Fiscal Agent will disburse such amount due on any FGIC Insured Bond to its owner upon receipt by the Fiscal Agent of evidence satisfactory to the Fiscal Agent of the owner's right to receive payment of the principal, accreted value or interest (as applicable) due for payment and evidence, including any appropriate instruments of assignment, that all of such owner's rights to payment of such principal, accreted value or interest (as applicable) shall be vested in FGIC. The term "nonpayment" in respect of a FGIC Insured Bond includes any payment of principal, accreted value or interest (as applicable) made to an owner of a FGIC Insured Bond which has been recovered from such owner pursuant to the United States Bankruptcy Code by a trustee in bankruptcy in accordance with a final, nonappealable order of a court having competent jurisdiction.

Once issued, the FGIC Insurance Policy is non-cancellable by FGIC. The FGIC Insurance Policy covers failure to pay principal (or accreted value, if applicable) of the FGIC Insured Bonds on their stated maturity dates and their mandatory sinking fund redemption dates, and not on any other date on which the FGIC Insured Bonds may have been otherwise called for redemption, accelerated or advanced in maturity. The FGIC Insurance Policy also covers the failure to pay interest on the stated date for its payment. In the event that payment of the FGIC

Insured Bonds is accelerated, FGIC will only be obligated to pay principal (or accreted value, if applicable) and interest in the originally scheduled amounts on the originally scheduled payment dates. Upon such payment, FGIC will become the owner of the FGIC Insured Bonds, appurtenant coupon or right to payment of principal or interest on such Bond and will be fully subrogated to all of the Bondholder's rights thereunder.

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

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

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

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

FGIC Financial Guaranty is a direct, wholly owned subsidiary of FGIC Corporation, a Delaware corporation. At June 30, 2007, the principal owners of FGIC Corporation and the approximate percentage of its outstanding common stock owned by each were as follows: The PMI Group, Inc. – 42%; affiliates of the Blackstone Group L.P. – 23%; and affiliates of the Cypress Group L.L.C. – 23%. Neither FGIC Corporation nor any of its stockholders or affiliates is obligated to pay any debts of Financial Guaranty or any claims under any insurance policy, including the Policy, issued by Financial Guaranty.

FGIC is subject to the insurance laws and regulations of the State of New York, where FGIC is domiciled, including New York's comprehensive financial guaranty insurance law. That law, among other things, limits the business of each financial guaranty insurer to financial guaranty insurance (and related lines); requires that each financial guaranty insurer maintain a minimum surplus to policyholders; establishes limits on the aggregate net amount of exposure that may be retained in respect of a particular issuer or revenue source (known as single risk limits) and on the aggregate net amount of exposure that may be retained in respect of particular types of risk as compared to the policyholders' surplus (known as aggregate risk limits); and establishes contingency, loss and unearned premium reserve requirements. In addition, FGIC is also subject to the applicable insurance laws and regulations of all other jurisdictions in which it is licensed to transact insurance business. The insurance laws and regulations, as well as the level of supervisory authority that may be exercised by the various insurance regulators, vary by jurisdiction.

At June 30, 2007, FGIC had net admitted assets of approximately \$4.040 billion, total liabilities of approximately \$2.944 billion, and total capital and policyholders' surplus of approximately \$1.096 billion, determined in accordance with statutory accounting practices ("SAP") prescribed or permitted by insurance regulatory authorities.

The unaudited financial statements as of June 30, 2007, and the audited consolidated financial statements of FGIC and subsidiaries, on the basis of U.S. generally accepted accounting principles ("GAAP"), as of December 31, 2006 and December 31, 2005, which will be filed with the NRMSIRs, are hereby included by specific reference in this Official Statement. Any statement contained herein under this heading "The FGIC Insurance Policy", or in any documents included by specific reference herein, shall be modified or superseded to the extent required by any statement in any document subsequently filed by FGIC with such NRMSIRs, and shall not be deemed, except as so modified or superseded, to constitute a part of this Official Statement. All financial statements of FGIC (if any) included in documents filed by FGIC with the NRMSIRs subsequent to the date of this Official Statement and prior to the termination of the offering of the Bonds shall be deemed to be included by specific reference into this Official Statement and to be a part hereof from the respective dates of filing of such documents.

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

Copies of FGIC's most recently published GAAP and SAP financial statements are available upon request to: Financial Guaranty Insurance Company, 125 Park Avenue, New York, NY 10017, Attention: Corporate Communications Department. FGIC's telephone number is (212) 312-3000.

Financial Guaranty's Credit Ratings. The financial strength of FGIC is rated "AAA" by S&P, "Aaa" by Moody's, and "AAA" by Fitch Ratings. Each rating of FGIC should be evaluated independently. The ratings reflect the respective ratings agencies' current assessments of the insurance financial strength of FGIC. Any further explanation of any rating may be obtained only from the applicable rating agency. These ratings are not recommendations to buy, sell or hold the FGIC Insured Bonds, and are subject to revision or withdrawal at any time by the rating agencies. Any downward revision or withdrawal of any of the above ratings may have an adverse effect on the market price of the FGIC Insured Bonds. FGIC does not guarantee the market price or investment value of the FGIC Insured Bonds nor does it guarantee that the ratings on the FGIC Insured Bonds will not be revised or withdrawn.

Neither FGIC nor any of its affiliates accepts any responsibility for the accuracy or completeness of the Official Statement or any information or disclosure that is provided to potential purchasers of the Bonds, or omitted from such disclosure, other than with respect to the accuracy of information with respect to FGIC or the FGIC Insurance Policy under this heading

“The FGIC Insurance Policy”. In addition, FGIC makes no representation regarding the Bonds or the advisability of investing in the Bonds.

The FSA Policy

Concurrently with the issuance of the Bonds, FSA will issue its Municipal Bond Insurance Policy for the FSA Insured Bonds (the “FSA Policy”). The FSA Policy guarantees the scheduled payment of principal of and interest on the FSA Insured Bonds when due as set forth in the form of the FSA Policy included as *Appendix VI* to this Official Statement.

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

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

At June 30, 2007, FSA’s combined policyholders' surplus and contingency reserves were approximately \$2,642,612,000 and its total net unearned premium reserve was approximately \$2,116,401,000 in accordance with statutory accounting principles. At June 30, 2007, FSA’s consolidated shareholder’s equity was approximately \$3,072,828,000 and its total net unearned premium reserve was approximately \$1,660,356,000 in accordance with generally accepted accounting principles.

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

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

The MBIA Policy

The following information has been furnished by MBIA for use in this Official Statement. Reference is made to *Appendix VII* for a specimen of the MBIA Policy.

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

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

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

Upon receipt of telephonic or telegraphic notice, such notice subsequently confirmed in writing by registered or certified mail, or upon receipt of written notice by registered or certified mail, by MBIA from the Registrar or any owner of a MBIA Insured Bond the payment of an insured amount for which is then due, that such required payment has not been made, MBIA on the due date of such payment or within one business day after receipt of notice of such nonpayment, whichever is later, will make a deposit of funds, in an account with U.S. Bank Trust National Association, in New York, New York, or its successor, sufficient for the payment of any such insured amounts which are then due. Upon presentment and surrender of such MBIA Insured Bonds or presentment of such other proof of ownership of the MBIA Insured Bonds, together with any appropriate instruments of assignment to evidence the assignment of

the insured amounts due on the MBIA Insured Bonds as are paid by MBIA, and appropriate instruments to effect the appointment of MBIA as agent for such owners of the MBIA Insured Bonds in any legal proceeding related to payment of insured amounts on the MBIA Insured Bonds, such instruments being in a form satisfactory to U.S. Bank Trust National Association, U.S. Bank Trust National Association shall disburse to such owners or the Registrar payment of the insured amounts due on such MBIA Insured Bonds, less any amount held by the Registrar for the payment of such insured amounts and legally available therefor.

MBIA Insurance Corporation.

MBIA is the principal operating subsidiary of MBIA Inc., a New York Stock Exchange listed company (the “Company”). The Company is not obligated to pay the debts of or claims against MBIA. MBIA is domiciled in the State of New York and licensed to do business in and subject to regulation under the laws of all 50 states, the District of Columbia, the Commonwealth, the Commonwealth of the Northern Mariana Islands, the Virgin Islands of the United States and the Territory of Guam. MBIA, either directly or through subsidiaries, is licensed to do business in the Republic of France, the United Kingdom and the Kingdom of Spain and is subject to regulation under the laws of those jurisdictions. In February 2007, the Company incorporated a new subsidiary, MBIA México, S.A. de C.V. (“MBIA Mexico”), through which it intends to write financial guarantee insurance in Mexico beginning in 2007.

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

Regulation.

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

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

Financial Strength Ratings of MBIA.

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

Standard & Poor's, a division of The McGraw-Hill Companies, Inc., rates the financial strength of MBIA “AAA.”

Fitch Ratings rates the financial strength of MBIA “AAA.”

Each rating of MBIA should be evaluated independently. The ratings reflect the respective rating agency's current assessment of the creditworthiness of MBIA and its ability to pay claims on

its policies of insurance. Any further explanation as to the significance of the above ratings may be obtained only from the applicable rating agency.

The above ratings are not recommendations to buy, sell or hold the Bonds, and such ratings may be subject to revision or withdrawal at any time by the rating agencies. Any downward revision or withdrawal of any of the above ratings may have an adverse effect on the market prices of the MBIA Insured Bonds. MBIA does not guaranty the market prices of the Bonds nor does it guaranty that the ratings on the Bonds will not be revised or withdrawn.

MBIA Financial Information.

As of December 31, 2006, MBIA had admitted assets of \$10.9 billion (audited), total liabilities of \$6.9 billion (audited), and total capital and surplus of \$4.0 billion (audited) determined in accordance with statutory accounting practices prescribed or permitted by insurance regulatory authorities. As of June 30, 2007, MBIA had admitted assets of \$10.8 billion (unaudited), total liabilities of \$6.8 billion (unaudited), and total capital and surplus of \$4.0 billion (unaudited) determined in accordance with statutory accounting practices prescribed or permitted by insurance regulatory authorities.

For further information concerning MBIA, see the consolidated financial statements of MBIA and its subsidiaries as of December 31, 2006 and December 31, 2005 and for each of the three years in the period ended December 31, 2006, prepared in accordance with generally accepted accounting principles, included in the Annual Report on Form 10-K of the Company for the year ended December 31, 2006 and the consolidated financial statements of MBIA and its subsidiaries as of June 30, 2007 and for the six month periods ended June 30, 2007 and June 30, 2006 included in the Quarterly Report on Form 10-Q of the Company for the quarter ended June 30, 2007, which are hereby incorporated by reference into this Official Statement and shall be deemed to be a part hereof.

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

Incorporation of Certain Documents by Reference

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

- (1) The Company's Annual Report on Form 10-K for the year ended December 31, 2006; and
- (2) The Company's Quarterly Report on Form 10-Q for the quarter ended June 30, 2007.

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

Any statement contained in a document incorporated or deemed to be incorporated by reference herein, or contained in this Official Statement, shall be deemed to be modified or superseded for purposes of this Official Statement to the extent that a statement contained herein or in any other subsequently filed document which also is or is deemed to be incorporated by reference herein modifies or supersedes such statement. Any such statement so modified or superseded shall not be deemed, except as so modified or superseded, to constitute a part of this Official Statement.

The Company files annual, quarterly and special reports, information statements and other information with the SEC under File No. 1-9583. Copies of the Company’s SEC filings (including (1) the Company’s Annual Report on Form 10-K for the year ended December 31, 2006, and (2) the Company’s Quarterly Reports on Form 10-Q for the quarters ended March 31, 2007 and June 30, 2007) are available (i) over the Internet at the SEC’s web site at <http://www.sec.gov>; (ii) at the SEC’s public reference room in Washington D.C.; (iii) over the Internet at the Company’s web site at <http://www.mbia.com>; and (iv) at no cost, upon request to MBIA at its principal executive offices.

Concerning the Insurance Policies of the Bond Insurers

The Bond Insurers shall be deemed the owners of the Insured Bonds in lieu of the Beneficial Owners, as long as the Bond Insurers shall not then be in default of their obligations under their respective Insurance Policies, for the purpose of giving of consents to the adoption of any resolution supplemental to the Bond Resolution.

PUBLIC SECTOR DEBT OF THE COMMONWEALTH

Public Sector Debt

The following table presents a summary of the public sector debt of the Commonwealth as of May 31, 2007. The table also shows the public sector debt as further adjusted by the following bond issuances and events that have occurred after May 31, 2007: (i) the issuance of the Sales Tax Bonds, (ii) the expected issuance by the Commonwealth on or about October 4, 2007 of \$408,800,000 principal amount of Public Improvement Bonds of 2007, Series A (the “2007 Series A Public Improvement Bonds”) and \$91,200,000 principal amount of Public Improvement Bonds of 2007, Series B (the “2007 Series B Public Improvement Bonds”), and (iii) the issuance of the Bonds and the 2007B Bonds and the refunding of the Refunded Bonds. The table should be read in conjunction with the information set forth under *Debt* in *Appendix I*.

**Commonwealth of Puerto Rico
Public Sector Debt*
(in thousands)**

	May 31, 2007	As Adjusted
Puerto Rico direct debt ⁽¹⁾	\$11,433,326	\$11,928,361
Municipal debt	2,448,771	2,448,771
Public corporations debt		
Puerto Rico guaranteed debt	800,044	800,044

Debt supported by Puerto Rico appropriations or taxes	16,969,012	16,969,012
Other non-guaranteed debt	11,919,124	11,919,124
Total public corporations debt	29,688,180	29,688,180
Total public sector debt	\$43,570,277	\$44,065,312

* For a complete recital of all notes to this table, see "Public Sector Debt" under *Debt in Appendix I*.

(1) Includes general obligation bonds, tax and revenues anticipation notes, and lines of credit provided by Government Development Bank. The amount excludes certain Commonwealth general obligations bonds that have been refunded with proceeds that were invested in non-eligible investments, even though such bonds will be considered outstanding under their respective authorizing resolutions and for purposes of calculating the Commonwealth's constitutional debt limitation.

Source: Government Development Bank

Debt Service Requirements for Commonwealth General Obligation Bonds and Certain Guaranteed Debt

The following table presents the debt service requirements for (i) Commonwealth general obligation bonds outstanding on May 31, 2007, plus the debt service requirements for the 2007 Series A Public Improvement Bonds and the 2007 Series B Public Improvement Bonds; (ii) the Bonds; and (iii) total Commonwealth general obligation bonds, adjusted for the issuance of the Bonds, the 2007B Bonds and the refunding of the Refunded Bonds. The table excludes debt service on Commonwealth general obligation bonds that have been refunded with the proceeds of refunding bonds invested in non-eligible investments, notwithstanding that such bonds will be considered to be outstanding under their authorizing resolution and for purposes of calculating the Commonwealth's debt limitation. Debt service requirements for each fiscal year, as shown in the following table, include principal and interest due on July 1 immediately following the close of such fiscal year.

Commonwealth of Puerto Rico Debt Service Requirements* (in thousands)

Fiscal Year Ending June 30,	Outstanding Bonds Total Debt Service ⁽¹⁾	2007B Bonds		The Bonds		Grand Total ⁽²⁾
		Principal	Interest	Principal	Interest	
2008	\$ 462,794		\$ 2,218		\$ 27,500	\$ 492,513
2009	590,204	\$ 46,625	3,132		38,823	678,784
2010	631,824	13,920	731		38,823	685,298
2011	640,096			\$ 4,000	38,823	682,919
2012	639,975			4,000	38,672	682,647
2013	639,940			7,645	38,345	685,930
2014	614,762			20,885	38,021	673,668
2015	624,299			26,925	36,925	688,149
2016	642,079			10,925	35,511	688,515
2017	593,239			59,910	35,054	688,203
2018	617,335			30,965	31,709	680,009
2019	601,125			53,215	30,006	684,345
2020	653,500			39,290	27,137	719,927

Commonwealth of Puerto Rico
Debt Service Requirements*
(in thousands)

Fiscal Year Ending June 30,	Outstanding Bonds Total Debt Service ⁽¹⁾	2007B Bonds		The Bonds		Grand Total ⁽²⁾
		Principal	Interest	Principal	Interest	
2021	487,616			36,205	24,976	548,797
2022	418,832			36,830	22,985	478,647
2023	375,035			35,850	20,959	431,844
2024	379,420			29,250	19,698	428,368
2025	380,503			9,950	18,669	409,122
2026	371,651			10,350	18,319	400,320
2027	351,577			30,425	17,955	399,957
2028	342,160			40,750	15,597	398,507
2029	341,679			42,375	16,739	400,793
2030	340,886			44,050	13,960	398,897
2031	314,215			71,700	12,411	398,325
2032	104,527			104,600	9,888	219,015
2033	70,999			108,825	6,208	186,032
2034	61,978			67,650	2,380	132,007
2035	61,497					61,497
2036	33,676					33,676
2037	33,680					33,680
Total	\$12,421,102	\$ 60,545	\$ 6,081	\$ 926,570	\$ 676,094	\$14,090,392

* Totals may not add due to rounding.

- (1) Since fiscal year 1997, the Commonwealth made annual debt service payments of approximately \$30 million pursuant to its guaranty of PRASA bonds. On January 1, 2006, PRASA began making annual debt service payments under its bonds as a result of anticipated increased revenues from its rate increases. Thus, the Commonwealth has ceased making annual debt service payments on guaranteed PRASA bonds. See “Other Public Corporations – Aqueduct and Sewer Authority” under *Public Corporations* in *Appendix I*. In the event PRASA is unable to make any portion of the future debt service payments on its guaranteed bonds, the Commonwealth would be required to make such payments under its guarantee from the General Fund. Also, debt service requirements on all general obligation bonds outstanding on May 31, 2007 are adjusted to exclude debt service on all general obligation bonds refunded with proceeds invested in non-eligible investments, notwithstanding that such bonds will be considered to be outstanding under their authorizing resolution and for purposes of calculating the Commonwealth’s debt limitation. Interest on the Series 2004 A Bonds is calculated at their actual rate per annum through July 1, 2012 and thereafter at 12% per annum. Interest on the Series 2004 B Bonds, the 2006 CPI Bonds and the Variable Rate Bonds is calculated using the respective fixed interest rates to be paid by the Commonwealth under the respective interest rate exchange agreements executed in connection with such bonds. Interest on the public improvement bonds to which the basis swap and the constant maturity swap relate is calculated using the respective fixed interest rates on said bonds rather than the payments exchanged under said swaps.
- (2) Debt service requirements on all general obligation bonds outstanding, adjusted as discussed in footnote 1 above and further adjusted to include the issuance of the Bonds and the refunding of the Refunded Bonds.

Sources: Government Development Bank and Department of the Treasury

TAX MATTERS

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

The opinion on tax matters will be based on and will assume the accuracy of certain representations and certifications, and continuing compliance with certain covenants, of the Commonwealth 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 Commonwealth’s certifications and representations or the continuing compliance with the Commonwealth’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 Commonwealth 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 Commonwealth has covenanted, to the extent permitted by the Constitution and the laws of the Commonwealth, to take the actions required of it for the interest on the Bonds to be and to remain excluded from gross income for federal income tax purposes, and not to take any actions that would adversely affect that exclusion. 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 Commonwealth from complying with the requirements of the Code.

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

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

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

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 value of the Bonds.

On May 21, 2007, the United States Supreme Court agreed to hear *Dep't of Revenue of Kentucky v. Davis*. In the *Davis* case, the Kentucky Court of Appeals held that Kentucky's exemption from taxation of interest on bonds issued by Kentucky and its political subdivisions and its taxation of interest on bonds issued by other states and their political subdivisions violates the Commerce Clause of the United States Constitution. This ruling does not apply directly to bonds of the Commonwealth (including the Bonds) because the interest on those bonds is exempt from state and local income taxation by virtue of federal law. If the United States Supreme Court sustains the *Davis* decision, however, one possible outcome could be that states with income tax laws similar to Kentucky's would cease to tax interest on bonds of other states and their political subdivisions. The introduction or enactment of any such future legislation might adversely affect the market value of the Bonds, as such legislation could reduce the current tax advantage of bonds of the Commonwealth. It is not possible to predict how the United States Supreme Court will decide the *Davis* case or to predict any change in state law that would be occasioned by the affirmance of the *Davis* decision, nor is it possible to predict the effect, if any, of that affirmance or any change in state law on the market value of the Bonds.

Prospective purchasers of the Bonds should consult their tax advisers regarding pending or proposed federal and state tax legislation, the *Davis* case, and other court proceedings, and prospective purchasers of the Bonds at other than their original issuance at the respective prices or yields indicated on the inside cover page of this Official Statement should also consult their 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 Commonwealth 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 Commonwealth as the taxpayer and the beneficial owners of the Bonds will have only limited rights, if any, to obtain and participate in judicial review of such audit. Any action of the IRS, including but not limited to selection of the Bonds for audit, or the course or result of such audit, or an audit of other obligations presenting similar tax issues, may affect the market prices for the Bonds.

Original Issue Premium

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

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

FINANCIAL ADVISOR

The Commonwealth has retained Mesirow Financial Inc., Chicago, Illinois, as financial advisor (the “Financial Advisor”) in connection with the issuance of the Bonds. The Financial Advisor is not obligated to undertake, and has not undertaken to make, an independent verification or to assume responsibility for the accuracy, completeness, or fairness of the information contained in this Official Statement.

APPROVAL OF LEGAL PROCEEDINGS

Legal matters incident to the authorization and issuance of the Bonds are subject to the approval of Squire, Sanders & Dempsey L.L.P., Miami, Florida, Bond Counsel, the proposed form of whose opinion is included herein as *Appendix II*. Certain legal matters will be passed upon for the Underwriters by Sidley Austin LLP, New York, New York.

LEGAL INVESTMENT

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

UNDERWRITING

The Underwriters have jointly and severally agreed, subject to certain conditions, to purchase the Bonds from the Commonwealth at an aggregate discount of \$3,192,512.42 from the initial offering prices of the Bonds set forth or derived from information set forth on the inside cover page hereof. The obligation of the Underwriters to purchase the Bonds is subject to certain conditions precedent, and they will be obligated to purchase all the Bonds if any Bonds are purchased. The Underwriters may offer to sell the Bonds to certain dealers and others at prices lower than the initial public offering prices. The offering prices may be changed, from time to time, by the Underwriters.

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

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 LLP (“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.

Oriental Financial Services Corporation (“OFS”) and Bear, Stearns & Co., Inc. (“Bear Stearns”) have entered into a joint venture agreement under which the parties shall provide services and advice to each other and take risk related to the structuring and execution of certain municipal finance transactions with governmental entities located in the Commonwealth. Pursuant to the terms of such joint venture 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.

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. For each issuance of municipal securities for which both parties act as co-senior manager or co-manager, any sales commissions or takedowns shall be allocated based on actual sales of municipal securities by JPMSI or SCUSA.

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 Commonwealth 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.

RATINGS

Moody's and S&P have given the Bonds (other than the respective Insured Bonds) ratings of "Baa3" and "BBB-", respectively. Moody's and S&P have given the Insured Bonds ratings of "Aaa" and "AAA", respectively, on the strength of the issuance concurrently with the delivery of the Bonds of the respective Policies by the Insurers. 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. Such rating agencies were provided with materials relating to the Commonwealth and the Bonds and other relevant information, and no application has been made to any other rating agency for the purpose of obtaining a rating on the Bonds.

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 such ratings, or either of them, 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 Securities and Exchange Commission (the "SEC"), the Commonwealth has covenanted in the Bond Resolution for the benefit of the Beneficial Owners (as defined in the Bond Resolution):

1. to file, within 305 days after the end of each fiscal year commencing with the fiscal year ending June 30, 2007, 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 Commonwealth’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 Commonwealth and its revenues, expenditures, financial operations and indebtedness, in each case generally found in this Official Statement; and
2. to file, in a timely manner, with each NRMSIR or with the Municipal Securities Rulemaking Board and with each Commonwealth SID, notice of any failure of the Commonwealth to comply with paragraph 1 above and of the occurrence of any of the following events with respect to the Bonds, if material:
 - a. principal and interest payment delinquencies;
 - b. non-payment related defaults;
 - c. unscheduled draws on debt service reserves reflecting financial difficulties;
 - d. unscheduled draws on credit enhancements reflecting financial difficulties;
 - e. substitution of credit or liquidity facility providers, or their failure to perform;
 - f. adverse opinions or events affecting the tax-exempt status of the Bonds;
 - g. modifications to rights of the holders (including Beneficial Owners) of the Bonds;
 - h. bond calls;
 - i. defeasances;
 - j. release, substitution, or sale of property securing repayment of the Bonds; and
 - k. rating changes.

Events (c), (d) and (e) are included pursuant to a letter from the SEC staff to the National Association of Bond Lawyers, dated September 19, 1995. However, events (c), (d) and (e) may not be applicable, since the terms of the Bonds do not provide for “debt service reserves”, “credit enhancements” or “liquidity facility providers”. In addition, with respect to the following events:

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

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

Event (h). The Commonwealth does not undertake to provide the above-described event notice of a mandatory scheduled redemption, not otherwise contingent upon the occurrence of an event, if the terms, dates and amounts of redemption are set forth in detail in this Official

Statement under “*The Bonds — Redemption*”, the only open issue is which Bonds will be redeemed in the case of a partial redemption, notice of redemption is given to the Bondholders as required under the terms of the Bonds, and public notice of the redemption is given pursuant to Securities Exchange Act of 1934 Release No. 34-23856 of the SEC, even if the originally scheduled amounts are reduced by prior optional redemptions or purchases of Bonds.

The Commonwealth expects to provide the information described in paragraph 1 above by filing its first bond official statement that includes such information for the preceding fiscal year or, if no such official statement is issued by the 305-day deadline, by filing a separate document containing such information.

The Commonwealth has made similar continuing disclosure covenants in connection with prior bond issuances, and has complied with all such covenants, except as hereinafter noted. The Commonwealth’s audited financial statements for the fiscal year ended June 30, 2002 were filed after the Commonwealth’s filing deadline of May 1, 2003 because of delays in finalizing such financial statements resulting from the implementation of GASB Statement No. 34 (“GASB 34”). The Commonwealth’s audited financial statements for the fiscal year ended June 30, 2003 were also filed after the Commonwealth’s filing deadline of April 30, 2004, because of delays in finalizing the financial statements of certain of the Commonwealth’s reporting units due to the implementation of GASB 34. The Commonwealth’s audited financial statements for the fiscal year ended June 30, 2004 and 2006 were also filed after the Commonwealth’s respective filing deadlines of May 1, 2005 and 2007, because various governmental agencies did not submit their audited financial statements to the central government’s external auditors on time, thereby delaying submission of the Commonwealth’s audited financial statements.

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

The Commonwealth 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 Commonwealth, such other events are material with respect to the Bonds, but the Commonwealth does not undertake to provide any such notice of the occurrence of any material event except those events listed above.

The Commonwealth acknowledges that its undertaking pursuant to the Rule described above is intended to be 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 Commonwealth’s obligations thereunder.

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

Commonwealth written notice of any request to cure such breach, and the Commonwealth shall have refused to comply within a reasonable time. All Proceedings shall be instituted only 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 any of the Covenants at issue. Moreover, Proceedings filed by Beneficial Owners against the Commonwealth may be subject to the sovereign immunity provisions of Section 2 and 2A of Act No. 104, approved June 29, 1955, as amended, which governs the scope of legal actions against the Commonwealth, substantially limits the amount of monetary damages that may be awarded against the Commonwealth and provides certain notice provisions, the failure to comply with which may further limit any recovery.

The Covenants may only be amended if:

(1) 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 Commonwealth, 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 change in circumstances; and the amendment does not materially impair the interest of Beneficial Owners, as determined by persons unaffiliated with the Commonwealth; or

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

The Commonwealth 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.

MISCELLANEOUS

The foregoing summaries of or references to the Act, the Bonds, the Bond Resolution, the Initial Liquidity Facilities, the Remarketing Agreements, the Escrow Deposit Agreement and the other documents and agreements referred to herein and the summaries of or references to the various acts contained in the Commonwealth Report, 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.

Appended to and constituting a part of this Official Statement are the Commonwealth Report (*Appendix I*), proposed form of opinion of Bond Counsel (*Appendix II*), descriptions of the Auction Procedures for the Auction Rate Securities (*Appendix III*) and the specimens of the Assured Policy, the FGIC Policy, the FSA Policy and the MBIA Policy (*Appendices IV, V, VI and VII*, respectively).

The information set forth in this Official Statement and incorporated herein by reference, except for information pertaining to DTC, the Bond Insurers and certain financial information of the Initial Liquidity Facility Providers was supplied by certain officials of the Commonwealth or certain of its agencies or instrumentalities, in their respective official capacities, or was obtained from publications of the Commonwealth or certain of its agencies or instrumentalities, and is included or incorporated by reference in this Official Statement on the authority of such officials or the authority of such publications as public official documents. The information pertaining to DTC was supplied by DTC.

This Official Statement will be filed with each NRMSIR and with the Municipal Securities Rulemaking Board.

COMMONWEALTH OF PUERTO RICO

By: /s/Juan C. Méndez Torres
Secretary of the Treasury

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COMMONWEALTH REPORT

COMMONWEALTH OF PUERTO RICO
Financial Information and Operating Data Report
July 1, 2007

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COMMONWEALTH OF PUERTO RICO
Financial Information and Operating Data Report
July 1, 2007

INTRODUCTION

Geographic Location and Demography

Puerto Rico, the fourth largest of the Caribbean islands, is located approximately 1,600 miles southeast of New York City. It is approximately 100 miles long and 35 miles wide.

According to the United States Census Bureau, the population of Puerto Rico was 3,808,610 in 2000 (3,927,776 as of July 1, 2006 according to a Census Bureau estimate), compared to 3,522,000 in 1990. As of 2000, the population of San Juan, the island's capital and largest city, was 434,375.

Relationship with the United States

Puerto Rico was discovered by Columbus in 1493 and shortly thereafter the island was conquered and settled by the Spaniards. It remained a Spanish possession for four centuries.

Puerto Rico came under United States sovereignty pursuant to the Treaty of Paris, signed on December 10, 1898, which ended the Spanish-American War. Puerto Ricans have been citizens of the United States since 1917. In 1950, after a long evolution toward greater self-government for Puerto Rico, the Congress of the United States enacted Public Law 600, which is "in the nature of a compact" and which became effective upon its acceptance by the electorate of Puerto Rico. It provides that those sections of existing law which defined the political, economic, and fiscal relationship between Puerto Rico and the United States would remain in full force. It also authorized the people of Puerto Rico to draft and adopt their own Constitution. The Constitution was drafted by a popularly elected constitutional convention, overwhelmingly approved in a special referendum by the people of Puerto Rico and approved by the United States Congress and the President of the United States, becoming effective upon proclamation of the Governor of Puerto Rico on July 25, 1952. Puerto Rico's relationship with the United States is referred to herein as commonwealth status.

The United States and the Commonwealth of Puerto Rico (the "Commonwealth") share a common defense, market, and currency. The Commonwealth exercises virtually the same control over its internal affairs as do the 50 states. It differs from the states, however, in its relationship with the federal government. The people of Puerto Rico are citizens of the United States but do not vote in national elections. They are represented in Congress by a Resident Commissioner who has a voice in the House of Representatives but no vote. Most federal taxes, except those such as Social Security taxes which are imposed by mutual consent, are not levied in Puerto Rico. No federal income tax is collected from Puerto Rico residents on income earned in Puerto Rico, except for certain federal employees who are subject to taxes on their salaries.

The official languages of Puerto Rico are Spanish and English.

Governmental Structure

The Constitution of the Commonwealth provides for the separation of powers of the executive, legislative, and judicial branches of government. The Governor is elected every four years. The Legislative Assembly consists of a Senate and a House of Representatives, the members of which are elected for four-year terms. The highest court within the local jurisdiction is the Supreme Court of Puerto

Rico. Puerto Rico constitutes a District in the federal judiciary and has its own United States District Court. Decisions of this court may be appealed to the United States Court of Appeals for the First Circuit and from there to the Supreme Court of the United States.

Governmental responsibilities assumed by the central government of the Commonwealth are similar in nature to those of the various state governments. In addition, the central government assumes responsibility for local police and fire protection, education, public health and welfare programs, and economic development.

Principal Officials Responsible for Fiscal Matters

Aníbal Acevedo Vilá was sworn in as Governor of Puerto Rico on January 2, 2005. He is a graduate of the University of Puerto Rico, where he obtained a Bachelor's degree in Political Science and a Juris Doctor degree. He obtained an LL.M. from Harvard Law School and served as law clerk for Puerto Rico Supreme Court Judge Federico Hernández Denton and for U.S. First Circuit Court of Appeals Judge Levin Campbell. He also served in the public sector as legislative adviser to the Governor of Puerto Rico. From 1993 to 2001, he served as an elected member of the Puerto Rico House of Representatives. From 2001 until assuming his position as Governor, he served as the elected Resident Commissioner of the Commonwealth in the U.S. House of Representatives.

Juan C. Méndez Torres, Secretary of the Department of the Treasury (the "Treasury"), took office in January 2005. He is a certified public accountant and a graduate of the University of Puerto Rico, where he obtained a Bachelor's degree in Accounting and a Juris Doctor degree. He obtained an LL.M. in tax law from Georgetown University Law Center. From 2002 to mid-2004, he worked as a technical advisor to the Secretary of the Treasury. Prior to 2002, he worked as a tax attorney at a large law firm in Puerto Rico.

CPA José Guillermo Dávila Matos was appointed Executive Director of the Commonwealth of Puerto Rico Office and Management and Budget in August 2006. Before that, he served for two years as Executive Vice President for Administration, Controllershship and Operations at GDB. Prior to entering public service, Dávila-Matos worked in the private sector for close to 20 years in various upper management positions. He is a Certified Public Accountant and earned a Bachelor's degree in Business Administration with a major in accounting from the University of Puerto Rico, Río Piedras. He is also a member of the American Institute of Certified Public Accountants.

Jorge Irizarry Herrans became Acting President of Government Development Bank ("GDB") effective on August 29, 2007. Mr. Irizarry served as Executive Vice President and Director of Financing of GDB from 2005 until his appointment as Acting President, and has over 30 years of experience in banking, investments and consulting, which he acquired while working at Chase Manhattan, Booz Allen Hamilton, Inc., Banco Mercantil, Banco de Ponce, PaineWebber, Inc., and Sandoval Associates. Mr. Irizarry has a Bachelor's degree in finance from New York University and holds a Masters Degree in Business Administration from Harvard Business School.

Political Trends

For many years there have been two major views in Puerto Rico with respect to Puerto Rico's relationship with the United States: one favoring commonwealth status, represented by the Popular Democratic Party, and the other favoring statehood, represented by the New Progressive Party. The following table shows the percentages of the total votes received by the gubernatorial candidates of the various parties in the last five elections. While the electoral choices of Puerto Rico's voters are not based solely on party preferences regarding Puerto Rico's relationship with the United States, candidates who

support a continuing relationship between Puerto Rico and the United States have prevailed in elections for many years.

	1988	1992	1996	2000	2004
Popular Democratic Party	48.7%	45.9%	44.5%	48.6%	48.4%
New Progressive Party	45.8%	49.9%	51.1%	45.7%	48.2%
Puerto Rico Independence Party	5.4%	4.2%	3.8%	5.2%	2.7%
Others	0.1%	-	0.6%	0.5%	0.6%

With the results of the 2004 election, control of the executive branch continued under the Popular Democratic Party while the legislative branch is now controlled by the New Progressive Party. The composition of the Senate and House of Representatives by political party is as follows:

	Senate	House
Popular Democratic Party	9	18
New Progressive Party	17	32
Puerto Rico Independence Party	1	1
Total	27	51

The next general election (gubernatorial, municipal, and legislative) in Puerto Rico will be held in November 2008. Voter participation in Puerto Rico is substantially higher than in the United States, averaging 82% since 1972.

THE ECONOMY

General

The Commonwealth has established policies and programs directed principally at developing the manufacturing and services sectors of the economy and expanding and modernizing the Commonwealth's infrastructure. Domestic and foreign investments have been stimulated by selective tax exemptions, development loans, and other financial and tax incentives. Infrastructure expansion and modernization have been to a large extent financed by bonds and notes issued by the Commonwealth, its public corporations, and municipalities. Economic progress has been aided by significant increases in the levels of education and occupational skills of the population.

Puerto Rico has enjoyed more than two decades of almost continuous economic expansion. Virtually every sector of the economy has participated in this expansion, and record levels of employment have been achieved. Factors contributing to this expansion include government-sponsored economic development programs, increases in the level of federal transfer payments, and the relatively low cost of borrowing. In some years, these factors were aided by a significant rise in construction investment driven by infrastructure projects, private investment, primarily in housing, and relatively low oil prices. In the three fiscal years after the previous recession, during fiscal year 2002, the economy expanded at a moderate annual rate of 2.2%. During fiscal year 2006, real gross national product increased only 0.7% and more recently, several key economic figures have begun to indicate a contraction of economic activity. For fiscal year 2007, the Planning Board's March 2007 projection forecasts a real gross national product decline of 1.4% followed by slight real growth of 0.8% for fiscal year 2008.

Personal income, both aggregate and per capita, has increased consistently each fiscal year from 1985 to 2006. In fiscal year 2006, aggregate personal income was \$50.9 billion (\$44.0 billion in 2000

prices) and personal income per capita was \$12,997 (\$11,218 in 2000 prices).¹ Personal income includes transfer payments to individuals in Puerto Rico under various social programs. Total federal payments to Puerto Rico, which amount to around \$15 billion annually and include transfers to local government entities and expenditures of federal agencies in Puerto Rico, in addition to federal transfer payments to individuals, are lower on a per capita basis in Puerto Rico than in any state of the United States. Contrary to the popular perception that a significant amount of federal transfers to individuals constitutes grants, 80% of the transfer payments to individuals in fiscal year 2006 (\$8.0 billion), represented entitlements for previously performed services or resulting from contributions to programs such as Social Security, Veterans' Benefits, Medicare, and U.S. Civil Service retirement pensions. Grants represent the remainder of the federal transfers to individuals, mostly concentrated in the Nutritional Assistance Program (Food Stamps) and Pell Grant (higher education) Scholarships.

Total average annual employment (as measured by the Department of Labor and Human Resources Household Employment Survey (the "Household Survey")) has also increased. From fiscal year 2003 to fiscal year 2007, annual employment increased 6.3% to 1,262,900.

The dominant sectors of the Puerto Rico economy in terms of production and income are manufacturing and services. The manufacturing sector has undergone fundamental changes over the years as a result of increased emphasis on higher wage, high technology industries, such as pharmaceuticals, biotechnology, computers, microprocessors, professional and scientific instruments, and certain high technology machinery and equipment. The services sector, including finance, insurance, real estate, wholesale and retail trade, and tourism, also plays a major role in the economy. It ranks second to manufacturing in contribution to the gross domestic product and leads all sectors in providing employment.

The following table shows the gross national product for the five fiscal years ended June 30, 2006.

	Commonwealth of Puerto Rico				
	Gross National Product				
	Fiscal Years Ended June 30,				
	2002	2003	2004	2005	2006⁽¹⁾
Gross national product – \$ millions ⁽²⁾	\$45,071	\$47,479	\$50,709	\$53,601	\$56,688
Real gross national product – \$ millions (2000 prices)	41,900	42,795	43,967	44,814	45,111
Annual percentage increase in real gross national product (2000 prices)	(0.3%)	2.1%	2.7%	1.9%	0.7%
U.S. annual percentage increase in real gross national product (2000 prices)	0.6%	1.9%	4.0%	3.0%	3.4%

(1) Preliminary.

(2) In current dollars.

Sources: Puerto Rico Planning Board and Global Insight Inc.

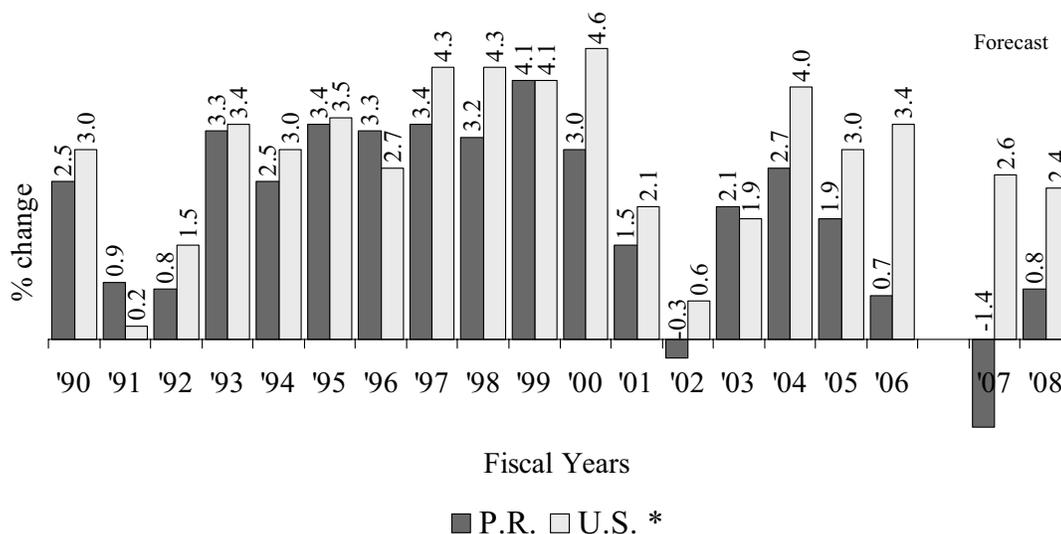
The economy of Puerto Rico is closely linked to the United States economy, as most of the external factors that affect the Puerto Rico economy (other than the price of oil) are determined by the policies and performance of the economy of the United States. These external factors include exports, direct investment, the amount of federal transfer payments, the level of interest rates, the rate of inflation, and tourist expenditures. During fiscal year 2006 (from July 1, 2005 to June 30, 2006) approximately

¹ Different price deflators are used for gross national product and personal income statistics. The year 2000 is used as a basis for comparison because that is the year used by the U.S. Department of Commerce.

83% of Puerto Rico’s exports went to the United States mainland, which was also the source of approximately 51% of Puerto Rico’s imports. Consequently, the recession in the United States in 2001 and the subsequent recovery were also reflected in the Puerto Rico economy, although to a lesser degree.

The following graph compares the growth rate of real gross national product for the Puerto Rico and United States economies since fiscal year 1990, and the forecast of the growth rate for fiscal years 2007 and 2008.

Real GNP Growth Rate



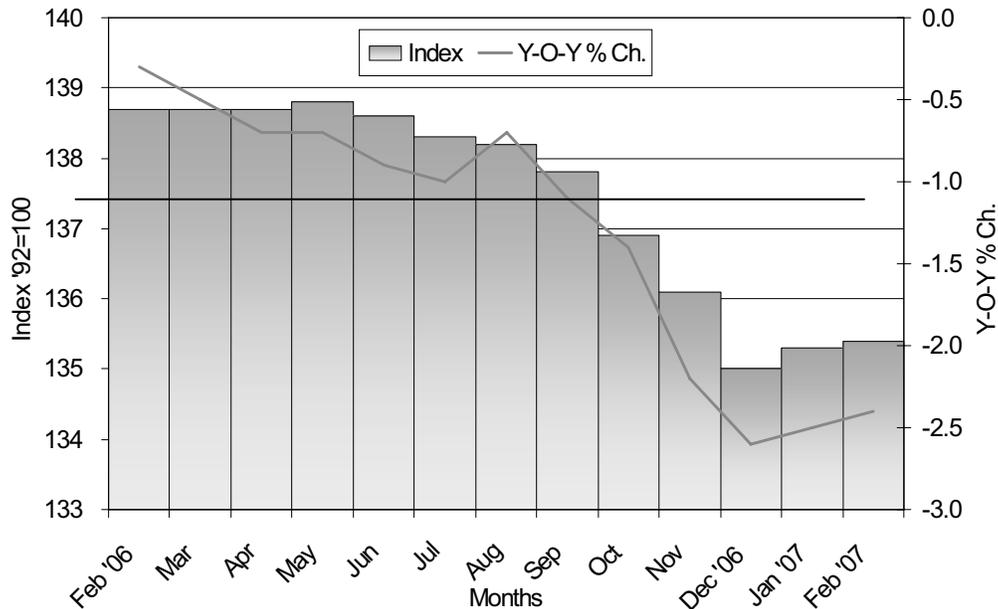
* Global Insight 7/07.

The Federal Open Market Committee has revised down its projections for GNP growth at the end of 2007 and 2008. The central tendency for growth in 2007 was reduced by about 40 basis points less than the July forecast for fiscal year 2007 and around 25 points for fiscal years 2008. Thus, Global Insight August forecast will reflect the downward scenario.

Since the 1950s, the Puerto Rico Planning Board (the “Planning Board”) has prepared a complete set of macroeconomic measures like those prepared for the United States by the Bureau of Economic Analysis (“BEA”) of the Department of Commerce, as part of the National Income and Product Accounts (“NIPA”). In contrast with BEA, which computes the economic accounts on a quarterly basis, the Planning Board computes Puerto Rico’s NIPA on an annual basis. Like BEA, the Planning Board revises its statistics on a regular basis. The Planning Board classifies its statistics as preliminary until they are revised and made final in conjunction with the release of new data each year. Thus, all macroeconomic accounts for fiscal year 2006 shown in this report are preliminary until the revised figures are released and the forecasts for fiscal years 2007 and 2008 revised. Certain information regarding current economic activity is, however, available in the form of the economic activity index of Puerto Rico, a coincident indicator of ongoing economic activity. This index, which is shown in the table below, is composed of several variables (total employment, retail sales, electric power generation, motor vehicle registrations, and indices for manufacturing, construction, tourism, and external trade), which gauge virtually all sectors of the economy.

As the following graph shows, annual economic growth has been declining since March 2006.

Coincident Economic Activity Index



Forecast for Fiscal Year 2007

The Planning Board's current real gross national product forecast for fiscal year 2007, which was released in March 2007, projected a decline of 1.4%, or 2.0% in current dollars. Personal income is expected to decline by 1.2%, or 3.1% in current dollars (see footnote 1 on page I-4). The Planning Board expects real growth to return in fiscal year 2008, albeit at only 0.8%, or 5.1% in current dollars. The major factors affecting the economy at this point are, among others, the still relatively high oil prices, the slowdown of the U.S. economic activity and the continuing economic uncertainty generated by the Commonwealth's fiscal crisis, among others, and the effects on economic activity of the implementation of the new sales tax. Consumers will take a while to adjust their behavior to this new system.

According to the Household Survey, total employment for fiscal year 2007 averaged 1,262,900, an increase of 0.8% compared to 1,253,400 for fiscal year 2006. The unemployment rate for fiscal year 2007 was 10.4%, a decrease from 11.7% for fiscal year 2006.

Fiscal Year 2006

The Planning Board's preliminary reports on the performance of the Puerto Rico economy for fiscal year 2006 indicate that real gross national product increased 0.7% (5.8% in current dollars) over fiscal year 2005. Nominal gross national product was \$56.7 billion in fiscal year 2006 (\$45.1 billion in 2000 prices), compared to \$53.6 billion in fiscal year 2005 (\$44.8 billion in 2000 prices). Aggregate personal income increased from \$48.3 billion in fiscal year 2005 (\$43.6 billion in 2000 prices) to \$50.9 billion in fiscal year 2006 (\$44.0 billion in 2000 prices), and personal income per capita increased from

\$12,365 in fiscal year 2005 (\$11,179 in 2000 prices), to \$12,997 in fiscal year 2006 (\$11,218 in 2000 prices).

According to the Household Survey, total employment for fiscal year 2006 averaged 1,253,400, an increase of 1.3% compared to 1,237,600 for fiscal year 2005. The driving force behind total employment is self-employment. The unemployment rate for fiscal year 2006 was 11.7%, an increase from 10.6% for fiscal year 2005, due to the partial government shutdown in May 2006 that resulted in the two week furlough of many government employees. As in the past, the economy of Puerto Rico followed the general performance and trends of the United States economy, although at a lower rate of growth.

Among the variables contributing to the Planning Board's downward revision in the forecast were the current effect of persistent high levels of oil prices, the upward trend in short-term interest rates, the depreciation of the dollar (which affects the value of imports from foreign countries, accounting for approximately 50% of total imports to Puerto Rico), and the deceleration of public investment due to the Commonwealth's budget deficit (which served, together with other factors, to reduce activity in construction and other sectors). The persistent high level of the price of oil and its derivatives (such as gasoline) has served to reduce the income available for other purchases and, thereby, negatively affected domestic demand. Due to the Commonwealth's dependence on oil for power generation and gasoline in spite of its recent improvements in power production diversification, the high level of oil prices is expected to account for an increased outflow of approximately \$2 billion in fiscal year 2006. The upward trend in short-term interest rates has also directly affected construction activity, which has been a major contributor to economic growth in recent years, and accentuated the fiscal difficulties of the Commonwealth's government with respect to the fiscal year 2006 budget deficit. The implementation of the tax reform legislation discussed below, however, is expected to alleviate the Commonwealth's fiscal difficulties by raising additional revenues from the imposition of a sales tax but this, too, may reduce net disposable income even after giving effect to certain income tax reductions provided in the tax reform legislation. For a discussion of the Commonwealth's fiscal difficulties and the recently enacted tax reform, see "Tax Reform" under *Puerto Rico Taxes, Other Revenues, and Expenditures*.

As can be observed from the above economic activity index charts, the EAI grew by 0.6% during fiscal year 2006 but was trending significantly downward during the second half of the fiscal year.

Fiscal Year 2005

The Planning Board's reports of the performance of the Puerto Rico economy during fiscal year 2005 indicate that the economy (as registered by real gross national product) grew by 1.9%. Nominal gross national product was \$53.6 billion (\$44.8 billion in 2000 prices), compared to \$50.7 billion in fiscal year 2004 (\$44.0 billion in 2000 prices). This represents an increase in nominal gross national product of 5.7%. Aggregate personal income increased from \$45.6 billion (\$42.5 billion in 2000 prices) to \$48.3 billion in fiscal year 2005 (\$43.6 billion in 2000 prices), and personal income per capita increased from \$11,724 in fiscal year 2004 (\$10,936 in 2000 prices), to \$12,365 in fiscal year 2005 (\$11,179 in 2000 prices).

According to the Household Survey, total employment for fiscal year 2005 averaged 1,237,600, an increase of 2.7% compared to 1,205,600 for fiscal year 2004. The unemployment rate for fiscal year 2005 was 10.6%, a decrease from 11.4% for fiscal year 2004. As in the past, the economy of Puerto Rico followed the performance and general trends of the United States economy but did not reach the level of U.S. real economic growth.

Economic Development Program

The Commonwealth's economic development program is now focused on initiatives aimed at producing more diversified and sustainable economic development. The six principal elements of these initiatives, as expressed in the Governor's Economic Development and Government Transformation Plan for Puerto Rico, are the following: (i) developing world-class infrastructure, while encouraging private investment with innovative financial models and agile, effective evaluation processes; (ii) accelerating Puerto Rico's entry into the knowledge economy by creating a center of excellence in biotechnology, engineering and computing; (iii) promoting local enterprise and supporting local businesses (in Spanish, Apoyo al de Aquí) by providing innovative financing alternatives and access to domestic and foreign markets; (iv) transforming the tourist industry into a vehicle for Puerto Rico's economic development; (v) diversifying energy-generating sources to reduce dependence on petroleum by half; and (vi) transforming Puerto Rico's government, without the need for layoffs or privatization, through effective agency consolidation and decentralization functions to offer first-class services to all citizens in a sensible, effective and agile manner and to contribute to Puerto Rico's socio-economic development.

The Commonwealth has formulated a strategic plan to increase its competitiveness in knowledge-based economic sectors, such as research and development of science and technology products. Four major components of this strategic plan are: (i) building on the strong presence in Puerto Rico of multinational companies in the science and technology sectors; (ii) building on Puerto Rico's skilled workforce to promote the expansion of research and development facilities by companies currently operating in Puerto Rico; (iii) attracting new companies in such sectors; and (iv) providing incentives for companies and entrepreneurs to engage in the process of innovation and commercialization of new products and to establish research and development facilities in Puerto Rico. The last initiative includes the creation of the Puerto Rico Science & Technology Trust, a government-sponsored trust (currently capitalized at \$4.9 million and expected to grow to \$25 million in three years), that will provide grants and financing to companies, entrepreneurs, and universities that engage in these activities. As part of this plan, construction has begun on a biotechnology plant in Mayagüez and a molecular sciences building on the main campus of the University of Puerto Rico in Río Piedras. Additionally, the Department of Transportation has transferred land to the University of Puerto Rico for the construction of a cancer center.

As part of this strategic plan, the Commonwealth is actively pursuing local participation in the aerospace industry, including engineering design services and the outsourcing of business activities. Also, recently Industrial Development Company ("PRIDCO") began a program to improve local entrepreneurial capacity by evaluating local businesses with worldwide best practices, and the Economic Development Bank started a new venture capital program offering financing to entrepreneurs that present projects with great potential for commercialization.

The Commonwealth is also providing incentives to promote the establishment of distribution and call centers, the acquisition and development of patents, and the development of a local entrepreneurial class. Distribution and call centers located in the Commonwealth will benefit from a preferential tax rate of 4% for call centers located in Puerto Rico if they offer services to Latin America and 2% if they offer hemisphere or worldwide services. The Commonwealth has decided to focus on this type of industry because it is labor intensive, presents no environmental concerns, and is generally able to start operations quickly. Over two dozen call centers have recently been established with employment of over 2,500 persons.

With respect to the acquisition and development of patents, under newly enacted legislation, the Secretary of the Treasury may (i) negotiate the payment of taxes on patent royalties; and (ii) reduce the tax rate on patent royalties to a rate as low as 2%. These incentives are in addition to those already

enacted for research and development carried out in the Commonwealth. To further develop a local entrepreneurial class, the Commonwealth has enacted legislation providing local entrepreneurs with the following benefits: (i) tax incentives to retailers that use their distribution channels to sell products made in Puerto Rico in other jurisdictions; (ii) requiring at least 15% of products and services purchased by government agencies to be locally manufactured or provided; and (iii) the use of government-sponsored financing, marketing and/or training to promote the production of economically feasible products or services for Puerto Rico markets.

Puerto Rico Tax Incentives

One of the benefits enjoyed by the Commonwealth is that corporations operating in Puerto Rico (other than corporations organized in the United States with a local branch) and individuals residing in Puerto Rico generally are not subject to federal income taxes on income derived in Puerto Rico. This enables the Commonwealth to utilize local tax legislation as a tool for stimulating economic development, and it has done so for many years. See “Tax Incentives” below.

In this regard, the Commonwealth enacted legislation extending certain benefits of its most recent tax incentives law, Act No. 135 of December 2, 1997, as amended (the “1998 Tax Incentives Act”), to all eligible businesses operating under previous tax incentives laws. These benefits include a 200% deduction for research and development expenses and worker training expenses, the ability to deduct, as a current expense, investments in machinery and equipment, and the ability to claim a tax credit equal to 25% of the purchase price of a product manufactured in the Commonwealth (in excess of a base amount) or 35% of the purchase price of a locally-manufactured, recycled product.

The 1998 Tax Incentives Act was also amended to allow a credit against their Puerto Rico income tax liability for investors that acquire the majority of the stock, partnership interests or operational assets of an exempted business that is in the process of closing operations in Puerto Rico. A credit against Puerto Rico income tax liability is also provided to investors that contribute cash to such exempted business for the construction or improvement of its physical plant and the purchase of machinery and equipment. The amount of the credit is equal to 50% of the cash invested for such purposes, not to exceed \$5,000,000 per exempted business. The credits are subject to approval by the Secretary of the Treasury, and the maximum amount of such credits for any fiscal year is \$15,000,000.

In addition, legislation was enacted (i) amending the 1998 Tax Incentives Act to permit income tax rates lower than 2% for companies that establish operations in Puerto Rico in “core pioneer industries” which utilize innovative technology in their operations not used in Puerto Rico prior to January 1, 2000; (ii) granting tax credits with respect to eligible investments made in the construction or substantial rehabilitation of housing units to be rented to low income families; (iii) granting income tax exemption to financial institutions for the fees and interest income received in connection with loans or guarantees of loans made to finance tourism development projects; (iv) granting an exemption to qualified associations administering timesharing rights or vacation clubs and to owners’ associations in areas designated as tourism enhancement districts; (v) granting tax exemption for investments in infrastructure made by housing developers; (vi) granting tax credits to Puerto Rico businesses that acquire products manufactured in Puerto Rico for exportation; and (vii) granting tax credits for rehabilitating urban centers through the development of housing projects, community areas, commercial areas, parks and recreational spaces, construction and renovation of structures, and the development of undeveloped or under-developed sites.

In December 2006, two laws were approved that provide additional tax incentives to foster economic development in Puerto Rico. Act No. 289 of December 26, 2006 amended the 1994 Puerto Rico tax code in order to facilitate the creation of local Real Estate Investment Trusts (REITs). A REIT is

a corporation, usually publicly traded, that manages a portfolio of real estate to earn profits for shareholders. Under Act No. 289, a special tax rate of 10% applies to the income from this type of investment. The creation of REITs is expected to encourage investment in residential, commercial and industrial properties and hotels, and will contribute to the development of a local capital market.

Act No. 287 of December 26, 2006 created a new financing conduit for PRIDCO-sponsored economic development activity, to be known as the Puerto Rico Investment Development Initiative. The interest paid on debt securities issued by companies operating under the Puerto Rico Industrial Incentives Act of 1998 is exempt from Puerto Rico income taxes for *bona fide* residents of Puerto Rico and local corporations. The proceeds of such debt can be used for general business purposes, such as raw materials and machinery acquisition, construction, general business expenses, intellectual property and research and development, among others, but 80% of the proceeds must be used within Puerto Rico by the benefited company.

The tax incentives under the 1998 Tax Incentives Act will be available until December 31, 2007 (although tax incentive concessions granted thereunder will continue to be in effect until their respective dates of expiration). Currently, the Puerto Rico Legislature is considering whether to amend, replace, or extend the effectiveness of the 1998 Tax Incentives Act.

Reduction of the Costs of Doing Business

The Commonwealth believes that to make Puerto Rico more competitive and foster investment it needs to reduce the cost of doing business in Puerto Rico. In order to accomplish this, the Commonwealth proposes to (i) promote the creation of more cogeneration power plants to diversify energy fuel sources and reduce oil imports for electric power generation; (ii) streamline the permitting process to accelerate and reduce the cost of investment in Puerto Rico; and (iii) create a multi-agency task force to expedite critical projects. The Commonwealth has also implemented additional initiatives to restructure certain government agencies in order to improve the services offered by these agencies and provide such services in a more efficient manner. Both PRIDCO and Tourism Company have completed restructurings resulting in their being able to respond more quickly to the needs of their constituents while shedding over 500 employment positions.

The Commonwealth is in the process of diversifying its energy fuel sources. Two cogeneration power plants, one of which is fueled by coal and the other by liquefied natural gas, have reduced Puerto Rico's dependence on oil imports for the generation of electricity by approximately 25%, from 99% to 74%. Currently, as part of the Electric Power Authority's capital improvement plan, the Authority is considering building an additional cogeneration power plant fueled by liquefied natural gas in the municipality of Mayagüez.

The Department of Economic Development and Commerce initiated a reengineering of the Commonwealth's investment project evaluation process in which all branches of the Commonwealth government participated. The first phase, completed in December 2006, evaluated and developed the model. Currently, the project is in second phase, which should be completed by the end of fiscal year 2007, and which consists of evaluating all laws, bylaws and management styles. The third phase – the implementation and measurement of the reengineering – is scheduled to start during the first semester of fiscal year 2008 and is expected to be completed the following fiscal year.

Federal Tax Incentives

In connection with the phase-out of Sections 30A and 936 of the U.S. Internal Revenue Code of 1986, as amended (the "U.S. Code") (see "Tax Incentives – Incentives under the U.S. Code" below), the

United States Senate requested the Joint Commission on Taxation (“JCT”) and the United States Government Accountability Office (“GAO”) to study the economic impact of this phase-out and present recommendations on alternative tax incentives for U.S.-based companies operating in Puerto Rico. In anticipation of the final phase-out of Sections 30A and 936 of the U.S. Code, most U.S.-based companies operating under Sections 30A and 936 converted from United States corporations to Controlled Foreign Corporations (“CFCs”), thus lessening the impact of the phase-out of those sections on their operations.

In May 2006, the GAO published its study titled “Fiscal Relations with the Federal Government and Economic Trends during the phase-out of the Possessions Tax Credit.” The GAO study found that Puerto Rico’s per capita gross domestic product and gross national product were significantly lower compared to United States averages, and the absolute gap between the per capita gross national product of Puerto Rico residents and that of United States residents has increased. The GAO study further found that, although the value-added by United States companies claiming the possessions tax credit decreased by about two-thirds during the period 1993-2003, much of the decline was offset by growth in other corporations, such as pharmaceuticals. Finally, the GAO study determined that although residents of Puerto Rico pay considerably less total tax per capita than residents of the United States, they pay approximately the same percentage of their personal income in taxes. The GAO study, which is informative in nature, is intended to help the United States Congress decide which economic development initiatives will best suit Puerto Rico’s current situation.

In June 2006, the JCT published its pamphlet titled “An Overview of the Special Tax Rules related to Puerto Rico and an Analysis of the Tax and Economic Policy Implications of Recent Legislative Options” (the “JCT Report”). The JCT Report provides an overview of the tax and non-tax rules applicable to United States possessions, the special tax rules applicable to Puerto Rico and an economic analysis of such special tax rules. The JCT Report also presents certain legislative options and specific proposals that have been advocated by various parties in order to stimulate economic growth in Puerto Rico. Although these legislative options and specific proposals are not recommendations, the JCT Report does state that federal and Commonwealth tax policy must be coordinated in order to design and implement new tax proposals aimed at enhancing development in Puerto Rico by targeting problems unique to Puerto Rico, instead of problems common to the United States and Puerto Rico, which proposals are likely to induce business to relocate from the United State to Puerto Rico.

Recently, the United States Congress approved legislation to extend to production activities that take place in Puerto Rico the benefit of section 199 of the U.S. Code, which provides a nine percent reduction in the federal income tax rate, phased-in over five years (from 35% to 31.85% after 2009). This extension applies to activities occurring on the island of branches of U.S. corporations that are not controlled foreign corporations (“CFCs”). The Commonwealth is also seeking the extension of additional sections of the U.S. Code that provide a dividends received deduction for a percentage of profits generated in Puerto Rico by CFCs, as well as deductions that would encourage investments in research and development activities.

Employment and Unemployment

The number of persons employed in Puerto Rico during fiscal year 2007 averaged 1,262,900, a 0.8% increase from 1,253,400 in fiscal year 2006. Unemployment, although at relatively low historical levels, is about twice the United States average. The average unemployment rate decreased from 11.7% in fiscal year 2006 to 10.4% in fiscal year 2007.

The following table presents annual statistics of employment and unemployment for fiscal year 2002 through fiscal year 2006 and monthly statistics, seasonally adjusted, for fiscal year 2007 and for July 2007 (the first month of fiscal year 2008). These employment figures are based on the Household Survey, which includes self-employed individuals, instead of the non-farm, payroll employment survey (the “Payroll Survey”), which does not. The number of self-employed individuals represents around 17% of civilian employment in Puerto Rico, more than double the level in the United States.

**Commonwealth of Puerto Rico
Employment and Unemployment⁽¹⁾
(persons age 16 and over)
(in thousands)**

<u>Fiscal Years Ended June 30,</u>	<u>Labor Force</u>	<u>Employed</u>	<u>Unemployed</u>	<u>Unemployment Rate⁽²⁾</u>
		(Annual Average)		
2002	1,309	1,152	158	12.0%
2003	1,352	1,188	164	12.1
2004	1,360	1,206	155	11.4
2005	1,385	1,238	147	10.6
2006	1,420	1,253	167	11.7
		(Seasonally Adjusted)		
<u>Fiscal Year 2007</u>				
July	1,394	1,235	158	11.4%
August	1,399	1,252	146	10.5
September	1,417	1,262	155	10.9
October	1,407	1,274	134	9.5
November	1,411	1,270	141	10.0
December	1,409	1,257	152	10.8
January	1,431	1,287	144	10.0
February	1,459	1,289	170	11.6
March	1,428	1,290	138	9.6
April	1,412	1,279	133	9.4
May	1,395	1,250	145	10.4
June	1,380	1,220	161	11.7
		(Seasonally Adjusted)		
<u>Fiscal Year 2008</u>				
July	1,389	1,226	163	11.8%

(1) Totals may not add due to rounding.

(2) Unemployed as percentage of labor force.

Source: Department of Labor and Human Resources – Household Survey

Economic Performance by Sector

From fiscal year 2002 to fiscal year 2006, the manufacturing and services sectors generated the largest portion of gross domestic product. The three sectors of the economy that provide the most employment are manufacturing, services and government.

The following table presents annual statistics of gross domestic product by sector and gross national product for the five fiscal years ended June 30, 2002 through 2006.

Commonwealth of Puerto Rico Gross Domestic Product by Sector and Gross National Product (in millions at current prices)

	Fiscal Years Ended June 30,				
	2002	2003	2004	2005	2006 ⁽¹⁾
Manufacturing	\$31,243	\$31,532	\$33,267	\$34,363	36,556
Services ⁽²⁾	26,913	28,919	30,476	32,299	33,613
Government ⁽³⁾	6,303	6,948	7,389	8,151	8,424
Transportation, communication and public utilities	4,948	5,178	5,343	5,353	5,508
Agriculture, forestry and fisheries	277	333	414	360	333
Construction ⁽⁴⁾	1,648	1,772	1,905	1,874	1,821
Statistical discrepancy	292	146	415	251	209
Total gross domestic product ⁽⁵⁾	\$71,624	\$74,827	\$79,209	\$82,650	\$86,464
Less: net payment abroad	(26,552)	(27,348)	(28,501)	(29,049)	(29,776)
Total gross national product ⁽⁵⁾	\$45,071	\$47,479	\$50,709	\$53,601	\$56,689

(1) Preliminary.

(2) Includes wholesale and retail trade, finance, insurance and real estate, tourism, and other services.

(3) Includes the Commonwealth, its municipalities and certain public corporations, and the federal government. Excludes certain other public corporations, like the Electric Power Authority and the Aqueduct and Sewer Authority whose activities are included under Services in the table.

(4) Includes mining.

(5) Totals may not add due to rounding.

Source: Planning Board

The data for employment by sector or industries presented here, like in the United States, are based on the Payroll Survey, which is designed to measure employment by sector. The Payroll Survey excludes agricultural employment and self-employed persons.

The following table presents annual statistics of average employment based on the North American Industry Classification System (NAICS) for fiscal years 2002 to 2007.

Commonwealth of Puerto Rico
Non-Farm, Payroll Employment by Economic Sector⁽¹⁾
(persons age 16 and over)

	Fiscal Years Ended June 30,					
	2002	2003	2004	2005	2006	2007 ⁽²⁾
Natural Resources and Construction	72,142	68,525	69,300	68,233	67,442	67,392
Manufacturing						
Durable Goods	50,500	48,567	48,808	48,067	46,492	44,850
Non-Durable Goods	74,300	70,192	69,633	69,250	66,367	60,958
Sub Total	124,800	118,759	118,441	117,317	112,859	105,808
Trade, Transportation, Warehouse & Utilities						
Wholesale Trade	32,200	32,183	33,300	33,717	33,992	33,158
Retail Trade	130,675	130,183	132,008	136,192	137,800	135,058
Transportation, Warehouse & Utilities	18,017	17,358	17,042	17,617	17,433	16,700
Sub Total	180,892	179,724	182,350	187,526	189,225	184,916
Information	22,483	21,617	21,917	22,608	22,600	21,733
Finance	44,975	44,667	46,850	48,633	49,767	49,975
Professional & Business	97,408	98,500	101,900	103,767	106,400	104,767
Educational & Health	86,400	92,408	98,108	99,967	103,583	105,842
Leisure & Hospitality	65,783	67,917	70,317	72,592	74,767	73,433
Other Services	16,992	18,858	20,671	21,257	21,267	22,283
Government	288,675	297,717	303,408	307,825	302,025	297,450
Total Non-Farm	1,000,550	1,008,692	1,033,262	1,049,725	1,049,935	1,033,599

(1) The figures presented in this table are based on the Payroll Survey prepared by the Bureau of Labor Statistics of the Department of Labor and Human Resources. There are numerous conceptual and methodological differences between the Household Survey and the Payroll Survey. The Payroll Survey reflects information collected from payroll records of a sample of business establishments, while the Household Survey is based on responses to a series of questions by persons in a sample of households. The Payroll Survey excludes the self-employed and agricultural employment. Totals may not add due to rounding.

(2) Preliminary.

Source: Department of Labor and Human Resources, Current Employment Statistics Survey (Establishment Survey – NAICS Codes)

Manufacturing

Manufacturing is the largest sector of the Puerto Rico economy in terms of gross domestic product. The Planning Board figures show that in fiscal year 2006 manufacturing generated \$36.6 billion, or 42.3%, of gross domestic product. During fiscal year 2007, payroll employment for the manufacturing sector was 105,808, a decrease of 6.2% compared with fiscal year 2006, with most of the job losses occurring in labor-intensive industries. Most of the island's manufacturing output is shipped to the United States mainland, which is also the principal source of semi-finished manufactured articles on which further manufacturing operations are performed in Puerto Rico. The United States minimum wage laws are applicable in Puerto Rico. As of June 2007, the average hourly manufacturing wage rate in Puerto Rico was 68.1% of the average mainland United States rate.

Manufacturing in Puerto Rico is now more diversified than during the earlier phases of its industrial development and includes several industries less prone to business cycles. In the last three

decades, industrial development has tended to be more capital intensive and more dependent on skilled labor. This gradual shift in emphasis is best exemplified by large investments over the last decade in the pharmaceutical, scientific instruments, computers and electrical products industries in Puerto Rico. One of the factors encouraging the development of the manufacturing sector has been the tax incentives offered by the federal and Puerto Rico governments. Federal legislation enacted in 1996, however, which amended Section 936 of the U.S. Code, phased out these federal tax incentives during a ten-year period that recently ended. See “Tax Incentives – Incentives under the U.S. Code” under *The Economy*.

The following table sets forth gross domestic product by manufacturing sector for the five fiscal years ended June 30, 2002 through June 30, 2006.

Commonwealth of Puerto Rico
Gross Domestic Product by Manufacturing Sector
(in millions at current prices)

	Fiscal Years Ended June 30,				
	2002	2003	2004	2005	2006⁽¹⁾
Pharmaceuticals	\$18,681	\$18,998	\$19,814	\$20,253	\$20,820
Machinery and metal products:					
Machinery, except electrical	3,845	3,507	3,372	3,397	3,378
Electrical machinery	1,757	1,771	1,818	1,926	2,237
Professional and scientific instruments	2,191	2,981	3,540	3,802	4,494
Other machinery and metal products	312	288	274	284	291
Food products	2,092	1,903	2,202	2,290	2,489
Other chemical and allied products	578	502	591	644	679
Apparel	530	353	344	364	337
Other ⁽²⁾	1,258	1,231	1,312	1,403	1,831
Total gross domestic product of manufacturing sector ⁽³⁾	<u>\$31,243</u>	<u>\$31,532</u>	<u>\$33,267</u>	<u>\$34,363</u>	<u>\$36,556</u>

(1) Preliminary.

(2) Includes petroleum products; petrochemicals; tobacco products; stone, clay and glass products; textiles and others.

(3) Totals may not add due to rounding.

Source: Planning Board

The following table presents annual statistics of average manufacturing employment by industry based on the North American Industry Classification System (NAICS) for fiscal years 2003 to 2007.

Commonwealth of Puerto Rico
Non-Farm Payroll Manufacturing Employment by Industry Group*
(persons age 16 years and over)

Industry Group	Fiscal Years Ended June 30,				
	2003	2004	2005	2006	2007⁽¹⁾
<u>Durable Goods</u>					
Nonmetallic Mineral Products Manufacturing	4,444	4,706	4,471	4,108	3,792
Cement and Concrete Products Manufacturing	3,543	3,867	3,750	3,542	3,208
Fabricated Metal Products	6,198	6,490	6,427	5,808	5,817
Computer and Electronic	11,623	10,581	10,673	10,808	10,133
Electrical Equipment	7,415	7,744	7,645	6,858	6,567
Electrical Equipment Manufacturing	4,399	4,935	4,971	4,708	4,525
Miscellaneous Manufacturing	12,308	12,070	11,157	11,225	11,200
Medical Equipment and Supplies Manufacturing	11,336	11,059	10,473	10,492	10,467
Other Durable Goods Manufacturing	7,646	8,185	7,693	7,685	7,341
Total – Durable Goods	49,634	49,776	48,066	46,492	44,850
<u>Non-Durable Goods</u>					
Food Manufacturing	13,628	13,244	13,050	12,667	12,433
Beverage and Tobacco Products Manufacturing	3,159	3,038	3,175	3,425	3,267
Apparel Manufacturing	8,988	8,522	8,873	8,400	7,250
Cut and Sew Apparel Manufacturing	8,969	8,518	8,846	8,183	6,933
Chemical Manufacturing	31,183	31,385	32,885	32,335	30,067
Pharmaceutical and Medicine Manufacturing	26,645	27,187	28,572	28,017	25,742
Plastics and Rubber Products	3,340	3,210	2,744	2,350	2,217
Plastics Product Manufacturing	3,030	2,917	2,266	2,158	2,083
Other Non-Durable Goods Manufacturing	8,823	9,261	8,529	7,200	5,724
Total – Non-Durable Goods	69,121	68,660	69,256	66,367	60,958
Total Manufacturing Employment	118,755	118,436	117,322	112,869	105,808

* Totals may not add due to rounding.

(1) Preliminary.

Source: Department of Labor and Human Resources, Current Employment Statistic Survey (Establishment Survey – NAICS Codes)

Total employment in the manufacturing sector decreased by 12,947 from fiscal year 2003 to fiscal year 2007. Manufacturing employment had been declining during the past decade, but the decline accelerated during fiscal years 2002 and 2003, falling -10.6% and -4.8%, respectively. After that, manufacturing employment seemed to stabilize around 118,000 jobs, but the deceleration reappeared in fiscal year 2006 with the sector experiencing another significant drop of -3.8%. For fiscal year 2007 the employment decline accelerated further to -6.2%. During the last year the economy has lost around 7,050 jobs in the manufacturing sector. There are several reasons which explain this sector's job shrinkage: the end of the phase-out of Section 936, the net loss of patents on certain pharmaceutical products, the escalation of manufacturing production costs (particularly labor and electricity), and the increased use of job outsourcing. Puerto Rico's manufacturing sector is facing increased international competition, and new ideas and initiatives are necessary to improve this sector.

Services

Puerto Rico has experienced significant growth in the services sector, which includes finance, insurance, real estate, wholesale and retail trade, tourism and other services, in terms of both income and employment over the past decade, showing a favorable trend as compared with certain other industrialized economies. During the period between fiscal years 2002 and 2006, the gross domestic product in this sector, in nominal terms, increased at an average annual rate of 4.5%, while payroll employment in this sector increased at an average annual rate of 2.5%. In the Puerto Rico labor market, self-employment, which is not accounted for in the Payroll Survey, represents approximately 17% of total employment according to the Household Survey. Most of the self-employment is concentrated in the service and construction sectors. For example, for fiscal year 2006, the number of self-employed individuals was 182,914, out of which 46.8% were in the services sector and 15.1% were in the construction sector. The development of the services sector has been positively affected by demand generated by other sectors of the economy, such as manufacturing, construction and agriculture. The services sector in Puerto Rico has a diversified base.

According to the Establishment Survey, for the first six months of fiscal year 2007 the net employment gain for this sector was 2,200 jobs, compared to same period in the previous year. Service, finance, insurance and real estate employment added 6,800 jobs, while trade lost 4,600 jobs; for a net growth rate of 1%.

The high degree of knowledge, skills, and expertise in professional and technical services available in Puerto Rico places the island in a favorable competitive position with respect to Latin America and other trading countries throughout the world.

The services sector ranks second to manufacturing in its contribution to gross domestic product, and it is the sector with the greatest employment. In fiscal year 2006, services generated \$33.6 billion of gross domestic product, or 38.9% of the total. Services employment grew from 523,691 in fiscal year 2003 to 562,949 in fiscal year 2007 (representing 54.5% of total, non-farm, payroll employment). This represents a cumulative increase of 7.5% during such period. Wholesale and retail trade, finance, insurance and real estate experienced significant growth in fiscal years 2002 to 2006, as measured by gross domestic product. From fiscal year 2002 to 2006, gross domestic product increased in wholesale and retail trade from \$8.6 billion to \$10.7 billion, and in finance, insurance, and real estate from \$11.2 billion to \$14.7 billion. There are sixteen commercial banks and trust companies currently operating in Puerto Rico. Total assets of these institutions as of March 31, 2007 were \$119.6 billion. As of March 31, 2007, there were approximately thirty-five international banking entities operating in Puerto Rico licensed to conduct offshore banking transactions with total assets of \$78.5 billion.

The following tables set forth gross domestic product for fiscal years 2002 to 2006 and employment for the services sector for fiscal years 2002 to 2007.

**Commonwealth of Puerto Rico
Gross Domestic Product by Service Sector*
(in millions at current prices)**

	Fiscal Years Ended June 30,				
	2002	2003	2004	2005	2006 ⁽¹⁾
Wholesale and retail trade	\$ 8,623	\$ 9,150	\$ 9,802	\$ 10,260	\$10,716
Finance, insurance and real estate	11,212	12,508	13,029	14,016	14,733
Other services ⁽²⁾	7,078	7,261	7,646	8,023	8,164
Total	\$26,913	\$28,919	\$30,476	\$32,299	\$33,613

* Totals may not add due to rounding.

(1) Preliminary.

(2) Includes tourism.

Source: Planning Board.

**Commonwealth of Puerto Rico
Non-Farm Payroll Employment by Services Sector*
(thousands of persons age 16 and over)**

	Fiscal Years Ended June 30,					
	2002	2003	2004	2005	2006	2007 ⁽¹⁾
Wholesale Trade	32,200	32,181	33,299	33,710	33,992	33,158
Retail Trade	130,675	130,180	132,008	136,189	137,800	135,058
Transportation, Warehouse & Utilities	18,017	17,352	17,054	17,615	17,433	16,700
Trade, Transportation, Warehouse & Utilities	180,892	179,713	182,361	187,514	189,225	184,916
Information	22,483	21,619	21,907	22,598	22,600	21,733
Finance	44,975	44,648	46,852	48,621	49,767	49,975
Professional and Business	97,408	98,498	101,899	103,767	106,400	104,767
Educational & Health	86,400	92,409	98,101	99,963	103,583	105,842
Leisure & Hospitality	65,783	67,912	70,310	72,586	74,767	73,433
Other Services	16,992	18,808	20,671	21,257	21,267	22,283
Total	514,933	523,607	542,101	556,306	567,609	562,949

* Totals may not add due to rounding.

(1) Preliminary.

Source: Department of Labor and Human Resources, Benchmark on Employment, Hours and Earnings

Hotels and Related Services – Tourism

During fiscal year 2006, the number of persons registered in tourist hotels, including residents of Puerto Rico and tourists staying in more than one hotel during their visit, was 1,913,400, an increase of 3.4% over the number of persons registered during the same period in fiscal year 2005. The number of non-resident tourists registered in tourist hotels during fiscal year 2006 increased 4.6% compared to fiscal year 2005. Hotel rooms available during fiscal year 2006 increased 3.9% compared to fiscal year 2005. The average number of rooms rented in tourist hotels increased 3.9% during fiscal year 2006 compared to fiscal year 2005. The average occupancy rate in tourist hotels during fiscal years 2005 and 2006 was 70.8%.

During the first nine months of fiscal year 2007, the number of persons registered in tourist hotels, including residents of Puerto Rico and tourists staying in more than one hotel during their visit, was 1,331,700, a decrease of 6.6% over the number of persons registered during the same period in fiscal year 2006. The average occupancy rate in tourist hotels during the first nine months of fiscal year 2007 was 70.9%, compared to 70.1% during the same period in fiscal year 2006. The average number of rooms rented in tourist hotels decreased 6.0% during the first nine months of fiscal year 2007 compared with the same period during fiscal year 2006. The average number of rooms available in tourist hotels decreased 7.2% during the first nine months of fiscal year 2007 compared to the same period in fiscal year 2006 as the completion of regular maintenance and rehabilitation of rooms (that normally results in a certain number of rooms being unavailable at any time) is taking longer to complete this year than in prior years.

San Juan is the largest homeport for cruise ships in the Caribbean and one of the largest homeports for cruise ships in the world.

The following table presents data relating to visitors to Puerto Rico and tourist expenditures for the five fiscal years ended June 30, 2006.

**Commonwealth of Puerto Rico
Tourism Data⁽¹⁾
Number of Visitors**

<u>Fiscal Years Ended June 30,</u>	<u>Tourist Hotels⁽²⁾</u>	<u>Cruise Ship</u>	<u>Other⁽³⁾</u>	<u>Total</u>	<u>Total Visitors' Expenditures (in millions)</u>
2002	1,147,800	1,277,000	1,939,300	4,364,100	\$2,486.4
2003	1,239,200	1,163,900	1,999,200	4,402,300	2,676.6
2004	1,307,000	1,348,200	2,234,000	4,889,200	3,024.0
2005	1,361,640	1,386,925	2,324,275	5,072,840	3,238.6
2006	1,424,200	1,300,100	2,297,800	5,022,100	3,369.3

- (1) Only includes information about non-resident tourists registering in tourist hotels. They are counted once even if registered in more than one hotel.
(2) Includes visitors in guesthouses.
(3) Includes visitors in homes of relatives, friends, and in hotel apartments.

Sources: Puerto Rico Tourism Company and the Planning Board

The Commonwealth, through the Convention Center District Authority, has completed the development of the largest convention center in the Caribbean, and the centerpiece of a 100-acre, private development, to include hotels, restaurants, cinemas, office space and housing. The convention center district is being developed at a total cost of \$1.3 billion to improve Puerto Rico's competitive position in the convention and group travel segments. The convention center opened on November 17, 2005.

The Convention Center District Authority also owns a multi-purpose coliseum located in San Juan, Puerto Rico. The coliseum, known as the Jose Miguel Agrelot Coliseum, was inaugurated in 2004 and has been host to various successful artistic and other events.

Government

The government sector of Puerto Rico plays an important role in the economy. In fiscal year 2006, the government accounted for \$8.4 billion of Puerto Rico's gross domestic product, or 9.7% of the total. The government is also a significant employer, providing jobs for 297,450 workers, or 28.8% of total, non-farm, payroll employment in fiscal year 2006. This total includes municipal employees. As of March 31, 2007, central government employment has been reduced by approximately 13,700 positions since September 2004.

On February 25, 1998, legislation was enacted permitting the unionization of employees of the central government (excluding municipal employees). Under this law, government employees are given collective bargaining rights subject to a number of limitations. Among those limitations are: employees are prohibited from striking; salary increases are contingent on the availability of budgeted revenues; employees cannot be required to become union members and pay union dues; and collective bargaining negotiations cannot occur in an election year. During fiscal year 2006, the Commonwealth and its instrumentalities began to negotiate the economic and non-economic terms of at least forty collective bargaining agreements. The results of these negotiations could have a material impact on the General Fund.

Transportation

Thirty-four shipping lines offer regular ocean freight service to eighty United States and foreign ports. San Juan is the island's leading seaport, but there are also seaport facilities at other locations in Puerto Rico including Arecibo, Culebra, Fajardo, Guayama, Guayanilla, Mayagüez, Ponce, Vieques, and Yabucoa.

Luis Muñoz Marín International Airport is currently served by 25 United States and international airlines. At present, there is daily direct service between San Juan and Atlanta, Boston, Chicago, Dallas, Miami, New York, Philadelphia, and numerous other destinations within the United States. There is also regularly scheduled service between Aguadilla and Ponce and New York and between Puerto Rico and other Caribbean islands and certain Latin American and European cities. A major United States airline uses San Juan as a hub for its intra-Caribbean airline service. Several smaller airports serve intra-island traffic.

The island's major cities are connected by a modern highway system, which, as of December 31, 2006, totaled approximately 4,621 miles. The highway system comprises 391 miles of primary system highways, which are the more important interregional traffic routes and include PR-52, PR-22, PR-53 and PR-20 toll highways, 230 miles of primary urban system highways, 959 miles of secondary system highways serving the needs of intra-regional traffic and 3,041 miles of tertiary highways and roads serving local, intra-regional traffic.

The first phase of a new mass transit system, known as Tren Urbano, has been completed. Tren Urbano serves a portion of metropolitan San Juan and is expected eventually to serve the municipalities of Carolina and Caguas as well. It currently has ridership of about 33,000 per day.

The Port of the Americas Authority ("PAA") is responsible for the development and operation of the Port of the Americas, a deep draft port on the south coast of Puerto Rico. The first phase of the Port of the Americas was completed in fiscal year 2004. This initial phase included the improvement of piers 4, 5 and 6 of the Port and the acquisition of heavy equipment at a cost of \$40 million. During calendar year 2005, the PAA began the second phase of the Port, which phase is expected to be completed by the end of calendar year 2007. Completion of this second phase will provide capacity to handle up to 250,000 Twenty-Foot Equivalent Units ("TEU"). This second phase includes (i) dredging the entrance channel and adjacent areas of the Port to a depth of 50 feet; (ii) reconstructing the container terminals; (iii) commencing certain required environmental risk mitigation procedures; and (iv) preparing final construction schematics. With respect to these tasks, dredging is 60% complete, the final design contract has been awarded, acquisition of environmental risk mitigation land is underway, and the contract for reconstruction of the container terminal was awarded in April 2006. The Port is expected to be capable of providing capacity for up to 700,000 TEUs when the third phase is completed.

As of May 31, 2007, PAA had an outstanding balance of \$86.3 million under various lines of credit from GDB. PAA is authorized to borrow up to \$250 million under these lines of credit. This debt is payable from annual legislative appropriations until the PAA starts generating revenues sufficient to cover debt service and is also guaranteed by the Commonwealth. Partial operation of the Port of the Americas, at a capacity of up to 250,000 TEUs per year, could begin in early 2008.

Construction

Although the construction industry represents a relatively small segment of the economy compared to other sectors, it has made significant contributions to the growth of economic activity. During the period from fiscal year 2002 through fiscal year 2006, however, real construction investment decreased 1.1%. This decline was small compared to the high level of construction activity in prior fiscal years. The total value of construction permits increased 2.5% during the same five fiscal year period.

Public investment has been an important component of construction investment. During fiscal year 2006, approximately 42% of the total investment in construction was related to public projects. For fiscal year 2006 compared to fiscal year 2005, the total value of construction permits decreased 4.3% and total sales of cement, including imports, decreased 1.0%. Average payroll employment in the construction sector during fiscal year 2006 was 67,059, a decrease of 1.7% from fiscal year 2005. Through the first three quarters of fiscal year 2007, construction employment increased to a seasonally adjusted 67,500, but cement sales (including imports) continued their decline falling 7.1% compared to the same period in fiscal year 2006.

Total construction investment for fiscal year 2006 decreased (in real terms) by 5.8% (following a 7% real decline in fiscal year 2005) due principally to the drop in construction related public projects. For fiscal years 2007 and 2008, the Planning Board forecasts further construction investment decreases (in real terms) of 3.5% and 3.4%, respectively. Public investment will be primarily in housing, new schools (and school reconstruction programs), water projects, and other public infrastructure projects. Public investment in construction has been negatively affected by the Commonwealth's fiscal difficulties.

During the first eleven months of fiscal year 2007, the number and the total value of construction permits decreased 11.8% and 20.2%, respectively, compared to the same period in fiscal year 2006.

Agriculture

The Department of Agriculture and related agencies have directed their efforts at increasing and improving local agricultural production, increasing efficiency and the quality of produce, and stimulating the consumption of locally produced agricultural products. During fiscal year 2006, gross income from agriculture was \$805.6 million, an increase of 1.5% compared with fiscal year 2005. Agriculture gross income consists of the total value of production in the principal agricultural sectors, which include traditional crops, livestock and poultry, grains, vegetables, fruits, ornamental plants and other products. During fiscal year 2006, starchy vegetables, coffee, poultry, fruits and ornamental plants contributed a higher percentage of the sector's income than in the previous fiscal year.

The Commonwealth supports agricultural activities through incentives, subsidies, and technical and support services, in addition to income tax exemptions for qualified income derived by bona fide farmers. Act No. 225 of 1995 provides a 90% income tax exemption for income derived from agricultural operations, an investment tax credit equal to 50% of the investment in qualified agricultural projects, and a 100% exemption from excise taxes, real and personal property taxes, municipal license taxes and tariff payments. It also provides full income tax exemption for interest income from bonds, notes and other debt instruments issued by financial institutions to provide financing to agricultural

businesses. Subsequent legislation imposed an aggregate annual limit of \$15 million on the investment tax credits available under Act No. 225.

Policy changes have been implemented to promote employment and income generated by the agricultural sector. The policy initiatives include a restructuring of the Department of Agriculture, an increase in government purchases of local agricultural products, new programs geared towards increasing the production and sales of agricultural products, and a new system of agricultural credits and subsidies for new projects.

Higher Education

During the five decades from 1950 to 2000, Puerto Rico made significant advances in the field of education, particularly at the college and graduate school level. The transformation of Puerto Rico during the 1950s and 1960s from an agricultural economy to an industrial economy brought about an increased demand for educational services at all levels. During the 1970s and 1980s, certain higher wage, higher technology industries became more prominent in Puerto Rico. More recently, employment in the services sector has increased significantly. This has resulted in an increased demand for workers having a higher level of education and greater expertise in various technical fields. During the same time period, enrollments in institutions of higher learning rose very rapidly due to growth in the college-age population, and the increasing proportion of college attendance by such population. During the 1990s and into the current decade, college attendance and college attendance as a percentage of the college-age population continued to increase, and the college-age population has declined since 2000.

The following table presents comparative trend data for Puerto Rico and the United States with respect to college-age population and the percentage of such population attending institutions of higher learning.

Commonwealth of Puerto Rico Trend in College Enrollment						
Academic Year	Commonwealth of Puerto Rico			Mainland United States		
	Population 18-24 Years of Age	Higher Education Enrollment	Percent⁽¹⁾	Population 18-24 Years of Age	Higher Education Enrollment	Percent⁽¹⁾
1970	341,448 ⁽²⁾	57,340	16.8%	23,714,000 ⁽²⁾	8,580,887	36.2%
1980	397,839 ⁽²⁾	130,105	32.7%	30,022,000 ⁽²⁾	12,096,895	40.3%
1990	417,636 ⁽²⁾	156,147	37.4%	26,961,000 ⁽²⁾	13,621,000	50.5%
2000	428,892 ⁽²⁾	176,015	41.0%	27,143,455 ⁽²⁾	15,313,000	56.4%
2001	426,194 ⁽³⁾	185,015	43.4%	27,971,000 ⁽³⁾	15,928,000	56.9%
2002	423,852 ⁽³⁾	190,776	45.0%	28,463,000 ⁽³⁾	16,612,000	58.4%
2003	420,295 ⁽³⁾	199,842	47.5%	28,947,000 ⁽³⁾	16,900,000	58.4%
2004	416,020 ⁽³⁾	207,074	49.8%	29,245,000 ⁽³⁾	17,272,000	59.1%
2005	411,580 ⁽³⁾	208,032	50.5%	29,307,000 ⁽³⁾	17,428,000	59.5%

(1) Number of persons of all ages enrolled in institutions of higher education as percent of population 18-24 years of age.

(2) Based on census population as of April 1 of the stated year.

(3) Estimated population (reference date July 1 of the stated year).

Sources: United States Census Bureau (Mainland United States Population), United States National Center for Education Statistics, Planning Board (Puerto Rico Population) and Council on Higher Education of Puerto Rico

The University of Puerto Rico, the only public university in Puerto Rico, has eleven campuses located throughout the island. The University's total enrollment for academic year 2006-2007 was approximately 62,340 students. The Commonwealth is legally bound to appropriate annually for the

University of Puerto Rico an amount equal to 9.60% of the average annual revenue from internal sources for each of the two fiscal years immediately preceding the current fiscal year.

In addition to the University of Puerto Rico, there are 40 public and private institutions of higher education located in Puerto Rico. Such institutions had an enrollment during academic year 2005-2006 of approximately 145,574 students and provide programs of study in liberal arts, education, business, natural sciences, technology, secretarial and computer sciences, nursing, medicine, and law. Degrees are offered by these institutions at the associate, bachelor, master, and doctoral levels.

Enrollment at other postsecondary education programs, including technical and vocational programs, amounted to an additional 33,629 students at approximately 76 institutions. This figure represents enrollment at federal Title IV eligible, non-degree granting institutions reporting data to the National Center for Education Statistics (Integrated Postsecondary Education Data System).

Institutions providing education in Puerto Rico must satisfy state licensing requirements to operate. Also, the vast majority of educational institutions are accredited by USDE-recognized accrediting entities.

Tax Incentives

One factor that has promoted and continues to promote the development of the manufacturing sector in Puerto Rico is the various local and federal tax incentives available, particularly those under Puerto Rico's Industrial Incentives Program and, until recently, Sections 30A and 936 of the U.S. Code. Tax and other incentives have also been established to promote the development of the tourism industry. These incentives are summarized below.

Industrial Incentives Program

Since 1948, Puerto Rico has had various industrial incentives laws designed to stimulate industrial investment in the island. Under these laws, which are designed to promote investment in Puerto Rico, companies engaged in manufacturing and certain other designated activities were eligible to receive full or partial exemption from income, property, and other local taxes. The most recent of these industrial incentives laws is the 1998 Tax Incentives Act.

The benefits provided by the 1998 Tax Incentives Act are available to new companies as well as companies currently conducting tax-exempt operations in Puerto Rico that choose to renegotiate their existing tax exemption grant, expand current operations or commence operating a new eligible business. The activities eligible for tax exemption include manufacturing, certain designated services performed for markets outside Puerto Rico (including the United States), the production of energy from local renewable sources for consumption in Puerto Rico and laboratories for research and development. Companies qualifying thereunder can benefit from income tax rates ranging from 2% to 7% for periods ranging from 10 to 25 years. In addition, the 1998 Tax Incentives Act grants 90% exemption from property taxes, 100% exemption from municipal license taxes during the first three semesters of operations and between 60% and 80% thereafter, and 100% exemption from excise taxes with respect to the acquisition of raw materials and certain machinery and equipment used in the exempt activities. The 1998 Tax Incentives Act also provides various special deductions designed to stimulate employment and productivity, research and development and capital investment in Puerto Rico.

Under the 1998 Tax Incentives Act, companies can repatriate or distribute their profits free of Puerto Rico dividend taxes. In addition, passive income derived from the investment of eligible funds in Puerto Rico financial institutions, obligations of the Commonwealth, and other designated investments

are fully exempt from income and municipal license taxes. Individual shareholders of an exempted business are allowed a credit against their Puerto Rico income taxes up to 30% of their proportionate share of the exempted business's income tax liability. Gain from the sale or exchange of shares of an exempted business by its shareholders during the exemption period is subject to a 4% income tax rate.

Under the 1998 Tax Incentives Act, core pioneer industries that employ innovative technologies in their operations, including high technology industries with activities that produce a significant economic impact, can be eligible for income tax rates below 2%. Eligible manufacturing industries may also qualify for certain payroll and training deductions, building and construction expense deductions, a 25% credit for purchases of products manufactured in Puerto Rico, and a 35% credit for purchases of locally recycled products and products manufactured with locally recycled materials.

The 1998 Tax Incentives Act also provides investors who acquire an exempted business that is in the process of closing its operations in Puerto Rico a 50% credit in connection with the cash purchase of such corporation's stocks or assets. Also, exempted businesses that produce high technology products may be eligible for a credit equal to the amount in excess of \$100 million of the annual taxes retained on the payment of rights, rents, royalties and licenses related to the production of such goods. Finally, call centers servicing markets outside Puerto Rico are exempt from paying excise taxes on the purchase of equipment needed for the operation of such call centers.

Tourism Incentives Program

For many years, Puerto Rico has also had incentives laws designed to stimulate investment in hotel operations on the island. The most recent of these laws, the Tourism Incentives Act of 1993 (the "Tourism Incentives Act"), provides partial exemptions from income, property, and municipal license taxes for a period of up to ten years. The Tourism Incentives Act also provides certain tax credits for qualifying investments in tourism activities, including hotel and condo-hotel development projects. Recently enacted legislation provides further tourism incentives by granting certain tax exemptions on interest income received from permanent or interim financing of tourism development projects and fees derived from credit enhancements provided to the financing of such projects. See "Government Development Bank for Puerto Rico – Tourism Development Fund" under *Public Corporations*.

As part of the incentives to promote the tourism industry, the Commonwealth established the Tourism Development Fund as a subsidiary of GDB with the authority to (i) make investments in or provide financing to entities that contribute to the development of the tourism industry and (ii) provide financial guarantees and direct loans for financing hotel development projects. To date, the Fund has provided direct loans and financial guarantees for loans made or bonds issued to finance the development of seventeen hotel projects representing over 3,900 new hotel rooms.

Incentives under the U.S. Code

United States corporations operating in Puerto Rico have been subject to special tax provisions since the Revenue Act of 1921. Prior to enactment of the Tax Reform Act of 1976, under Section 931 of the U.S. Code, United States corporations operating in Puerto Rico (and meeting certain source of income tests) were taxed only on income arising from sources within the United States.

The Tax Reform Act of 1976 created Section 936 of the U.S. Code, which revised the tax treatment of United States corporations operating in Puerto Rico by taxing such corporations on their worldwide income in a manner similar to that applicable to any other United States corporation but providing such corporations a full credit for the federal tax on their business and qualified investment

income in Puerto Rico. The credit provided an effective 100% federal tax exemption for operating and qualifying investment income from Puerto Rico sources.

As a result of amendments to Section 936 of the U.S. Code made in 1996 (the “1996 Amendments”), its income tax credit based on operating and certain investment income was phased out over a ten-year period for companies that were operating in Puerto Rico in 1995, and is no longer available.

Controlled Foreign Corporations

Because of the modification and phase out of the federal tax incentives under Section 936 of the U.S. Code, many corporations previously operating thereunder reorganized their operations in Puerto Rico to become controlled foreign corporations (“CFCs”). A CFC is a corporation that is organized outside the United States and is controlled by United States shareholders. In general, a CFC may defer the payment of federal income taxes on its trade or business income until such income is repatriated to the United States in the form of dividends or through investments in certain United States properties. The Puerto Rico Office of Industrial Tax Exemption has received notification from numerous corporations that have converted part or all of their operations to CFCs. These include most of the major pharmaceutical, instrument and electronics manufacturing companies in Puerto Rico.

CFCs operate under transfer pricing rules for intangible income that are different from those applicable to United States corporations operating under Section 936 of the U.S. Code (“Section 936 Corporations”). In many cases, they are allowed to attribute a larger share of this income to their Puerto Rico operation but must make a royalty payment “commensurate with income” to their U.S. affiliates. Section 936 Corporations were exempted from Puerto Rico withholding taxes on any cost sharing payments they might have opted to make, but CFCs are subject to a fifteen percent Puerto Rico withholding tax on royalty payments.

Recently, the United States Congress approved legislation that would extend the benefit of Section 199 of the U.S. Code to production activities that take place in Puerto Rico. Section 199 provides a three-point reduction in the federal income tax rate, phased in over five years (from 35% to 31.85% after 2009). This extension applies to the U.S. branch activities located on the island and are not controlled foreign corporations.

DEBT

Public Sector Debt

Public sector debt comprises bonds and notes of the Commonwealth, its municipalities, and public corporations (“notes” as used in this section refers to certain types of non-bonded debt regardless of maturity), subject to the exclusions described below.

Section 2 of Article VI of the Constitution of the Commonwealth provides that direct obligations of the Commonwealth evidenced by full faith and credit bonds or notes shall not be issued if the amount of the principal of and interest on such bonds and notes and on all such bonds and notes theretofore issued which is payable in any fiscal year, together with any amount paid by the Commonwealth in the fiscal year preceding the fiscal year of such proposed issuance on account of bonds or notes guaranteed by the Commonwealth, exceeds 15% of the average annual revenues raised under the provisions of Commonwealth legislation and deposited into the Treasury (hereinafter “internal revenues”) in the two fiscal years preceding the fiscal year of such proposed issuance. Section 2 of Article VI does not limit the amount of debt that the Commonwealth may guarantee so long as the 15% limitation is not exceeded

through payments by the Commonwealth on such guaranteed debt. Internal revenues consist principally of income taxes, property taxes and excise taxes. Certain revenues, such as federal excise taxes on offshore shipments of alcoholic beverages and tobacco products and customs duties, which are collected by the United States Government and returned to the Treasury and motor vehicle fuel taxes and license fees, which are allocated to the Highway and Transportation Authority, are not included as internal revenues for the purpose of calculating the debt limit, although they may be available for the payment of debt service. In addition, the portion of the Sales Tax (as defined under “Tax Reform” under *Puerto Rico Taxes, Other Revenues, and Expenditures* below) allocated to the Puerto Rico Sales Tax Financing Corporation is also not included as internal revenues consistent with the legislation creating the Sales Tax Financing Corporation, which legislation provides that such portion is not “available resources” under the Constitutional provisions relating to the Bonds.

All or a portion of the proceeds of certain refunding bonds issued by the Commonwealth were invested in guaranteed investment contracts or federal agency securities (in each case rated in the highest category by Moody’s and S&P, none of which is eligible to be used for a legal defeasance under Puerto Rico law (“non-eligible investments”)). Since bonds refunded with proceeds of non-eligible investments are not legally defeased, such bonds are treated as outstanding for purposes of the 15% debt limitation.

Future maximum annual debt service for the Commonwealth’s outstanding general obligation debt is \$768,843,250 in the fiscal year ending June 30, 2020 (based on the assumption that the Public Improvement Refunding Bonds, Series 2004 A, which are variable rate bonds, bear interest at their actual rate per annum through July 1, 2012 and thereafter at 12% per annum, and the Public Improvement Refunding Bonds, Series 2004 B and a portion of the Public Improvement Bonds of 2006, Series A, each of which are also variable rate bonds, bear interest at 12% per annum). This amount (\$768,843,250) is equal to 9.21% of \$8,346,104,000, which is the average of the adjusted internal revenues for the fiscal years ended June 30, 2005 and June 30, 2006. If bonds refunded with non-eligible investments described in the preceding paragraph were treated as not being outstanding, and the interest on the Public Improvement Refunding Bonds, Series 2004 B and the above portion of the Public Improvement Bonds of 2006, Series A, was calculated using the effective fixed interest rate payable by the Commonwealth under the interest rate exchange agreements entered into in respect thereof, the percentage referred to in the preceding sentence would be 8.19% and future maximum annual debt service for the Commonwealth’s outstanding general obligation debt would be \$680,742,340 in the fiscal year ending June 30, 2020. Annual debt service payments on the PRASA guaranteed bonds have been paid by PRASA since fiscal year 2006 and, thus, such payments are not now included now in the calculation of the 15% debt limitation. In the event PRASA is unable to make any portion of the future debt service payments on its guaranteed bonds, the Commonwealth would be required to make such payments under its guarantee from the General Fund, and such debt service would be included in the calculation of the 15% debt limitation.

The Commonwealth’s policy has been and continues to be to maintain the amount of such debt prudently below the constitutional limitation. Debt of municipalities, other than bond anticipation notes, is supported by real and personal property taxes and municipal license taxes. Debt of public corporations, other than bond anticipation notes, is generally supported by the revenues of such corporations from rates charged for services or products. See *Public Corporations*. However, certain debt of public corporations is supported, in whole or in part, directly or indirectly, by Commonwealth appropriations or taxes.

Direct debt of the Commonwealth is issued pursuant to specific legislation approved in each particular case. Debt of the municipalities is issued pursuant to ordinances adopted by the respective municipal assemblies. Debt of public corporations is issued in accordance with their enabling statutes. GDB, as fiscal agent of the Commonwealth and its municipalities and public corporations, must approve the specific terms of each issuance.

The following table presents a summary of public sector debt as of May 31, 2007. Excluded from the table is debt not primarily payable from either Commonwealth or municipal taxes, Commonwealth appropriations or rates charged by public corporations for services or products, some of which debt is set forth in footnote 4 below. Also excluded from the table is debt the inclusion of which would reflect double counting including, but not limited to, \$1.46 billion of outstanding bonds (as of May 31, 2007) issued by the Municipal Finance Agency to finance its purchase of bonds of Puerto Rico municipalities, and \$2.6 billion of obligations of the Public Finance Corporation issued to purchase certain Commonwealth public sector debt.

**Commonwealth of Puerto Rico
Public Sector Debt
(in thousands)**

	May 31, 2007
Puerto Rico direct debt ⁽¹⁾	\$11,433,326
Municipal debt	2,448,771
Public corporations debt	
Puerto Rico guaranteed debt ⁽²⁾	800,044
Debt supported by Puerto Rico appropriations or taxes ⁽³⁾	16,969,012
Other non-guaranteed debt ⁽⁴⁾	11,919,124
Total public corporations debt	29,688,180
Total public sector debt	\$43,570,277

- (1) Includes general obligation bonds, tax and revenue anticipation notes, and lines of credit provided by GDB. Excludes certain Commonwealth general obligation bonds in the principal amount of \$1.1 billion that have been refunded with proceeds that were invested in guaranteed investment contracts or other securities not eligible to effect a legal defeasance, even though such bonds will be considered outstanding under their respective authorizing resolutions and for purposes of calculating the Commonwealth's constitutional debt limitation.
- (2) Consists of \$487 million of bonds issued by Aqueduct and Sewer Authority, \$226.8 million of State Revolving Fund Loans incurred under various federal water laws, and \$86.3 million of bonds issued by Port of the Americas Authority. Excludes Public Buildings Authority bonds in the principal amount of \$2.83 billion and \$267 million of GDB bonds payable from available moneys of GDB.
- (3) Represents, among others, bonds and notes issued by Aqueduct and Sewer Authority, Highway and Transportation Authority, Housing Finance Authority, Infrastructure Financing Authority, Public Buildings Authority and Public Finance Corporation.
- (4) Excludes the following: \$1.8 billion of Infrastructure Financing Authority bonds, which are payable solely from the investment income of funds on deposit in the Infrastructure Development Fund consisting of proceeds from the sale of a controlling interest in Puerto Rico Telephone Company; \$1.2 billion of Children's Trust bonds which are payable solely from the payments to be received pursuant to the tobacco litigation settlement; \$627.8 million of Housing Finance Authority bonds, which are payable from Puerto Rico Housing Administration's annual allocation of Public Housing Capital Funds from the United States Department of Housing and Urban Development; \$153 million of Special Facilities Revenue Bonds issued by the Highway and Transportation Authority, which are payable from net toll revenues collected from the Teodoro Moscoso Bridge; \$155 million of Special Facilities Bonds issued by the Ports Authority, which are solely payable from the pledge of certain payments made by a private corporation under a special facilities agreement; \$82.7 million of Educational Facilities Revenue Bonds, 2000 Series A (University Plaza Project) issued by the Industrial, Tourist, Educational, Medical and Environmental Control Facilities Financing Authority, which are payable from rent payments made by the University of Puerto Rico; and approximately \$111 million of bonds issued by the Industrial, Tourist, Educational, Medical and Environmental Control Facilities Financing Authority to finance the construction of various government infrastructure projects, which are payable from rent payments made by various government entities. The bonds listed in this footnote are subsequently collectively referred to as the "Excluded Bonds." If the principal amounts of the Excluded Bonds were included in the above table, total public corporations' debt would be \$30,128,755,000 and total public sector debt would be \$45,870,694,000.

Source: Government Development Bank for Puerto Rico

No deductions have been made in the table above for debt service funds and debt service reserve funds. The table above and the amounts shown throughout this section as representing outstanding debt include outstanding capital appreciation bonds at their respective original principal amounts and do not include any accretion thereon.

Debt Service Requirements for Commonwealth General Obligation Bonds

The following table presents the debt service requirements for Commonwealth general obligation bonds outstanding as of May 31, 2007.

The table excludes debt service on \$1.08 billion of general obligation bonds refunded with refunding bonds the proceeds of which, pending the redemption of the refunded bonds, were invested in guaranteed investment contracts or other securities not eligible to effect a legal defeasance. Such refunded bonds will be considered to be outstanding under their respective authorizing resolutions and for purposes of calculating the Commonwealth's constitutional debt limitation described above. In addition, in respect of certain variable rate, general obligation bonds as to which the Commonwealth has entered into interest rate exchange agreements, the interest in the table is calculated by using the respective fixed rates of interest that the Commonwealth is paying under said agreements. Debt service requirements for each fiscal year, as shown in the following table, include principal and interest due on July 1 immediately following the close of such fiscal year.

Puerto Rico Debt Service Requirements*
(in thousands)

<u>Fiscal Year Ending June 30</u>	<u>Outstanding Bonds</u>		<u>Total Debt Service⁽¹⁾</u>
	<u>Principal</u>	<u>Interest</u>	
2007	\$164,012	\$454,465	\$618,477
2008	210,367	432,419	642,786
2009	261,645	388,748	650,393
2010	276,720	373,802	650,522
2011	289,322	358,762	648,085
2012	310,255	337,670	647,925
2013	329,180	318,754	647,934
2014	328,358	321,620	649,978
2015	343,665	306,188	649,853
2016	360,585	289,631	650,216
2017	377,162	272,669	649,830
2018	395,220	254,996	650,216
2019	429,936	220,638	650,574
2020	489,305	191,437	680,742
2021	361,255	167,292	528,547
2022	287,855	150,541	438,396
2023	257,220	137,383	394,603
2024	245,635	125,685	371,320
2025	256,585	114,826	371,411
2026	258,780	103,804	362,584
2027	270,185	92,013	362,198
2028	282,090	79,751	361,841
2029	294,615	66,758	361,373
2030	308,115	52,474	360,589
2031	321,825	37,953	359,778
2032	157,515	22,638	180,153
2033	131,585	15,040	146,625
2034	99,205	8,409	107,614
2035	68,965	3,448	72,413
	<u>\$8,167,160</u>	<u>\$5,699,814</u>	<u>\$13,866,974</u>

* Totals may not add due to rounding. Excludes the debt service on certain economically (but not legally) defeased, general obligation bonds and includes the effective fixed rate on certain variable rate, general obligation bonds as to which the Commonwealth has entered into interest rate exchange agreements.

(1) Since fiscal year 1997, the Commonwealth had been paying approximately \$30 million annual debt service on PRASA bonds and other obligations guaranteed by the Commonwealth. Beginning with the debt service payment due January 1, 2006, the Commonwealth stopped making such payments, and PRASA resumed making all payments due on and after such date from its net revenues. In the event PRASA is unable to make any portion of the future debt service payments on its guaranteed bonds, the Commonwealth would once more be required to make such payments under its guarantee from the General Fund. See "Other Public Corporations – Aqueduct and Sewer Authority" under *Public Corporations* below.

Sources: Government Development Bank for Puerto Rico and Department of the Treasury

Ratings of Commonwealth General Obligation Bonds

On May 22, 2007, Moody's Investors Service ("Moody's") confirmed its "Baa3" and "Ba1" rating on the Commonwealth's general obligation debt and its appropriation debt, respectively, and its negative ratings outlook thereon.

On May 22, 2007, Standard & Poor's Rating Services, a division of The McGraw-Hill Companies, Inc. ("S&P"), lowered its rating on the Commonwealth's general obligation debt to "BBB-", changed its negative ratings outlook thereon to stable, and confirmed its "BBB-" rating on the Commonwealth's appropriation debt.

Commonwealth Guaranteed Debt

As of May 31, 2007, \$2.83 billion of Commonwealth guaranteed bonds of the Public Buildings Authority were outstanding. Maximum annual debt service on these bonds is \$219.5 million in fiscal year ending June 30, 2011, with their final maturity being July 1, 2036. No payments under the Commonwealth guaranty have been required to date for these bonds.

As of May 31, 2007, \$267 million of Commonwealth guaranteed bonds of GDB were outstanding. No payments under the Commonwealth guaranty have been required for these bonds.

As of May 31, 2007, GDB held approximately \$86.3 million of the Port of the Americas Authority's outstanding bonds, which are guaranteed by the Commonwealth. The Authority is authorized to issue and GDB is authorized to purchase its bonds guaranteed by the Commonwealth in a maximum aggregate principal amount of \$250 million. The proceeds from these bonds will be used to continue the development of the Port of the Americas. No payments under the Commonwealth guaranty have been required for these bonds.

As of May 31, 2007, the aggregate outstanding principal amount of obligations of PRASA guaranteed by the Commonwealth was \$713.8 million. This amount consisted of \$277.8 million in revenue bonds sold to the public, \$209.1 million in bonds issued to the United States Department of Agriculture, Rural Development, and \$226.8 million of loans by the State Revolving (Clean Water and Safe Drinking Water Act) Funds for the benefit of PRASA. From January 1997 through fiscal year 2005, the Commonwealth made debt service payments under its guaranty. Beginning with the debt service payment due January 1, 2006, the Commonwealth stopped making guarantee payments on these obligations. PRASA has resumed making payment on this debt. In the event PRASA is unable to make any portion of the future debt service payments on its guaranteed obligations, the Commonwealth would be required once more to make such payments from the General Fund under its guarantee. See "Other Public Corporations – Aqueduct and Sewer Authority" under *Public Corporations* below.

Trends of Public Sector Debt

The following table shows the growth rate of short-term and long-term public sector debt and the growth rate of Gross National Product (in current dollars) for the five fiscal years ended June 30, 2006 and the first eleven months of fiscal year 2007. As of May 31, 2007, outstanding short-term debt, relative to total debt, was 9.5%.

Commonwealth of Puerto Rico
Public Sector Debt and Gross National Product
(dollars in millions)*

June 30,	Public Sector Debt					Gross National Product ⁽¹⁾	
	Long Term ⁽²⁾	Short Term ⁽³⁾	Short Term as % of Total	Total	Rate of Increase	Amount	Rate of Increase
2002.....	\$26,737	\$1,250 ⁽⁴⁾	4.5%	\$27,987	\$11.0%	\$45,071	2.3%
2003.....	28,102	1,605 ⁽⁴⁾	5.4%	29,707	6.1%	47,479	5.3%
2004.....	31,767	2,175 ⁽⁴⁾	6.4%	33,942	14.3%	50,709	6.8%
2005.....	34,789	1,914 ⁽⁴⁾	5.2%	36,703	8.1%	53,601	5.7%
2006.....	37,313	2,620 ⁽⁴⁾⁽⁵⁾	6.6%	39,933	8.8%	56,689	5.8%
May 31, 2007.....	39,437	4,133	9.5%	43,570	9.1%	N/A	N/A

* Totals may not add due to rounding.

(1) In current dollars.

(2) Does not include the Excluded Bonds identified in footnote 4 of the table above entitled "Commonwealth of Puerto Rico — Public Sector Debt," which would have been issued and outstanding at the time, all of which would be considered long-term debt.

(3) Obligations (other than bonds) issued with an original maturity of three years or less and lines of credit with a remaining maturity of three years or less are considered short-term debt.

(4) Does not include the tax and revenue anticipation notes that were outstanding at the close of the indicated fiscal years because prior to the end of said fiscal years sufficient funds had been set aside for the payment of such notes in full.

(5) Includes a \$368 million line of credit from GDB to the Secretary of the Treasury, the proceeds of which were applied to pay debt service on general obligation bonds.

Source: Government Development Bank for Puerto Rico

The following table shows the trend of public sector debt by major category for the five fiscal years ended June 30, 2006 and the first eleven months of fiscal year 2007.

Commonwealth of Puerto Rico
Public Sector Debt by Major Category
(dollars in millions)*

June 30,	Commonwealth			Municipalities			Public Corporation ⁽¹⁾			Total		
	Long Term	Short Term ⁽²⁾	Total	Long Term	Short Term ⁽²⁾	Total	Long Term	Short Term ⁽²⁾	Total	Long Term	Short Term ⁽²⁾	Total
2002.....	\$6,025	\$91 ⁽³⁾	\$6,116	\$1,618	\$177	\$1,795	\$19,094	\$982	\$20,076	\$26,737	\$1,250	\$27,987
2003.....	6,709	177 ⁽³⁾	6,886	1,754	201	1,955	19,639	1,227	20,866	28,102	1,605	29,707
2004.....	7,758	761 ⁽³⁾	8,519	1,820	226	2,046	22,190	1,187	23,377	31,767	2,175	33,942
2005.....	8,761	257 ⁽³⁾	9,018	1,927	254	2,181	24,101	1,403	25,504	34,789	1,914	36,703
2006.....	9,841	552 ⁽³⁾⁽⁴⁾	10,393	2,037	293	2,330	25,435	1,775	27,210	37,313	2,620	39,933
May 31, 2007.....	10,335	1,098	11,433	2,151	298	2,449	26,951	2,737	29,688	39,437	4,133	43,570

* Totals may not add due to rounding.

(1) Includes Commonwealth guaranteed debt; does not include the Excluded Bonds.

(2) Obligations (other than bonds) issued with an original maturity of three years or less and lines of credit with a remaining maturity of three years or less are considered short-term debt.

(3) Does not include the tax and revenue anticipation notes which were outstanding at the close of the indicated fiscal years because prior to the end of said fiscal years sufficient funds had been set aside for the payment of such notes in full.

(4) Includes a \$368 million line of credit from GDB to the Secretary of the Treasury, the proceeds of which were applied to pay debt service on general obligation bonds.

Source: Government Development Bank for Puerto Rico

PUBLIC CORPORATIONS

In Puerto Rico, many governmental and quasi-governmental functions are performed by public corporations created by the Legislative Assembly with varying degrees of independence from the central government to perform generally a single function or a limited number of related functions. Most public corporations obtain revenues from rates charged for services or products, but many are subsidized to some extent by the central government. Most public corporations are governed by boards whose members are appointed by the Governor with the advice and consent of the Senate, but some public corporations are attached to departments of the central government. Capital improvements of most of the larger public corporations are financed by revenue bonds issued under trust agreements or bond resolutions, or notes issued under loan agreements. The following table presents the outstanding bonds and notes of certain of the public corporations as of May 31, 2007 (“notes” as used in this section refers primarily to certain types of non-bonded debt regardless of maturity). Debt of certain other public corporations is excluded from this table because such debt is payable primarily from funds or grants provided by the federal government, is payable from sources other than Commonwealth appropriations or taxes or revenues of public corporations, or is payable from revenues derived from private sector services or products, such as industrial development bonds. Also excluded from this table is debt of certain public corporations the inclusion of which would reflect double counting. No deductions have been made in the table for debt service funds and debt service reserve funds. More detailed information about the major public corporations is presented in the following sections.

Commonwealth of Puerto Rico
Outstanding Debt of Public Corporations
May 31, 2007
(in thousands)

	Bonds			Notes			Total Bonds and Notes		
	With Guaranty	Without Guaranty	Total	With Guaranty	Without Guaranty	Total	With Guaranty	Without Guaranty	Total
Aqueduct and Sewer Authority	\$ 486,985	\$ -	\$ 486,985	\$ 226,772	\$ 1,235,262	\$ 1,462,034	\$ 713,757	\$ 1,235,262	\$ 1,949,019
Convention Center District									
Authority	-	468,800	468,800	-	155,221	155,221	-	624,021	624,021
Electric Power Authority	-	5,695,440	5,695,440	-	884,550	884,550	-	6,579,990	6,579,990
Highway and Transportation									
Authority	-	6,494,094 ⁽¹⁾	6,494,094	-	200,000	200,000	-	6,694,094	6,694,094
Housing Finance Authority ⁽²⁾	-	537,673	537,673	-	46,469	46,469	-	584,142	584,142
Industrial Development									
Company	-	270,744	270,744	-	81,081	81,081	-	351,825	351,825
Infrastructure Financing									
Authority	-	1,898,848 ⁽³⁾	1,898,848	-	39,842	39,842	-	1,938,690	1,938,690
Public Buildings Authority	2,827,632	-	2,827,632	-	194,596	194,596	2,827,632	194,596	3,022,228
Public Finance Corporation	-	4,272,406 ⁽⁴⁾	4,272,406	-	303,024	303,024	-	4,575,430	4,575,430
Port of the Americas Authority	86,287	-	86,287	-	-	-	86,287	-	86,287
Ports Authority	-	66,190 ⁽⁵⁾	66,190	-	546,148	546,148	-	612,338	612,338
University of Puerto Rico	-	619,518 ⁽⁶⁾	619,518	-	19,812	19,812	-	639,330	639,330
Others	-	-	-	-	2,030,786	2,030,786	-	2,030,786	2,030,786
Total⁽⁷⁾	\$ 3,400,904	\$20,323,713	\$23,724,617	\$ 226,772	\$ 5,736,791	\$ 5,963,563	\$ 3,627,676	\$26,060,504	\$29,688,180

- (1) Excludes \$153 million of Special Facilities Revenue Bonds issued by the Highway and Transportation Authority, which are payable from net toll revenues collected from the Teodoro Moscoso Bridge.
- (2) Excludes the \$627.8 million of Housing Finance Authority bonds, which are payable solely from Puerto Rico Public Housing Administration's annual allocation of Public Housing Capital Funds from the United States Department of Housing and Urban Development.
- (3) Excludes \$1 billion of outstanding bonds of Infrastructure Financing Authority, which bonds are payable solely from the investment income of funds on deposit in the Infrastructure Development Fund consisting of proceeds from the sale of a controlling interest in Puerto Rico Telephone Company.
- (4) Payable primarily from Commonwealth appropriations.
- (5) Excludes \$155 million of Special Facilities Bonds issued by the Ports Authority, which bonds are payable solely from by the pledge of certain payments made by a private corporation under a special facilities agreement.
- (6) Excludes \$82.7 million of Educational Facilities Revenue Bonds, 2000 Series A (University Plaza Project) issued by the Industrial, Tourist, Educational, Medical and Environmental Control Facilities Financing Authority, which bonds are payable from rent payments made by the University of Puerto Rico.
- (7) Excludes accretion of interest from the respective issuance dates on capital appreciation bonds. Also excludes \$1.2 billion original principal amount of Children's Trust Tobacco Settlement Asset-Backed Bonds, Series 2002, which bonds will be repaid from payments made by certain tobacco companies under a master settlement agreement. See "Other Public Corporations" below.

Source: Government Development Bank for Puerto Rico

Government Development Bank for Puerto Rico

The principal functions of GDB are to act as financial advisor to and fiscal agent for the Commonwealth, its municipalities and public corporations in connection with the issuance of bonds and notes, to make loans and advances to public corporations and municipalities, and to make loans to private enterprises to aid in the economic development of Puerto Rico.

As of May 31, 2007, just under \$2 billion of bonds and notes of GDB (excluding its subsidiaries) were outstanding, consisting of \$267 million in Commonwealth guaranteed bonds and \$1.7 billion of medium term senior notes. Act No. 12 of May 9, 1975, as amended, provides that the payment of principal of and interest on specified notes and other obligations of GDB, not exceeding \$550 million, may be guaranteed by the Commonwealth, of which \$267 million were outstanding as of May 31, 2007. As of said date, GDB also had \$5.9 billion in loans outstanding to the central government of the Commonwealth and its public corporations and municipalities.

Act No. 82 of June 16, 2002 (“Act No. 82”) amended GDB’s Charter to authorize GDB to transfer annually to the General Fund, beginning with fiscal year 2001, up to 10% of its audited net income or \$10,000,000, whichever is greater. GDB is not required by Act No. 82 to transfer any funds. GDB made payments to the General Fund of \$11.6 million for fiscal year 2003 and \$18.4 million for fiscal year 2004. GDB did not make a payment to the General Fund under Act No. 82 for fiscal years 2005 and 2006 and does not expect to make a payment for fiscal year 2007.

Under Act No. 271 of November 21, 2002, GDB made a required special capital contribution to the Special Communities Perpetual Trust (the “Trust”) of \$500 million and provided the Trust with a \$500 million, non-revolving, line of credit. The amounts transferred to the Trust were deposited in two investment accounts held by GDB for the benefit of the Trust. As of May 31, 2007, the Trust had repaid \$114.9 million of its line of credit and had an outstanding balance of \$385.1 million. The line of credit is payable from legislative appropriations.

GDB has several subsidiaries which perform various functions. The principal subsidiaries and their functions are listed below:

Housing Finance Authority. Housing Finance Authority (formerly known as Housing Finance Corporation) was created to provide needed rental housing units and stimulate the construction industry under federally subsidized programs. Effective February 8, 2002, Housing Finance Corporation became the Housing Finance Authority and the Housing Bank and Finance Agency was dissolved and its powers transferred to the Housing Finance Authority. Housing Finance Authority provides financing for rental housing units, stimulates the construction industry under federally subsidized programs and provides interim financing for low-income housing projects and single-family homeownership programs. It is also engaged in insuring and servicing mortgages originated by the former Housing Bank and Finance Agency. As of May 31, 2007, Housing Finance Authority’s total outstanding loans to the private sector for development of housing projects targeted to low-and moderate income families were \$115 million. The Authority’s mortgage loans to low and moderate income homeowners represented an additional \$78 million as of the same date.

Housing Finance Authority has outstanding tax-exempt revenue bonds and notes that were issued to finance the construction of housing units approved for federal rental subsidies and to finance home ownership of single family housing units. Such bonds and notes are generally limited obligations of Housing Finance Authority payable solely from revenues collected from such housing units, with certain exceptions. As of May 31, 2007, \$537.7 million of Housing Finance Authority bonds were outstanding.

As of May 31, 2007, the Authority also had outstanding \$521.7 million of bonds and notes issued to fund certain payments of the Commonwealth under its mortgage subsidy and other programs for low and moderate income families, and to guarantee certain insurance obligations of the former Housing Bank and Finance Agency.

As of May 31, 2007, the Authority had total notes and bonds outstanding of \$1.262 billion (including \$46.5 million of debt outstanding under GDB lines of credit and \$6.8 million with other banks) and total unrestricted net assets of \$750.9 million.

Tourism Development Fund. The Tourism Development Fund promotes Puerto Rico's hotel and tourism industry by making available direct loans and guarantees to secure the private financing for new hotel development projects. The Tourism Development Fund is also authorized to make capital investments in tourism related projects. As of May 31, 2007, the Tourism Development Fund had outstanding direct loans in an aggregate principal amount of \$244.9 million and guarantees issued in the outstanding amount of \$128.9 million to finance several hotels and tourism-related projects.

The Tourism Development Fund has made payments under its guarantees and letters of credit in the aggregate amount of approximately \$313.4 million with respect to several projects, including \$282 million disbursed to pay in full the bonds issued to finance three projects, which bonds had been declared due and payable at the direction of the Tourism Development Fund due to the failure of the applicable borrowers to comply with their obligations under the related reimbursement agreements. Of the total amount disbursed, the Tourism Development Fund has been able to recover approximately \$199.7 million from the borrowers. After taking these payments and all related recoveries into account, the unrestricted net assets of the Tourism Development Fund as of May 31, 2007, were approximately \$136 million, and its allowances for losses on guarantees, loans, other assets and letters of credit were approximately \$28.9 million.

Capital Fund. The Government Development Bank for Puerto Rico Capital Fund (the "Capital Fund") invests and trades in debt obligations and publicly traded shares of domestic and foreign corporations separate from GDB's general investment operations. As of May 31, 2007, the Capital Fund had assets of \$88.8 million, of which \$65.6 million were invested in an equity index fund that invests mainly in growth, value, small cap and international stocks.

Development Fund. The Puerto Rico Development Fund (the "Development Fund") provides an alternate source of financing to private enterprises in Puerto Rico that have difficulties in obtaining financing from traditional sources. The Development Fund also guarantees obligations of these enterprises and invests in their equity securities. As of May 31, 2007, the Development Fund had no investments due to the sale of most of its assets to the Economic Development Bank for Puerto Rico in June 2006.

Public Finance Corporation. Puerto Rico Public Finance Corporation ("Public Finance Corporation") provides agencies and instrumentalities of the Commonwealth with alternate means of meeting their financing requirements. Public Finance Corporation currently holds notes payable by the Commonwealth, the Maritime Shipping Authority, the Office for the Improvement of Public Schools, the Department of Health, and the Aqueduct and Sewer Authority, among others. As of July 31, 2007, it had \$3 billion aggregate principal amount of bonds outstanding. All such bonds are limited, non-recourse obligations of Public Finance Corporation payable solely from Commonwealth appropriations made to pay the notes held by Public Finance Corporation. In addition, Public Finance Corporation had \$303 million of notes outstanding under a line of credit with GDB whose proceeds were used to pay fiscal year 2007 debt service on its bonds due to the failure of the Commonwealth to make the required debt service appropriations on account of its fiscal problems.

A description of certain other affiliates of GDB is provided in “Other Public Corporations” below.

Other Public Corporations

Aqueduct and Sewer Authority. Puerto Rico Aqueduct and Sewer Authority (“PRASA”) owns and operates the island’s public water supply and sanitary sewer facilities systems (the “Systems”).

PRASA needs to make substantial investments in infrastructure and a major overhaul of its operations to maintain the viability of the Systems and to finance its expansion for new users. Funds for this investment will be provided through a combination of revenues from PRASA, financing transactions, federal grants and other sources. Debt service on revenue bonds is payable from net revenues of the Systems after payment of current expenses. Due to PRASA’s financial difficulties and its inability to access the bond market, the Commonwealth guarantees the principal and interest payments to the bondholders of all outstanding revenue bonds issued by PRASA, including those issued to the United States Department of Agriculture, Rural Development, and loans granted by the Clean Water and Drinking Water State Revolving Funds for the benefit of PRASA. In February 2004, this guaranty was extended through new legislation to include debt obligations issued until 2010.

PRASA reported operational losses of \$343 million and \$361 million during fiscal years 2005 and 2006, respectively. The total debt of PRASA was \$1.9 billion as of May 31, 2007.

Beginning in fiscal year 2006, the Commonwealth’s General Fund ceased to provide financial assistance to PRASA, including making payments on PRASA’s guaranteed revenue bonds (as of January 1, 2006). As part of its efforts to regain fiscal independence, PRASA implemented substantial increases in water and wastewater service rates in two phases. The first phase took effect on October 10, 2005. The second phase took effect on July 1, 2006. The new rate structure also includes changes from bi-monthly to monthly invoicing of residential customers. GDB and a consortium of Puerto Rico commercial banks have extended PRASA lines of credit in the aggregate principal amount of \$450 million to allow PRASA to implement the rate increase by providing PRASA with working capital. PRASA expects to repay this line of credit from the additional net revenues generated by the rate increase. There is no assurance, however, that PRASA will generate sufficient revenues to enable it, after satisfying other senior obligations described below, to continue to pay debt service on its guaranteed bonds. In the event PRASA is unable to make any portion of the future debt service payments on its guaranteed bonds, the Commonwealth would once again be required to make such payments under its guarantee from the General Fund. PRASA has also begun to pay from its revenues the debt service on a note it issued to Public Finance Corporation (in the principal amount of \$368.3 million), which note financed the cost of the north coast super-aqueduct, as well as notes issued to Public Finance Corporation (in the principal amount of approximately \$747 million), which notes financed its operations.

In June 2006, PRASA entered into an agreement to plead guilty to an indictment charging 15 felony counts of violating the federal Clean Water Act through the illegal discharge of pollutants from nine sanitary wastewater treatment plants and five drinking water treatment plants. Under the plea agreement, PRASA will pay a criminal fine of \$9 million. PRASA and the United States also reached a comprehensive civil settlement to resolve repeated environmental violations at 61 wastewater treatment plants throughout the Commonwealth. According to the civil settlement, PRASA will spend an estimated \$1.7 billion implementing approximately 145 capital improvement projects and other remedial measures at all of its wastewater treatment plants and related collection systems over the next 15 years. In December 2006, PRASA and the Commonwealth Department of Health executed a settlement agreement superseding 180 administrative orders against, and three prior settlement agreements with, PRASA. Under the terms of this agreement, PRASA paid a civil penalty of \$1.0 million and agreed to implement

short, medium and long-term work plans, as well as interim mitigation and preventative measures, all to bring PRASA's water system into compliance with federal and Commonwealth potable water regulations. The total cost of complying with this settlement agreement is expected to be between \$700 and \$800 million.

PRASA is currently in the process of putting together a bond issue of approximately \$930 million of senior lien, net revenue bonds to fund its capital improvement program and to refinance certain debt, including some of the working capital debt described above. In connection with this transaction, through April 30, 2007, PRASA had outstanding \$620 million in bond anticipation notes.

Children's Trust is a not-for-profit corporate entity created in 1999 as a public instrumentality of the Commonwealth. The Commonwealth has transferred to Children's Trust all of its rights, title and interest under the tobacco litigation Master Settlement Agreement, including the Commonwealth's right to receive initial, annual and strategic contribution payments to be made by the participating cigarette manufacturers under the Master Settlement Agreement.

Children's Trust issued \$1.2 billion Tobacco Settlement Asset-Backed Bonds in October 2002. The bond proceeds were used, among other things, to pay the cost of certain capital expenses of the Commonwealth and certain capital and working capital expenses of PRASA. On June 30, 2005, the Children's Trust issued \$108.2 million subordinate Tobacco Settlement Asset-Backed Bonds to pay working capital expenses of the Commonwealth. As of May 31, 2007, the outstanding principal amount of the Trust's bonds was \$1.2 billion. These bonds and any other additional senior bonds issued by Children's Trust are secured by a statutory pledge of the payments made and to be made by the participating cigarette manufacturers under the Master Settlement Agreement. To date, all principal and interest payments required to be made by the Trust on its outstanding bonds have been made on a timely basis from contribution payments made by the participating cigarette manufacturers under the Master Settlement Agreement.

Convention Center District Authority. The Convention Center District Authority was created to own, develop, finance, plan, design, build, operate, maintain, administrate and promote a new convention center and designated private parcels located within the Convention Center District in San Juan. The convention center opened on November 17, 2005.

The Industrial, Tourist, Educational, Medical and Environmental Control Facilities Financing Authority ("AFICA") financed the construction of a multi-purpose coliseum in San Juan, known as the José Miguel Agrelot Coliseum, with a line of credit provided by GDB. The Coliseum was transferred to the Convention Center District Authority along with the associated line of credit. As of May 31, 2007, this line of credit with GDB had an outstanding balance of \$155.2 million, which is expected to be paid from the proceeds of Commonwealth general obligation bonds. The Authority's debt as of May 31, 2007 was \$624 million including \$468.8 million of bonds issued in March 2006 to finance the Convention Center and payable from a portion of a hotel room tax.

Electric Power Authority. The Authority owns and operates the island's electric system. The capital improvement program for the five-year period ending June 30, 2011 is estimated to cost approximately \$2.2 billion and will be financed primarily by borrowed funds, supplemented by internally generated funds. The Authority's bonded debt consists of Power Revenue Bonds, secured by a lien on net revenues of the electric system. As of May 31, 2007, the Authority's total debt was \$6.6 billion, including \$5.7 billion of bonds outstanding (not including accretion of interest from the respective issuance dates on capital appreciation bonds). As a means of reducing its dependency on oil, the Authority has entered into long-term power purchase agreements with the operators of two co-generation

plants that use fuels other than oil. Currently, these two co-generation plants provide approximately 27% of the Authority's energy needs.

Health Insurance Administration was created in 1993 to negotiate and contract for the provision of comprehensive health insurance coverage for qualifying (generally low income) Puerto Rico residents. Under this system, the government selects, through a bidding system, one private health insurance company in each of eight designated regions of the island and pays such insurance company the insurance premium for each eligible beneficiary within such region. The health insurance system covers the entire island, and approximately 1.5 million persons were covered by the system during fiscal year 2006.

In January 2006, the Commonwealth entered into various contracts with several Medicare Advantage Organizations for the provision of health coverage to approximately 200,000 eligible beneficiaries. Pursuant to these agreements, the Commonwealth pays each Medicare Advantage Organization a premium difference to cover services not included in their contracts with the Center for Medicaid and Medicare Services.

The total cost of the health insurance program for fiscal year 2006 was \$1.56 billion, compared to \$1.46 billion for fiscal year 2005 and \$1.37 billion for fiscal year 2004. For fiscal year 2006, the General Fund covered \$984 million of the total cost of the health insurance program, while the remaining \$586 million was paid from federal, municipal and other sources. The fiscal year 2007 budget pegged the cost of the health insurance program at more than \$1.6 billion, of which the General Fund covered \$984 million, while the remaining \$633 million was paid from federal, municipal and other sources, including a loan of \$203 million from GDB. The health insurance program projected an \$82 million surplus for fiscal year 2007, which surplus will be used for costs of the program in fiscal year 2008. Negotiations with insurance companies will be focused on cost containment strategies that will seek to reduce this cost to the amount appropriated. See *Budget of the Commonwealth of Puerto Rico*.

Highways and Transportation Authority. The Authority is responsible for highway construction in Puerto Rico. Such construction is financed by debt (interim notes and revenue bonds), revenues of the Authority, and federal and Commonwealth grants. Debt service on the Authority's revenue bonds constitutes a first lien on its gross revenues, which consist currently of all the proceeds of the tax on gasoline, one-half of the proceeds of the tax on gas oil and diesel oil, all the proceeds of the excise taxes on crude oil, unfinished oil and derivative products, up to \$120 million per fiscal year, highway toll revenues (which were increased approximately 43% in September 2005), and the gross receipts of \$15.00 per vehicle per year from certain motor vehicle license fees. Such revenues (except for toll revenues) may be applied first to the payment of debt service on general obligation bonds and notes of the Commonwealth and to payments required to be made by the Commonwealth under its guarantees of bonds and notes, to the extent that no other revenues are available for such purpose. The Commonwealth has never applied such revenues for such payment. As of May 31, 2007, the Authority's total debt was \$6.7 billion, including \$6.5 billion in outstanding bonds.

The Authority has completed the first phase of a new mass transit system, known as Tren Urbano, to serve a portion of metropolitan San Juan. It was constructed under several design/build contracts and is being privately operated under a five-year contract with an additional five-year option at the Authority's election. The cost of the first phase was \$2.25 billion, which cost was financed by federal Transit Administration grants, other federal funding sources and the Authority's own resources, including revenue bonds. Tren Urbano commenced operations in June 2005.

The Authority is a party to a concession agreement under which a private company designed, constructed and currently is operating a toll bridge spanning the San José Lagoon. The toll bridge was financed with special facility revenue bonds of the Authority, the outstanding principal balance of which

was \$153.2 million as of May 31, 2007, payable by the private operator of the bridge principally from toll revenues. The concession is for a term of 35 years, subject to earlier termination or extension. The bridge opened for traffic in February 1994. In certain circumstances described in the concession agreement, including where toll revenues are insufficient to generate certain rates of return to the private operator, the private operator may require the Authority, among other things, to assume the operator's obligations with respect to the special facility revenue bonds. Some of those circumstances, including low toll revenues, exist at this time, but the Authority does not currently anticipate that the operator will exercise its remedy against the Authority.

Industrial Development Company participates in the Commonwealth-sponsored economic development program by providing physical facilities, general assistance, and special incentive grants to manufacturers. The Company was merged with the Economic Development Administration in January 1998. Rentals derived from the leasing of specified facilities of the Company are pledged to the payment of the Company's revenue bonds. As of May 31, 2007, the Company's total debt was \$351.8 million. The Company restructured its operations in order to allow it to react quickly to changing business situations. Part of this restructuring included a significant reduction in the number of its employees.

Industrial, Tourist, Educational, Medical and Environmental Control Facilities Financing Authority was created to finance (through the issuance of its revenue bonds) industrial, tourist, educational, medical, and environmental control facilities in Puerto Rico for the use of private companies, non-profit entities, or government agencies. The bonds are payable solely from payments to be made to AFICA by such private companies, non-profit entities, or government agencies, and do not constitute a debt of the Commonwealth or any of its other public corporations or municipalities. As of May 31, 2007, approximately \$1.6 billion of AFICA's bonds were outstanding.

Infrastructure Financing Authority was created to provide financial, administrative, consulting, technical, advisory, and other types of assistance to other public corporations, governmental instrumentalities, political subdivisions and municipalities (collectively, "Benefited Entities") authorized to develop infrastructure facilities and to establish alternate means for financing those facilities. The Authority is authorized to issue bonds and provide loans, grants and other financial assistance for the construction, acquisition, repair, maintenance and reconstruction of infrastructure projects by Benefited Entities. The Authority oversees the Puerto Rico Infrastructure Fund, which is funded with annual fixed amounts from the first proceeds of federal excise taxes imposed on rum and other articles produced in Puerto Rico and sold in the United States which are transferred to Puerto Rico pursuant to the United States Internal Revenue Code of 1986, as amended. Currently, this amount is \$90 million through fiscal year 2009 and will then increase to \$117 million annually through fiscal year 2052. Rum is the only article currently produced in Puerto Rico subject to federal excise taxes, the proceeds of which are required to be returned to the Treasury. The Authority is using these amounts to provide financial support for various infrastructure and other projects. As of May 31, 2007, the Authority's total debt was \$1.9 billion.

The Authority has provided assistance to PRASA, among other Benefited Entities, with regards to (i) the design and construction of various strategic regional water and sewer projects intended to provide improved services to targeted regions throughout the island; (ii) the implementation of an action plan to address a number of small water and sewer rehabilitation projects; (iii) the achievement of compliance with certain environmental laws; and (iv) the establishment of a prioritized capital program.

The Authority will invest approximately \$405 million in new infrastructure projects in connection with the holding of the Central American and Caribbean Games in Mayagüez, Puerto Rico, in 2010. In September 2006, the Authority issued \$469.8 million of bonds to finance these and other infrastructure projects.

Municipal Finance Agency is the municipal “bond bank” for Puerto Rico. The Agency is authorized to issue bonds to purchase general obligation bonds and notes of Puerto Rico municipalities and to fund a debt service reserve. Debt service on the Agency’s bonds is payable from debt service payments on municipal bonds and notes held by the Agency and from the debt service reserve, including investment income thereon. The Commonwealth has agreed to pay such amounts to the debt service reserve as may be necessary to maintain it at its required level, subject to appropriation by the Legislative Assembly, which appropriation is authorized but not legally required to be made. To date no such payments have been required. As of May 31, 2007, the Agency had \$1.5 billion of bonds outstanding.

Port of the Americas Authority. Port of the Americas Authority is responsible for the development and operation of the Port of the Americas (the “Port”), a deep draft port on the south coast of Puerto Rico. In December of 2004, the first phase of the Port was completed at a cost of \$40 million. The Authority is authorized to issue bonds guaranteed by the Commonwealth in a maximum aggregate principal amount of \$250 million. The proceeds from these bonds will be used to continue the development of the Port. Currently, GDB is authorized to purchase bonds of the Authority in an aggregate principal amount not to exceed \$250 million. As of May 31, 2007, GDB held approximately \$86.3 million of the Authority’s outstanding bonds, which are guaranteed by the Commonwealth.

Ports Authority. The Authority owns and operates the major airport and seaport facilities in Puerto Rico. The Authority derives revenues from a variety of sources, including charges on airplane fuel sales, air terminal space rentals, landing fees, wharfage, dockage and harbor fees, and rentals for the lease of property and seaport equipment. As of May 31, 2007, the Authority had \$612.3 million in debt, including \$2.7 million under a line of credit with GDB.

Public Buildings Authority is authorized to construct, purchase or lease office, school, health, correctional and other facilities for lease to departments, public corporations, and instrumentalities of the Commonwealth. Bonds that have been issued by the Authority to finance such facilities (through retirement of interim notes or otherwise) are payable from lease payments, which are largely derived from legislative appropriations and are secured by the Commonwealth’s guaranty. The Authority is authorized by law to have outstanding at any one time up to \$3.325 billion of bonds guaranteed by the Commonwealth. As of May 31, 2007, \$2.8 billion of such bonds of the Authority were outstanding (not including accretion of interest from the respective issuance dates on capital appreciation bonds). As of May 31, 2007, Public Building Authority’s line of credit with GDB had an outstanding balance of \$194.6 million.

Special Communities Perpetual Trust. The Special Communities Perpetual Trust, a public corporation, is an irrevocable and permanent trust. The Trust’s principal purpose is to fund development projects which address the infrastructure and housing needs of underprivileged communities. GDB has made a special capital contribution to the Special Communities Perpetual Trust of \$500 million and provided the Trust with a \$500 million, non-revolving, line of credit. The amounts transferred by GDB were deposited in two investment accounts held by GDB for the benefit of the Special Communities Irrevocable Trust, of which \$311.9 million had been disbursed to the Trust as of May 31, 2007. As of May 31, 2007, the Special Communities Perpetual Trust’s line of credit with GDB had an outstanding balance of \$385.1 million. The line of credit is payable from legislative appropriations.

Telephone Authority was created in July 1974 when the Commonwealth purchased the Puerto Rico Telephone Company (“PRTC”) from International Telephone and Telegraph Corporation. PRTC operates the principal telephone system in Puerto Rico.

In 1999, the Telephone Authority sold a controlling interest in PRTC to a consortium led by a predecessor of Verizon Communications, Inc (“Verizon”). The net proceeds of \$1.2 billion, after PRTC’s

outstanding debt was retired and certain employee benefits were paid, was deposited into the Infrastructure Development Fund held by the Infrastructure Financing Authority. In 2002, Verizon exercised an option to purchase additional shares from the Telephone Authority for \$172 million, leaving the Authority with a 28% ownership interest in PRTC. In 2007, the Authority sold its remaining interest in PRTC to a subsidiary of América Móvil, S.A. de C.V. for \$529 million, the proceeds from which were transferred to the Employees Retirement System of the Commonwealth.

University of Puerto Rico (the “University”), with approximately 62,340 students in academic year 2006-2007, is by far the largest institution of higher education on the island. Government appropriations are the principal source of University revenues, but additional revenues are derived from tuition, student fees, auxiliary enterprises, interest income, federal grants, and other sources. University capital improvements have been financed mainly by revenue bonds. As of May 31, 2007, the University’s total debt was \$639.3 million, including \$619.5 million of outstanding revenue bonds.

In 2000, AFICA issued its \$86,735,000 Educational Facilities Revenue Bonds, 2000 Series A (University Plaza Project) for the purpose of financing the construction of additional student housing and parking and office space for the University. The project was built, is being operated by Desarrollos Universitarios, Inc., a Puerto Rico not-for-profit corporation, and is leased to the University for a term equal to the term of the bonds with University lease payments being sufficient to pay debt service on said bonds as they become due. These bonds are not included in the University’s total debt or outstanding revenue bonds set forth in the prior paragraph.

Other public corporations (not described above) have outstanding debt in the aggregate amount of \$1.5 billion as of May 31, 2007. Debt service on \$676.2 million of such outstanding debt is being paid from legislative appropriations and sales tax receipts. The Commonwealth is not, however, obligated to make any such appropriations. Additional legislative appropriations are made to enable certain of such corporations to pay their operating expenses.

INSURANCE MATTERS

Government-owned property is insured through policies obtained by the Secretary of the Treasury and through self-insurance, except for property owned by the Electric Power Authority and PRASA, whose properties are insured through arrangements and policies obtained by the respective Authorities. Personal injury awards against the Commonwealth are limited by law to \$150,000 per occurrence.

RETIREMENT SYSTEMS

General. Public employees of the Commonwealth and its instrumentalities are covered by five retirement systems: the Employees Retirement System, the Puerto Rico System of Annuities and Pensions for Teachers (the “Teachers Retirement System”), the Commonwealth Judiciary Retirement System (the “Judiciary Retirement System”), the Retirement System of the University of Puerto Rico (the “University Retirement System”), and the Employees Retirement System of Puerto Rico Electric Power Authority (the “Electric Power Authority Retirement System”).

The University Retirement System and the Electric Power Authority Retirement System apply to employees of the University of Puerto Rico and Electric Power Authority, respectively. The Commonwealth is not required to contribute directly to those two systems, although a large portion of University revenues is derived from legislative appropriations.

Covered Employees. The Teachers Retirement System covers public school teachers and certain private school teachers, as well as teachers working in administrative positions. Substantially all active

teachers of the Commonwealth's Department of Education are covered by Act No. 91 of March 29, 2004 which superseded Act No. 218 of 1951. The new law establishes that: (i) the Teachers Retirement System's active employees as of March 29, 2004 (not public school teachers or other Education Department employees) have the option to participate in the Teachers Retirement System or in the Employees Retirement System; (ii) persons hired by Teachers Retirement System after the approval of the new law may only become members of the Teachers Retirement System, (iii) active teacher employees of the Department of Education are members of the Teachers Retirement System, and (iv) licensed teachers working in private schools or other educational organizations may elect to become members of the Teachers Retirement System as long as the required employer and employee contributions are satisfied. The Judiciary Retirement System covers judges, and the Employees Retirement System covers all other employees of the Commonwealth, its municipalities and instrumentalities. As of March 30, 2007, the total number of participants, including active participants and retirees, in the three systems was as follows: Employees Retirement System, 274,060; Teachers Retirement System, 77,500 (June 30, 2006 datum); and Judiciary Retirement System, 691. The three systems are financed by contributions made by employers (the Commonwealth, public corporations, and municipalities) and employees, and investment income.

Funding Requirements. The central government is responsible for approximately 62% of total employer contributions to the Employees Retirement System, and the other 38% is the responsibility of public corporations and municipalities. The central government is also responsible for 100% and 99% of total employer contributions to the Judiciary and Teachers Retirement Systems, respectively. Retirement and related benefits provided by the systems and required contributions to the systems by employers and employees are determined by law rather than by actuarial requirements. For the Employees Retirement System, required employer contributions are 9.275% of applicable payroll. Required employee contributions for the Employees Retirement System vary according to salary and how the individual employee's retirement benefits are coordinated with social security benefits. For the Judiciary Retirement System, required contributions are 20% of applicable payroll for the employer and 8% for the employees. For the Teachers Retirement System, required contributions are 8.5% of applicable payroll for the employer and 9.0% for the employees.

Actuarial Valuation of Employees and Judiciary Retirement System. According to the most recent actuarial valuation of the Employees Retirement System and Judiciary Retirement System submitted by a firm of independent consulting actuaries, as of June 30, 2005, the total pension benefit obligations for the Employees Retirement System and Judiciary Retirement System were \$12.284 billion and \$179 million, respectively. The unfunded pension benefit obligations of the Employees Retirement System and Judiciary Retirement System for the same period were \$9.956 billion and \$104 million, respectively, representing funding ratios of 19% and 40%, respectively. Any amounts receivable from the Commonwealth with respect to benefits under special benefits laws (discussed below) are considered in the actuarial evaluation process to determine the unfunded pension benefit obligation of the Employees Retirement System to the extent receivables are recognized as such by the Employees Retirement System. The June 30, 2005 actuarial valuation was completed in accordance with the "Projected Unit Credit" method and assumed an investment return of 8.5% per year and a salary increase of 5% per year. Insofar as the statutorily mandated annual deposit to the Employees Retirement System and Judiciary Retirement System is insufficient to cover the actuarial pension benefit obligation, the unfunded pension benefit obligation of the System will continue to increase in the short term, and additional funding from the Commonwealth may ultimately be necessary to cover such unfunded obligation.

Actuarial Valuation of Teachers Retirement System. According to the most recent actuarial valuation of the Teachers Retirement System submitted by a firm of independent consulting actuaries, as of June 30, 2004 the accrued actuarial liability of the system was \$4.7 billion and the value of its assets amounted to \$2.4 billion, representing a funding ratio of 51%, and the resulting unfunded accrued liability

was \$2.3 billion. This funding ratio takes into account the recent turn-around in the equities market and the restructuring of the portfolio's asset composition. The actuarial valuation assumed an investment return of 8%, yearly salary increases of 5%, employee and employer contributions of 9% and 8.5%, respectively, an inflation rate of 3.5%, and a remaining amortization period of 16 years for the unfunded accrued liability. The actuarial accrued liability does not include benefits paid under special benefits laws (described below) and will not include the obligation with respect to the prospective payments under special benefits laws because these are not obligations of the Teachers Retirement System, and the funding for such benefits will originate from the Commonwealth's General Fund. Insofar as the statutorily mandated annual deposit to the Teachers Retirement System is insufficient to cover the actuarial pension liability, the unfunded pension benefit obligation will continue to increase, and additional funding from the Commonwealth may ultimately be necessary to cover such unfunded liability.

Special Benefits. Various special benefits laws enacted in previous years provided for additional benefits for the Employees Retirement System, Teachers Retirement System, and Judiciary Retirement System. Specifically, in the case of the Employees Retirement System, Act No. 10 of May 21, 1992 provided for special benefit increases of 3% every three years. The first 3% increase was granted to retirees who had been receiving their annuities for three or more years as of that date. The second 3% increase was granted to retirees who had been receiving their annuities for three or more years as of January 1, 1995. This increase is being financed by additional contributions from the employers. The third 3% increase was granted to retirees who had been receiving their annuities for three or more years as of January 1, 1998. This third increase is being partially funded with additional contributions from some of the employers. In June 2001, the Legislative Assembly approved a fourth 3% increase, effective as of January 1, 2001, in post-retirement annuity payments granted on or prior to January 1, 1998. This increase will be funded by the General Fund for retirees who were employees of the central government and by municipalities and public corporations for retirees who were their employees. In June 2003, the Legislative Assembly approved a fifth increase of 3% in post retirement benefits effective January 1, 2004. This increase will also be funded by the General Fund for retirees who were employees of the central government and by municipalities and public corporations for retirees who were their employees. In June 2007, the Legislative Assembly approved a sixth increase of 3% in post retirement benefits effective January 1, 2007. This increase will also be funded by the General Fund for retirees who were employees of the central government and by municipalities and public corporations for retirees who were their employees. Subsequent increases will depend upon the express approval of the Board of Trustees of the Employees Retirement System and the Legislative Assembly, and must provide a funding source. In the case of the Judiciary Retirement System, Act No. 41 of June 13, 2001 provided a 3% special benefit increase in annuity payments, commencing on January 1, 2002 and every three years thereafter, to retirees who have been receiving their annuities for three or more years as of that date. This increase will be funded by the General Fund.

The Teachers Retirement System is seeking reimbursement from the Commonwealth's Office of Management and Budget in the amount of \$119 million for special benefits paid by the System to its beneficiaries through June 30, 2004 pursuant to special benefit laws enacted by the Legislative Assembly. The Teachers Retirement System's interpretation of these special benefit laws, to the effect that the Commonwealth is required to reimburse the Teachers Retirement System for such special benefits paid, is being disputed by OMB. This dispute is currently under inter-agency arbitration proceedings. The Employees Retirement System is also seeking reimbursement from the Commonwealth (in connection with other special benefits laws applicable to its beneficiaries) in the amount of \$73.8 million, representing cumulative benefits paid to beneficiaries through June 30, 2005. The Employees Retirement System projects an additional shortfall of \$39.4 million for fiscal year 2006 in connection with special benefits laws payments. OMB believes that the basis of the claims from the Employees Retirement System is valid but that the amounts claimed remain to be verified and reconciled.

Amendments to Employees Retirement System. In February 1990, the organic act of the Employees Retirement System was amended to reduce the future pension liabilities of the Employees Retirement System. Among other provisions, the legislation increased the level of contributions to the Employees Retirement System and limited the retirement benefits for new employees by increasing the length of employment required for the vesting of certain benefits and reducing the level of benefits in the case of early retirement. The legislation also reduced the level of occupational disability benefits and death benefits received by new employees.

In 1999, the organic act of the Employees Retirement System was further amended to change it, prospectively, from a defined benefit system to a defined contribution system. This amendment provides for the establishment of an individual account for each employee hired by the Commonwealth after December 31, 1999 and for those current employees who elect to transfer from the existing defined benefit system. The individual account of each current employee is credited initially with an amount equal to his aggregate contributions to the Employees Retirement System, plus interest. Current employees who did not elect to transfer to the new defined contribution system will continue accruing benefits under the current defined benefit system. The individual account of each participant of the new defined contribution system is credited monthly with the participant's contribution and is credited semiannually with a rate of return based on either of two notional investment returns. Such accounts are not credited with any contribution by the employer. Instead, employer contributions will now be used completely to reduce the accumulated unfunded pension benefit obligation of the Employees Retirement System.

The law approving the sale of a controlling interest in PRTC to a consortium led by GTE International Telecommunications Incorporated (subsequently acquired by Verizon Communications Inc.) (see *Public Corporations – Other Public Corporations – Telephone Authority*) provides that any future proceeds received by the government from the sale of its then remaining 43% stock ownership in PRTC will be transferred to the Employees Retirement System to reduce its accumulated unfunded pension benefit obligation. In January 2002, Verizon exercised its option to purchase an additional 15% of the stock of PRTC for \$172 million. The proceeds of the sale were transferred to the Employees Retirement System. The Commonwealth has decided to exercise its "tag along" rights in connection with the sale by Verizon of its PRTC stock to Sercotel. As a result of the exercise of such rights, the Employees Retirement System received in June 2007 approximately \$529 million from the sale of its remaining stock participation in PRTC.

Historically, the Employees Retirement System achieved a return on investment of less than 2% on the PRTC stock, while the average return of the other assets in its portfolio was approximately 10.8%. In order to improve its funding ratio and address its continuing cash shortfalls, the Employees Retirement System intends to use the proceeds received from the sale of the PRTC stock to acquire other, higher-yield assets, such as personal and mortgage loans to participants of the System.

Cash Flow Shortfalls. The Employees Retirement System's disbursements of benefits during fiscal years 2003 through 2006 exceeded contributions and investment income for those years. The cash shortfall for fiscal year 2003 was covered with a portion of the proceeds from the sale to Verizon of the 15% stock ownership in PRTC and a loan received from the Department of the Treasury. The cash shortfall for fiscal year 2004 was covered with a loan received from the Department of the Treasury. Balances owed to the Department of the Treasury and other pending working capital needs through fiscal year 2005 were refinanced through a repurchase agreement with a financial institution in an amount of \$138 million collateralized with the assets of the Employees Retirement System. The cash shortfall for fiscal year 2006 was approximately \$70 million. This shortfall was covered with a line of credit provided by a private financial institution and collateralized with the assets of the Employees Retirement System. There was no cash shortfall for fiscal year 2007 on account of the receipt of the proceeds from the sale of

the PRTC stock. Also with these proceeds the Employees Retirement System paid off the balances of the 2005 repurchase agreement and the 2006 line of credit used to cover the respective year's cash shortfalls.

Efforts to Address Cash Flow Shortfall and Improve Funding Ratio. The Employees Retirement System anticipates that its future cash flow needs for disbursement of benefits to participants are likely to exceed the sum of the employer and employee contributions received and its investment and other recurring income. The Employees Retirement System is also evaluating other measures to improve its cash flows and funding ratio. Some of these measures include, but are not limited to, the establishment of a maximum salary to calculate pension benefits, aggressive collection efforts with respect to employer contributions owed by the Commonwealth, the municipalities and public corporations, and the transfer to the Employees Retirement System of any amounts remaining in the Children's Trust after payment of all the outstanding bonds. See "Tax Reform" under *Puerto Rico Taxes, Other Revenues, and Expenditures*.

In addition, the Employees Retirement System is currently undertaking a financing that would significantly increase the System's funding ratio and reduce its unfunded pension benefit obligation. The financing involves the issuance by the Employees Retirement System of debt secured by a pledge of future employer contributions over the next 50 years. All net cash generated by this financing would be deposited into the Employees Retirement System trust to be invested along with its other assets as described above. The Employees Retirement System estimates that the financing will be undertaken during fiscal year 2008 and subsequent years.

The following tables present the Statement of Plan Net Assets and Statement of Changes in Plan Net Assets of the Employees Retirement System and the Judiciary Retirement System for the fiscal years 2005 and 2006 and at and as of the period ended April 30, 2007, and of the Teachers Retirement System for fiscal years 2004, 2005 and 2006.

**The Commonwealth of Puerto Rico
Employees Retirement System
Statement of Plan Net Assets*
As of June 30, 2005 and as of April 30, 2007**

	2007 ⁽¹⁾	2006 ⁽¹⁾	2005 ⁽¹⁾
	Unaudited		
ASSETS			
Cash and Investments:			
Cash and Cash Equivalents:			
Deposits at Commercial banks	\$ 42,830,000	\$ 27,849,000	\$ 13,196,000
Deposited with GDB:			
Unrestricted	95,422,000	25,778,000	29,177,000
Restricted	2,306,000	2,156,000	1,578,000
Total Cash	<u>140,588,000</u>	<u>55,783,000</u>	<u>43,951,000</u>
Marketable Securities:			
Notes and Bonds	1,863,000	154,825,000	20,786,000
Stocks	1,643,507,000	1,376,901,000	1,200,132,000
Master Repo	148,273,000	-	145,654,000
Alternative investments	44,968,000	41,609,000	41,244,000
Total Investments	<u>1,838,611,000</u>	<u>1,573,335,000</u>	<u>1,407,816,000</u>
LOANS TO PLAN MEMBERS:			
Mortgage	97,649,000	96,544,000	82,295,000
Personal	431,538,000	405,756,000	362,363,000
Cultural Trips	26,305,000	23,762,000	20,590,000
Int. rec'able (net of loss allowance on loans)		2,490,000	-
Total Loans to Plan Members	<u>555,492,000</u>	<u>528,552,000</u>	<u>465,247,000</u>
Investment in PRTA Holdings	<u>495,318,000</u>	<u>495,318,000</u>	<u>486,080,000</u>
Total Cash, Investments and Loans to Plan Members	<u>3,029,980,000</u>	<u>2,652,988,000</u>	<u>2,403,094,000</u>
RECEIVABLES:			
Employer	75,919,000	43,343,000	34,656,000
General Fund of the Commonwealth	1,543,000	10,401,000	21,463,000
The Commonwealth of PR Judiciary	4,051,000	3,161,000	1,376,000
Investment Sales	3,812,000	1,279,000	2,090,000
Accrued Interest	2,688,000	2,385,000	2,209,000
Accrued Dividends		23,720,000	-
Other	65,936,000	23,579,000	21,896,000
Total Receivables	<u>153,949,000</u>	<u>107,868,000</u>	<u>83,689,000</u>
PROPERTY:	<u>6,982,000</u>	<u>7,694,000</u>	<u>8,411,000</u>
OTHER ASSETS:	<u>7,311,000</u>	<u>7,592,000</u>	<u>7,764,000</u>
Total Assets	<u>3,198,222,000</u>	<u>2,776,142,000</u>	<u>2,502,958,000</u>
LIABILITIES			
Book overdraft	43,861,000	-	-
Short Term Obligations	140,623,000	139,074,000	138,000,000
Line of Credit	60,000,000	60,000,000	-
Escrow Funds to Plan Members and Guarantee			
Insurance	7,986,000	8,433,000	20,366,000
Investment Purchases	5,341,000	1,179,000	2,079,000
Other Liabilities	99,495,000	26,125,000	14,642,000
Total Liabilities	<u>357,306,000</u>	<u>234,811,000</u>	<u>175,087,000</u>
Net Assets Held in Trust for Pension Benefits	<u>\$2,840,916,000</u>	<u>\$2,541,331,000</u>	<u>\$2,327,871,000</u>

* Totals may not add due to rounding.

⁽¹⁾ Rounded to the nearest thousand.

The Commonwealth of Puerto Rico
Employees Retirement System
Statement of Changes in Plan Net Assets*
As of June 30, 2005 and 2006 and as of April 30, 2007

	<u>2007⁽¹⁾</u>	<u>2006⁽¹⁾</u>	<u>2005⁽¹⁾</u>
ADDITIONS:	Unaudited		
Contributions:			
Employer	\$ 380,650,000	\$ 398,372,000	\$ 374,823,000
Employees	281,940,000	342,697,000	332,376,000
Special	17,000,000	16,684,000	14,731,000
Total Contributions	<u>679,590,000</u>	<u>757,753,000</u>	<u>721,930,000</u>
Investment Income:			
Realized Gain or Loss	29,102,000	33,023,000	36,418,000
Unrealized Gain or Loss	244,335,000	156,492,000	150,225,000
Dividend Income	13,628,000	49,938,000	19,111,000
Interest Income	59,699,000	63,486,000	49,917,000
Total	<u>346,764,000</u>	<u>302,939,000</u>	<u>255,672,000</u>
Less Investment Expense	(6,723,000)	(10,123,000)	(3,749,000)
Insurance Premiums on Plan Member Loans		14,492,000	-
Other Income	6,376,000	8,778,000	7,925,000
Net Investment Income	<u>346,417,000</u>	<u>292,816,000</u>	<u>259,848,000</u>
Total Additions	<u>1,026,006,000</u>	<u>1,073,839,000</u>	<u>981,777,000</u>
DEDUCTIONS:			
Annuities	643,873,000	772,647,000	713,814,000
Special	17,000,000	16,684,000	14,731,000
Death Benefits	25,539,000	14,984,000	10,895,000
Refunds:			
Employer	4,630,000	1,666,000	1,734,000
Employees	5,039,000	20,707,000	17,947,000
Insurance Claims on Plan Member Loans		1,216,000	-
Administrative Expenses	30,340,000	32,475,000	36,228,000
Net Adjustment in the conversion to a new loan application	-	-	-
Total Deductions	<u>726,422,000</u>	<u>860,379,000</u>	<u>795,348,000</u>
Net Increase	<u>299,585,000</u>	<u>213,460,000</u>	<u>186,430,000</u>
Net Assets Held in Trust for Pension			
Benefits:			
Beginning of the Year	2,541,331,000	2,327,871,000	2,141,442,000
End of Year	<u>\$2,840,916,000</u>	<u>\$2,541,331,000</u>	<u>\$2,327,871,000</u>

* Totals may not add due to rounding.

⁽¹⁾ Rounded to the nearest thousand.

**The Commonwealth of Puerto Rico
Judiciary Retirement System
Statement of Plan Net Assets*
As of June 30, 2005 and 2006 and as of April 30, 2007**

	<u>2007⁽¹⁾</u>	<u>2006⁽¹⁾</u>	<u>2005</u>
ASSETS	Unaudited		
Cash and Investments:			
Cash and Cash Equivalents	\$ 2,430,000	\$ 1,599,000	\$ 1,803,777
Cash Deposited with GDB			
Unrestricted	208,000	180,000	921,430
Restricted	-	-	871
Total Cash	<u>2,638,000</u>	<u>1,779,000</u>	<u>2,726,079</u>
Receivables:			
Accrued Interest	245,000	250,000	252,862
Investment Sales	244,000	561,000	102,365
Other	41,000	45,000	48,657
Total Receivables	<u>530,000</u>	<u>856,000</u>	<u>403,885</u>
Marketable Securities:			
Notes and Bonds	21,338,000	19,822,000	20,031,133
Stock	66,691,000	56,108,000	49,360,624
Total Marketable Securities	<u>88,029,000</u>	<u>75,930,000</u>	<u>69,391,458</u>
LOANS TO PLAN MEMBERS			
(including accrued interest receivables)			
Mortgage	19,000	36,000	43,247
Personal	198,000	190,000	173,292
Cultural Trips	36,000	48,000	34,453
Total Loans to Plan Members	<u>253,000</u>	<u>274,000</u>	<u>251,269</u>
Total Cash, Investments and Loans to Plan Members	<u>91,450,000</u>	<u>78,839,000</u>	<u>72,772,692</u>
LIABILITIES			
Book Overdraft	3,686,000	1,902,000	827,661
Due to the Employees Retirement System of the Government of Puerto Rico	4,051,000	3,161,000	1,376,260
Escrow Funds to Plan Members and Guarantee Insurance	52,000	52,000	130,022
Investment Purchases	309,000	67,000	123,315
Other Liabilities	2,515,000	807,000	518,647
Total Liabilities	<u>10,613,000</u>	<u>5,989,000</u>	<u>2,975,906</u>
Net Assets Held in Trust for Pension Benefits	<u>\$80,837,000</u>	<u>\$72,850,000</u>	<u>\$69,796,786</u>

* Totals may not add due to rounding.

⁽¹⁾ The fiscal years 2006 and 2007 financial statements list all amounts "in thousands".

The Commonwealth of Puerto Rico
Judiciary Retirement System
Statement of Changes in Plan Net Assets*
As of June 30, 2005 and 2006 and as of April 30, 2007

	<u>2007⁽¹⁾</u>	<u>2006⁽¹⁾</u>	<u>2005</u>
ADDITIONS:	Unaudited		
Contributions:			
Employer	\$ 5,387,000	\$ 6,727,000	\$ 6,469,432
Employees	2,274,000	2,960,000	2,775,268
Total Contributions	<u>7,661,000</u>	<u>9,687,000</u>	<u>9,244,701</u>
Investment Income:			
Realized Gain or Loss	1,162,000	952,700	1,997,588
Unrealized Gain or Loss	9,838,000	5,943,982	2,247,722
Dividend Income	182,000	205,000	206,323
Interest Income	1,208,000	1,220,000	1,158,023
Total	<u>12,390,000</u>	<u>7,943,247</u>	<u>5,609,657</u>
Less Investment Expense	(3,000)	(279,000)	(190,134)
Other Income	-	-	3,645
Net Investment Income	<u>12,387,000</u>	<u>6,964,000</u>	<u>5,423,169</u>
Total Additions	<u>20,048,000</u>	<u>16,651,000</u>	<u>14,667,871</u>
DEDUCTIONS:			
Annuities	11,088,000	12,403,000	11,229,901
Refunds:			
Employer	-	-	135,074
Employees	38,000	-	124,296
Administrative Expenses	935,000	1,195,000	1,232,060
Net Adjustment in the conversion to a new loan application	-	-	-
Total Deductions	<u>12,061,000</u>	<u>13,598,000</u>	<u>12,721,333</u>
Net Increase	<u>7,987,000</u>	<u>3,053,000</u>	<u>1,946,538</u>
Net Assets Held in Trust for Pension Benefits:			
Beginning of the Year	<u>72,850,000</u>	<u>69,796,786</u>	<u>67,850,247</u>
End of the Year	<u>\$ 80,837,000</u>	<u>\$ 72,850,000</u>	<u>\$ 69,796,786</u>

* Totals may not add due to rounding.

⁽¹⁾ The fiscal years 2006 and 2007 financial statements list all amounts "in thousands".

**The Commonwealth of Puerto Rico
Annuities and Pension for Teachers
Statement of Plan Net Assets*
As of June 30 of the Indicated Years
(in thousands)**

	<u>2006</u>	<u>2005</u>	<u>2004</u>
ASSETS			
Cash:			
Cash and cash equivalents	\$ 53,515	\$ 79,017	\$ 67,113
Cash with fiscal agent	-	2,853	-
Cash restricted	1,717	1,595	2,396
Cash deposited with Government Development Bank for Puerto Rico	2,993	3,536	3,717
Total Cash	<u>58,225</u>	<u>87,001</u>	<u>73,226</u>
Investments, at fair value:			
Bonds and notes	463,474	257,030	280,747
Stocks	1,886,625	1,833,168	1,678,679
Total investment at fair value	<u>2,350,099</u>	<u>2,090,198</u>	<u>1,959,426</u>
Other investments:			
Mortgage notes acquired from third parties	-	-	-
Private equity investments	46,215	44,747	43,660
Total investments	<u>2,396,314</u>	<u>2,134,945</u>	<u>2,003,086</u>
Loan to plan members:			
Mortgage	104,830	109,605	110,293
Personal	246,074	234,335	233,342
Cultural trips	1,429	1,338	1,148
Total loans to plan members	<u>352,333</u>	<u>345,278</u>	<u>344,783</u>
Total investments and loans	<u>2,806,872</u>	<u>2,567,224</u>	<u>2,421,095</u>
Accounts receivable:			
Receivable for investments sold	12,163	10,516	5,535
Accrued interest and dividends receivable	6,371	4,449	5,380
Other	14,932	2,593	2,500
Total accounts receivable	<u>33,466</u>	<u>17,558</u>	<u>13,415</u>
Property and equipment, net	25,665	26,206	24,332
Other assets	691	600	619
Total Assets	<u>\$ 2,866,694</u>	<u>\$ 2,611,588</u>	<u>\$ 2,459,461</u>
LIABILITIES			
Investments purchased	\$ 11,422	\$ 14,262	\$ 10,567
Cash overdraft in cash with fiscal agent	13,949	-	7,812
Accounts payable	3,043	3,768	2,570
Obligation under capital lease	57	78	96
Accrued expenses	4,289	4,314	3,071
Line of credit	4	4	240
Escrow fund of mortgage loans and guarantee insurance reserve for loans to plan members	5,988	6,069	9,911
Bonds payable	20,430	21,285	22,090
Other liabilities	625	669	109
Total liabilities	<u>59,807</u>	<u>50,449</u>	<u>56,466</u>
Net Assets Held in Trust for Pension Benefits	<u>\$ 2,806,887</u>	<u>\$ 2,561,139</u>	<u>\$ 2,402,995</u>

* Totals may not add due to rounding.

**The Commonwealth of Puerto Rico
Annuities and Pensions for Teachers
Statement of Changes in Plan Net Assets*
As of June 30 of the Indicated Years
(in thousands)**

	<u>2006</u>	<u>2005</u>	<u>2004</u>
ADDITIONS:			
Contributions:			
Participating Employees	\$ 129,473	\$ 131,481	\$ 118,743
Employer	119,199	120,887	110,548
Special	61,066	60,853	40,409
Total contributions	<u>309,738</u>	<u>313,221</u>	<u>269,700</u>
Investment Income:			
Interest income	57,899	47,577	55,878
Dividend Income	14,684	20,339	17,264
Net appreciation (depreciation) in fair value of investments	258,182	161,685	240,732
	<u>330,765</u>	<u>229,601</u>	<u>313,874</u>
Less investment expense	5,792	4,986	4,958
Net investment income	<u>324,973</u>	<u>224,615</u>	<u>308,916</u>
Other income	13,085	1,167	32,397
Total additions	<u>\$ 647,796</u>	<u>\$ 539,003</u>	<u>\$ 611,013</u>
DEDUCTIONS:			
Benefit paid to participants:			
Annuities and death benefits	332,425	313,551	292,401
Special benefits	42,837	38,592	32,210
Refunds of contributions	4,135	2,912	3,432
Administrative expenses	22,651	25,804	22,637
Total deductions	<u>402,048</u>	<u>380,859</u>	<u>350,680</u>
Net increase in net assets held in trust for pension benefits	<u>245,748</u>	<u>158,144</u>	<u>260,333</u>
Net assets held in trust for pension benefits			
Beginning of year	2,561,139	2,402,995	2,142,662
End of year	<u>\$ 2,806,887</u>	<u>\$ 2,561,139</u>	<u>\$ 2,402,995</u>

* Totals may not add due to rounding.

COMMONWEALTH FINANCIAL STATEMENTS

For fiscal year 2006, the basic financial statements of the Commonwealth were audited by KPMG LLP. KPMG LLP did not audit the financial statements of the Public Buildings Authority capital project fund or The Children's Trust special revenue funds (major funds), and certain activities, funds and component units identified separately in its report. Those financial statements were audited by other independent auditors whose reports were furnished to KPMG LLP, and its opinion on the basic financial statements, insofar as it relates to the amounts included in the basic financial statements pertaining to such activities, funds and component units, is based solely on the reports of the other auditors. The report of KPMG LLP contains an emphasis paragraph for the adoption of Governmental Accounting Standards Board (GASB) Statement No. 42, *Accounting and Financial Reporting for Impairment of Capital Assets and for Insurance Recoveries*, as of June 30, 2006.

The Comprehensive Annual Financial Report of the Commonwealth ("CAFR") for fiscal year 2006, which includes the basic financial statements of the Commonwealth for fiscal year 2006, was filed by the Commonwealth with each nationally recognized municipal securities information repository (each, a "NRMSIR") in August 2007, and an amendment thereto was filed with each NRMSIR in September 2007.

PUERTO RICO TAXES, OTHER REVENUES, AND EXPENDITURES

The Secretary of the Treasury has custody of the funds of the central government and is responsible for the accounting, disbursement and investment of such funds. Central government funds are grouped into three major categories or "types" of funds, as follows: (i) Governmental Fund Types, which include the General, Special Revenue, Debt Service (also referred to herein as Redemption), and Capital Project Funds; (ii) Proprietary Fund Types, which include the Enterprise and Internal Service Funds; and (iii) Fiduciary Fund Types, which include the Trust and Agency Funds. These funds do not include funds of the municipalities, because the municipalities are governmental entities with independent treasuries. The Special Revenue Fund is incorporated into the General Fund for financial reporting purposes (but not for budgetary purposes).

The General Fund is the primary operating fund of the Commonwealth. General Fund revenues are broadly based and include revenues raised internally as well as those from non-Puerto Rico sources. Internal revenues consist principally of income taxes and excise and sales taxes. Revenues from non-Puerto Rico sources are derived from federal excise taxes and customs duties returned to the Commonwealth. The primary expenditures of the Commonwealth through the General Fund are for grants and subsidies, and personal and other services.

Summary and Management's Discussion of General Fund Results

The following table presents the actual revenues and expenditures of the General Fund on a cash basis for fiscal year 2004 through fiscal year 2006, and the projected revenues and expenditures for fiscal years 2007 and 2008.

The amounts shown in the following table as expenditures may be different than those reflected in the budget or in the Commonwealth's financial statements because the table shows only cash disbursements, while the budget includes all authorized expenditures, regardless of when the related cash is actually disbursed. In addition, transfers to the Redemption Fund (used to pay debt service on the Commonwealth's bonds), which are included in the budget under "debt service," are shown as a deduction from total revenues in calculating "adjusted revenues" in the table and are not included under "expenditures." Finally, certain expenditures incurred in excess of budgeted amounts may not be

reflected in the table as expenditures to the extent they are paid from reserve funds, such as moneys in the Budgetary Fund. In fiscal years 2004 and 2005, there were approximately \$85 million and \$98.6 million, respectively, of such expenditures that are not reflected in the table. A discussion of the budget for fiscal years 2007 and 2008 appears below under *Budget of the Commonwealth of Puerto Rico*.

Amounts listed under “Other Income” represent recurring General Fund revenues not appropriately attributable to other revenue line items, such as repayment of General Fund advances to municipalities and government agencies and funds. “Other Expenditures” represent recurring General Fund expenditures not appropriately attributable to other expenditures line items, such as advances to government agencies and municipalities, which advances are to be reimbursed to the General Fund by law. Amounts listed under “Capital Outlays and Other Debt Service” represent debt service on obligations and capital expenditures for which the Legislative Assembly has by resolution agreed to appropriate funds. General Fund revenues, expenditures, and transfers as presented in the table differ from the General Fund revenues, expenditures, and transfers as presented in the financial statements of the Commonwealth, as the latter statements reflect an expanded General Fund entity in accordance with generally accepted accounting principles.

Commonwealth of Puerto Rico
General Fund Revenues, Expenditures, and Changes in Cash Balance
(in thousands)

	2004	2005	2006	2007 ^(*)	2008 ⁽⁺⁾
Beginning cash balance	\$ 179,058	\$ 108,512	\$ 42,933	\$ (0)	\$ (478,665)
Revenues from internal sources:					
Income Taxes:					
Individuals	2,720,920	2,885,903	3,087,748	3,112,892	3,067,000
Corporations	1,831,027	1,870,937	1,872,458	2,007,902	1,922,000
Partnerships	3,005	3,245	2,787	2,960	3,000
Withheld from non-residents	631,100	612,005	921,260	933,728	1,206,000
Tollgate taxes	31,579	22,973	27,397	25,082	10,000
Interest	10,108	10,489	11,536	12,112	13,000
Dividends	70,192	80,398	66,721	138,860	66,000
Total income taxes	5,297,931	5,485,950	5,989,906	6,233,536	6,287,000
Sales and use tax	-	-	-	582,560	911,000
Commonwealth excise taxes:					
Alcoholic beverages	296,302	298,235	292,180	279,028	288,000
Cigarettes	144,733	146,527	135,267	132,398	128,000
Motor vehicles	551,181	606,662	533,957	396,667	429,000
Other excise taxes	701,129	740,921	682,477	315,847	94,000
Total Commonwealth excise taxes	1,693,345	1,792,345	1,643,881	1,123,940	939,000
Property taxes	-	3,949	1,106	800	-
Inheritance and gift taxes	15,691	7,129	9,466	4,663	4,000
Licenses	84,231	85,216	91,310	98,594	107,000
Other:					
Lottery	65,387	64,638	62,729	65,508	63,000
Electronic lottery	86,115	68,011	55,212	72,253	60,000
Miscellaneous non-tax revenues	379,501	430,534	431,803 ⁽⁶⁾	321,154	331,000
Total Other	531,003	563,183	549,744	458,915	454,000
Total revenues from internal sources	7,622,201	7,937,772	8,285,413	8,503,008	8,702,000
Revenues from non-Commonwealth sources:					
Federal excise taxes ⁽¹⁾	328,921	341,166	346,272	372,536	361,000
Customs	34,266	26,731	9,553	14,503	14,000
Total revenues from non-Commonwealth sources	363,187	367,897	355,825	387,039	375,000
Total net revenues	7,985,388	8,305,669	8,641,238	8,890,047	9,077,000
Other Income (refunds) ⁽²⁾	62,789	(55,409)	76,085	(8,335)	150,000 ⁽⁸⁾
Transfers to Redemption Fund ⁽³⁾	(341,538)	(369,985)	(484,812)	(512,197)	(450,702)
Proceeds of notes and other borrowings ⁽⁴⁾	3,940,397	4,925,595	4,115,897 ⁽⁷⁾	1,872,096	2,300,000
Repayment of notes and other borrowings ⁽⁵⁾	(3,713,634)	(3,909,434)	(3,005,838)	(1,926,273)	(2,356,497)
Adjusted revenues	7,933,402	8,896,436	9,342,570	8,315,338	8,719,801
Expenditures:					
Grants and subsidies	3,468,531	3,617,386	3,944,349	3,387,199	2,262,516
Personal services	3,951,387	4,783,567	4,796,382	4,590,962	5,592,684
Other services	400,594	389,346	525,377	594,345	592,994
Materials and supplies	73,757	72,411	50,227	79,186	161,924
Equipment purchases	20,572	20,707	19,378	27,965	62,757
Capital outlays and other debt service	675	78,598	49,789	21,576	103,423
Transfers to agencies	-	-	-	92,770	-
Other disbursements	88,432	-	-	-	-
Total expenditures	8,003,948	8,962,015	9,385,503	8,794,003	8,776,298
Adjusted revenues less expenditures	(70,546)	(65,579)	(42,933)	(478,665)	(56,497)
Ending cash balance	\$ 108,512	\$ 42,933	\$ 0	\$ (478,665)	\$ (535,162)

(*) Preliminary.

(+) Estimated.

(1) Excludes transfers by the Commonwealth to the Conservation Trust Fund and amounts deposited by the Secretary of the Treasury into a separate account for the promotion of Puerto Rico rums in foreign markets.

(2) Consists of net revenues from the General Fund's non budgetary funds plus a reserve for future tax refunds reduced by estimated tax refunds.

(3) Consists of amounts to pay principal of and interest on general obligation bonds and notes of the Commonwealth. Does not include amounts deposited directly into the Redemption Fund from non-General Fund revenues.

(4) Consists of proceeds of borrowing from GDB and proceeds from Commonwealth's Tax and Revenue Anticipation Notes, including a \$741 million loan from GDB authorized by the Legislature in 2006.

(5) Consists of repayments of borrowing from GDB and repayments of Commonwealth's Tax and Revenue Anticipation Notes.

(6) Includes proceeds of \$100 million generated by the issuance of the Commonwealth's Public Improvement Refunding Bonds, Series 2006 A, which were privately placed.

(7) Includes \$50 million from the Emergency Fund used for operating expenses.

(8) Includes \$150 million related to the sale of properties.

Source: Department of the Treasury

Fiscal Year 2007

Preliminary collections for the fiscal year ended on June 30, 2007 totaled \$8.890 billion, \$7 million more than the Treasury Department's revised estimate for that period. This amount includes (i) \$933 million in non-resident withholding, (ii) \$1.123 billion in excise taxes, (iii) \$583 million of sales tax revenues, and (iv) \$269 million from special temporary tax measures.

General Fund expenses for fiscal year 2007 are currently projected to be \$9.221 billion, which is \$267 million below the amount initially budgeted and takes into consideration \$160 million in a portion of savings from the 10% budget reserve and \$107 million in health-related expenditure reductions. The \$9.221 billion amount does not include \$522 million of debt service payments on a portion of the Commonwealth's outstanding appropriation debt, which debt service was excluded from the budget based on the provisions of Act No. 91 of May 13, 2006, which created the Dedicated Sales Tax Fund to service in part the repayment of such appropriation debt.

The difference between projected revenues and expenses for fiscal year 2007 will be covered, if legislation is approved, by a \$240 million transfer of funds from Government Development Bank that was originally set aside from General Fund appropriations to cover a portion of debt service payments on the Commonwealth's appropriation debt which set aside is no longer needed on account of the passage of Act No. 91 referred to above. The remaining shortfall (about \$100 million) will be covered by cash management procedures such as delaying payments to certain vendors for a short period of time (carrying over into fiscal year 2008).

Fiscal Year 2006

General Fund total revenues for fiscal year 2006 were \$8.541 billion (approximately \$235 million, or 2.8%, more than received in fiscal year 2005). This increase was attributable to increases in income taxes (\$504 million, including \$309 million in taxes withheld from non-residents), together with decreases in external revenues (\$12 million), excise taxes (\$147 million), and miscellaneous non-tax revenues (\$113 million). The increase in revenues from individual income taxes is mainly attributable to administrative measures and economic activity. The increase in the withholding tax on non-residents includes two extraordinary payments amounting to \$200 million.

Total cash expenditures for fiscal year 2006 were \$9.596 billion (excluding about \$500 million in expenditures that occurred "off budget" for items such as refinanced debt service on general obligation debt and payment of vendor debts from prior years for Public Buildings Authority and subsidy and operational expenses of Agricultural Services and Development Administration) which exceeded original budgeted expenditures by \$651 million, attributed mainly to increases in the area of education (\$321 million), public safety and protection (\$99 million), health (\$207 million), and special contributions to pensions (\$42 million), and reductions in the area of general government (\$4 million), welfare (\$3 million), contributions to municipalities (\$1 million), and other debt service (\$10 million).

The approximately \$1.6 billion shortfall was covered by the release of \$64 million in reserve funds held at GDB, borrowings from GDB and other sources of about \$1.4 billion and about \$150 million of "cash management" practices which had the effect of delaying payment of certain expenses until the start of fiscal year 2007. Also, during a two-week period in early May 2006, the Commonwealth was forced to furlough non-essential government workers because it was projected to run out of cash until the above borrowings were implemented in the aftermath of the passage of fiscal and tax reform legislation described below in order to allow the workers to return to work.

Fiscal Year 2005

General Fund total net revenues for fiscal year 2005 were \$8.306 billion, representing an increase of \$320 million or 4%, from fiscal year 2004 net revenues. This amount excludes proceeds of a loan of \$550 million obtained from GDB, which is included as part of "Proceeds of notes and other borrowings." The major changes in revenues from fiscal year 2004 were: (i) increases in total income taxes of \$188 million, mainly resulting from increases in income taxes collected from individuals of \$165 million and in income taxes collected from corporations of \$40 million; (ii) increases in total excise taxes of \$99 million; and (iii) net increases in other revenues of \$32 million, mainly as a result of an increase in miscellaneous non-tax revenues of \$51 million.

Total cash expenditures for fiscal year 2005 were \$9.220 billion (excluding \$98.6 million covered with funds from the Budgetary Fund), which exceeded budgeted expenditures by \$366 million, attributed mainly to increases in the area of education (\$300.5 million), public safety and protection (\$18.6 million), health (\$28.7 million), welfare (\$10.2 million), and economic development (\$8 million). This amount also excludes approximately \$98.6 million of additional expenditures that were not originally budgeted. Various financing transactions were entered into to cover this imbalance.

Fiscal Year 2004

General Fund total net revenues for fiscal year 2004 were \$7.985 billion, representing an increase of \$394 million, or 5.2%, from fiscal year 2003 net revenues. This amount excludes proceeds of a loan of \$233 million obtained from GDB, which is included as part of "Proceeds of notes and other borrowings." This amount also excludes \$88 million of additional non-recurring revenues. The major changes in revenues from fiscal year 2003 were: (i) increases in total income taxes of \$377 million, mainly resulting from increases in income taxes from individuals of \$203 million and in income taxes withheld from non-residents of \$114 million; (ii) increases in total excise taxes of \$42 million; and (iii) decreases in other revenues of \$65 million, mainly as a result of a decrease in miscellaneous non-tax revenues of \$59 million. Approximately \$170 million of the increase in total income taxes for fiscal year 2004 relates to the collection of past taxes as a result of an incentives plan implemented by the Treasury.

Total cash expenditures for fiscal year 2004 were \$8.004 billion, which amount excludes certain amounts related to fiscal year 2004 but disbursed in fiscal year 2005. This amount also excludes approximately \$293 million of additional expenditures that were not originally budgeted and were covered with reserve funds (\$50 million), the reimbursement of certain federal education funds (\$141 million), and other sources. After considering (i) debt service payments (separately identified in the table as "Transfers to Redemption Fund"), (ii) \$227 million in net borrowings from GDB and other sources, and (iii) \$63 million in other income from the General Fund's non-budgetary funds, the ending cash balance of the General Fund decreased from \$179 million at the end of fiscal year 2003 to \$109 million at the end of fiscal year 2004.

Fiscal Year 2003

General Fund total revenues for fiscal year 2003 were \$7.592 billion, representing an increase of \$138 million, or 1.9%, from actual fiscal year 2002 revenues. This amount excludes proceeds of a loan of \$250 million obtained from GDB, which is included as part of "Proceeds of notes and other borrowings." The major changes from fiscal year 2002 were: (i) increases in income taxes from individuals of \$67 million and in corporate income taxes of \$71 million; (ii) increases in excise taxes on alcoholic beverages and cigarettes of \$83 million, and an increase in motor vehicles excise taxes of \$81 million; (iii) an increase in electronic lottery revenues of \$32 million; and (iv) a decrease in miscellaneous non-tax revenues of \$124 million and in income taxes withheld from non-residents of \$66 million. The decrease

in miscellaneous non-tax revenues relates to certain special administrative measures that had been implemented by the Secretary of the Treasury in fiscal year 2002 and that did not apply to fiscal year 2003.

Total cash expenditures for fiscal year 2003 were \$7.590 billion, which amount excludes certain amounts related to fiscal year 2003 but disbursed in fiscal year 2004. This amount also excludes \$150 million of additional expenditures that were not originally budgeted and were covered with reserve funds, federal fiscal relief funds and other sources. The principal reason for these higher expenditures was higher than anticipated education costs. After considering (i) \$332 million in debt service payments (separately identified on the table as “Transfers to Redemption Fund”), (ii) \$238 million in net borrowings from GDB (which includes the \$250 million loan mentioned above) and other sources, and (iii) \$79 million in reserve for future tax refunds reduced by estimated tax refunds (separately identified on the table as “Other Income (refunds)”), the ending cash balance of the General Fund was reduced from \$350 million at the end of fiscal year 2002 to \$179 million at the end of fiscal year 2003.

Tax Reform

Act No. 117 of July 4, 2006 (“Act 117”) amended the Puerto Rico Internal Revenue Code of 1994 (the “PR Code”) to provide, among other things, for a general sale and use tax of 5.5% to be imposed by the central government (the “Central Government Sales Tax”). Act 117 also authorized each municipal government to impose a municipal sale and use tax of 1.5% (the “Municipal Sales Tax” and, together with the Central Government Sales Tax, the “Sales Tax”). In general, the Municipal Sales Tax has the same tax base, exemptions (except for unprocessed foods) and limitations as those provided for the Central Government Sales Tax. Act 117 also provides certain income tax reductions to address the regressive effect of the Sales Tax on taxpayers in lower income tax brackets.

The Sales Tax is imposed on the sale, use, consumption and storage of taxable items, which include tangible personal property, taxable services, admission rights and certain other types of transactions covering separable and identifiable taxable items which are sold for a single price, subject to certain exceptions and limitations. The Sales Tax will not be imposed on, among other things: (i) taxable items acquired by merchants for resale, (ii) taxable items acquired by manufacturing plants, (iii) taxable items acquired for use and consumption outside of Puerto Rico, (iv) certain food products that do not need to be heated before their sale, (v) prescription drugs, (vi) the rental payments received by a lessor of real property which is used for residential or commercial purposes, (vii) services provided by designated professionals, (viii) cash, cash equivalents, stocks, bonds, notes, mortgage loans, insurance, securities and interest derived for the use or forbearance of money, (ix) sales of real property, and (x) leases in which the Industrial Development Company is the owner of the property.

Act 117 also repealed the 5% general excise tax imposed on imported goods and the 3.6% general excise tax imposed on goods manufactured in Puerto Rico. Other items, such as fuel, crude oil and petroleum products, and vehicles, however, will remain subject to the excise tax previously applicable to such items, and are not subject to the Sales Tax.

The Sales Tax became effective on November 15, 2006 and the effective date of the repeal of the 5% general excise tax was October 16, 2006. Municipalities were authorized to implement the Municipal Sales Tax starting on July 1, 2006, and most have done so. The revenues derived from the Sales Tax will be distributed as follows: (i) municipal governments will retain 13/15 of the Municipal Sales Tax (equivalent to a tax of 1.3% out of the total 7% Sales Tax), (ii) the Dedicated Sales Tax Fund, created by Act No. 91 of May 13, 2006, as amended, will receive one-seventh of the Sales Tax (equivalent to a tax of 1% out of the total 7% Sales Tax), and (iii) the General Fund will receive the balance of the Sales Tax (equivalent to a tax of 4.7% out of the total 7% Sales Tax). The Secretary of the Treasury projects for

fiscal year 2008 that each percentage point of the Sales Tax will generate annually approximately \$202 million of gross revenues and that the Sales Tax will generate total annual gross revenues for the General Fund of approximately \$911 million. For fiscal year 2007, the corresponding projections are \$191 million and \$576 million. The increase in revenues to be generated by the Sales Tax will be partly offset by the elimination of the 5% general excise tax and the effect of the income tax reduction measures included in Act 117.

Act 117 also provided for special income tax rates with respect to certain transactions occurring on and between July 1, 2006 and December 31, 2006 (the “Transition Period”). Eligible dividends declared by domestic corporations or partnerships during the Transition Period will qualify for a 5% special income tax. The dividend does not need to be distributed to qualify for the 5% special income tax rate. During the Transition Period, Act 117 also provides a special tax rate of 5% (10% in the case of resident corporations and partnerships) in connection with “built-in” gains associated to capital assets held for periods in excess of six months (the “Special Capital Gains Tax”). In order to take advantage of the Special Capital Gains Tax, a taxpayer must file an election with the Secretary of the Treasury. The sale of the capital asset is not required to qualify for the Special Capital Gains Tax. In addition to the other conditions mentioned herein, the Special Capital Gains Tax is only available in connection with capital assets consisting of stock or participations of domestic and foreign corporations and partnerships, and real property located in Puerto Rico. However, in the case of resident corporations and partnerships, the Special Capital Gains Tax applies only to real property located in Puerto Rico.

For a discussion of the budget imbalance in fiscal year 2007 and the revenues generated through March 31, 2007 from the provisions of Act 117, see “Fiscal Year 2007” under “Summary and Management’s Discussion of General Fund Results” above.

Major Sources of General Fund Revenues

Income Taxes

The Commonwealth’s income tax law, the Internal Revenue Code of 1994, as amended (the “P.R. Code”), imposes a tax on the income of individual residents of Puerto Rico, trusts, estates, and domestic and foreign (if engaged in a trade or business in Puerto Rico) corporations and partnerships at graduated rates. A flat tax is imposed on certain payments made to non-residents of Puerto Rico, which is collected through an income tax withholding.

Individuals. Resident individuals are subject to tax on their taxable income from all sources. The P.R. Code has five tax brackets for individuals with tax rates of 7%, 10%, 15%, 28%, and 33%. Dividend income from Puerto Rico corporations and certain qualifying foreign corporations is taxed at a rate of 10%.

Gain realized from the sale or exchange of a capital asset by resident individuals, if held for more than six months, is taxed at a rate of 12.5%.

Interest income in excess of \$2,000 on deposit with Puerto Rico financial institutions is taxed at a rate of 17%; the first \$2,000 of interest income from such institutions is exempt from taxation. Interest income on certain qualifying debt obligations issued by Puerto Rico corporations and certain qualifying foreign corporations and paid to resident individuals, trusts, estates, corporations and partnerships qualifies for a special 10% tax rate.

Corporations and Partnerships. Puerto Rico corporations and partnerships are subject to tax on income from all sources; foreign corporations and partnerships that are engaged in a trade or business in

Puerto Rico are subject to tax on their income from Puerto Rico sources and on income from sources outside Puerto Rico that is effectively connected with the conduct of their trade or business in Puerto Rico. Unless a corporation or partnership qualifies for partial exemption from corporate income and other taxes under the industrial incentives program (see “Tax Incentives” under *The Economy* above), it is subject to tax at graduated rates.

In general, the P.R. Code provides for six income tax brackets for corporations and partnerships, with the highest rate (39%) applicable to net taxable income in excess of \$300,000. Also, Act No. 41 of August 1, 2005 was enacted to impose a temporary additional tax of 2.5% on corporations and partnerships with a net taxable income of \$20,000 or more. In addition, Act No. 98 of May 16, 2006, provides for an extraordinary tax of 5% on resident corporations and partnerships engaged in business for pecuniary profit and whose gross income for the immediately preceding taxable year ended on or prior to December 31, 2005 exceed \$10 million. The 5% tax must be paid on or prior to July 31, 2006 and such amount may be subsequently claimed as a tax credit against such entity’s income tax liability. Act No. 89 of May 13, 2006 also imposes an additional special tax for the taxable year commencing in 2006 of 2% on the net income subject to standard taxation of all corporations operating under the provisions of the Puerto Rico Banking Law.

Gains realized from the sale or exchange of a capital asset, if held for more than six months, are taxed at a maximum rate of 20%. Dividends received by Puerto Rico corporations and partnerships of foreign corporations and partnerships engaged in trade or business in Puerto Rico are subject to general income tax rates. A dividends received credit may be available when the corporation or partnership making the distribution is organized in Puerto Rico. A special tax rate of 17% is applicable to dividend distributions of REITs received by corporations. Interest income on certain qualifying debt obligations issued by Puerto Rico corporations and certain qualifying foreign corporations and paid to resident corporations and partnerships qualifies for a special tax rate of 10%.

In general, corporations and partnerships operating under a new grant of tax exemption issued under the 1998 Tax Incentives Act are subject to a maximum income tax rate of 7% during their basic exemption period. Certain corporations and partnerships covered by the tax incentives acts continue to be subject to a maximum tax rate of 45% on their taxable income. Corporations and partnerships covered by the Puerto Rico Tourism Incentives Act of 1993, as amended, are subject to a maximum tax rate of 42% on their taxable income. The P.R. Code also provides for an alternative minimum tax of 22%.

The P.R. Code imposes a branch profits tax on resident foreign corporations less than 80% of whose gross income qualifies as income effectively connected with a Puerto Rico trade or business. The branch profits tax is 10% of an annual dividend equivalent amount, and it applies without regard to the Puerto Rico source of income rules.

Interest from Puerto Rico sources paid to non-resident non-affiliated corporate recipients is not subject to any income or withholding tax. Interest paid to certain related non-resident recipients is subject to a withholding tax of 29%. Dividends paid to non-resident corporate recipients are subject to a withholding tax of 15%. Dividends distributed by corporations (including Section 936 Corporations) operating under new grants of tax exemption issued under the 1998 Tax Incentives Act are not subject to Puerto Rico income tax. However, royalty payments made by such corporations to non-resident recipients are subject to a 15% withholding tax. The basic tax on dividends paid to foreign corporate shareholders of Section 936 Corporations operating under grants of tax exemption issued under prior incentives laws is 10% but is subject to reduction if a percentage of the profits are invested in certain eligible instruments for specified periods of time.

Subject to certain exceptions, payments in excess of \$1,500 during a calendar year made by the Commonwealth and persons engaged in a trade or business in Puerto Rico in consideration of the receipt of services rendered in Puerto Rico are subject to a 7% withholding tax.

Sales and Use Taxes

The Sales Tax is imposed on the sale, use, consumption and storage of taxable items, which include tangible personal property, taxable services, admission rights and combined transactions, subject to certain exceptions and limitations. The Sales Tax will not be imposed on, among other things: (i) taxable items acquired by merchants for resale, (ii) taxable items acquired by manufacturing plants, (iii) taxable items acquired for use and consumption outside of Puerto Rico, (iv) certain food products that do not need to be heated before their sale, (v) prescription drugs, (vi) the rental payments received by a lessor of real property which is used for residential or commercial purposes, (vii) services provided by designated professionals, (viii) cash, cash equivalents, stocks, bonds, notes, mortgage loans, insurance, securities and interest derived for the use or forbearance of money, (ix) sales of real property, and (x) leases in which the Industrial Development Company is the owner of the property. The Sales Tax was effective starting on November 15, 2006 and is projected to generate for the General Fund approximately \$911 million for fiscal year 2008 and approximately \$576 million for fiscal year 2007.

Excise Taxes

The P.R. Code imposes an excise tax on certain articles and commodities, such as cigarettes, alcohol, sugar, cement, motor vehicles and certain petroleum products, which are taxed at different rates. The excise tax imposed on articles and commodities imported into Puerto Rico for consumption in Puerto Rico ended on October 16, 2006 and has been replaced by the previously described sales and use tax on November 15, 2006.

Other Taxes and Revenues

Motor vehicle license plate and registration fees comprise the major portion of license tax receipts. Recent legislation was enacted to increase license fees on luxury vehicles.

Non-tax revenues consist principally of lottery proceeds, documentary stamps, permits, fees and forfeits, proceeds of land sales and receipts from public corporations in lieu of taxes.

Revenues from non-Commonwealth sources include customs duties collected in Puerto Rico and excise taxes on shipments of rum from the island to the United States mainland. The customs duties and excise taxes on shipments are imposed and collected by the United States and returned to the Commonwealth. The excise tax on shipments of rum from Puerto Rico and other rum producing countries is \$13.50 per gallon. Of this amount, the lesser of \$13.25 per proof gallon and the actual excise tax imposed is currently returned to the Treasury through December 31, 2007.

Property Taxes

Personal property, which accounts for approximately 48% of total collections of taxable property, is self-assessed. Real property taxes are assessed based on 1958 property values. No real property reassessment has been made since 1958, and construction taking place after that year has been assessed on the basis of what the value of the property would have been in 1958. Accordingly, the overall assessed valuation of real property for taxation purposes is substantially lower than the actual market value. Also, an exemption on the first \$15,000 of assessed valuation in owner-occupied residences is available.

Property taxes are assessed, determined and collected for the benefit of the municipalities by the Municipal Revenues Collection Center (“CRIM”), a government instrumentality of the Commonwealth. However, a special 1.03% tax on the assessed value of all property (other than exempted property) imposed by the Commonwealth for purposes of paying the Commonwealth’s general obligation debt is deposited in the Commonwealth’s Redemption Fund.

The following table presents the assessed valuations and real and personal property taxes collected for fiscal years ending June 30, 2002 through June 30, 2006.

Commonwealth of Puerto Rico
Assessed Valuations and Real and Personal Property Taxes
(Commonwealth and Municipalities Combined)
(in thousands)

Fiscal Years Ended June 30,	Assessed Valuations⁽¹⁾	Taxes Levied	Collections of Current Year	Collections of Previous Years	Total Collections⁽²⁾
2002	\$22,743,568	\$792,799	\$645,117	\$60,677	\$705,794
2003	23,138,903	824,933	671,163	79,421	750,584
2004	23,540,237	836,734	706,677	79,772	786,449
2005	25,277,795	899,893	738,074	50,751	788,825
2006	25,606,121	925,618	801,497	70,908	872,405

(1) Valuation set as of July 1 of each fiscal year.

(2) During fiscal year 2004 a property tax amnesty was approved by the Legislative Assembly and implemented by CRIM. In addition to the amounts shown, under the amnesty program a total of \$105.3 million was collected in fiscal year 2004 and \$21.1 million in fiscal year 2005.

Source: Municipal Revenues Collection Center

Collections of Income, Sales and Excise Taxes

The Treasury has continued its program for improving tax collections. The program consists, in part, of taking the initiative in sponsoring and implementing tax reform, particularly in the areas of excise taxes and income taxes, in order to decrease the incidences of nonpayment of taxes and to expand the taxpayer base. The program has also included (i) improving the methods by which delinquent taxpayers are identified, primarily through the use of computer analyses, (ii) computerizing the processing of tax returns, and (iii) identifying and eliminating taxpayer evasion. With the elimination of the general excise tax last October, Treasury excise tax personnel have been reassigned to monitor compliance with the new sales tax.

Transfers to General Obligation Redemption Fund

These consist of transfers from the General Fund to the Redemption Fund for the amortization of the principal of and interest on general obligation bonds and notes of the Commonwealth.

Components of General Fund Expenditures

Grants and Subsidies

This category includes grants and contributions to municipalities, public corporations with independent treasuries, and charitable institutions. It also includes items for or included in court awards, damage awards for personal injury or property damage, and payment of taxes and payments in lieu of taxes.

Personal Services

This category includes compensation paid for personal services rendered to the Commonwealth and its public instrumentalities by individuals or firms in the form of salaries, wages, *per diems*, fees, commissions, or other forms of compensation.

Other Services

This category includes compensation for services other than the services referred to above, including advertising, printing, communications, legal expenses, utilities, building and equipment rental and maintenance expenses, insurance premiums and miscellaneous services.

Materials and Supplies

This category includes all articles that ordinarily have a short life and durability, lose their characteristic identity in the process of use, have only nominal value (\$25 or less), or are not otherwise chargeable as equipment.

Equipment Purchases

This category includes items that have three special characteristics distinguishing them from materials: durability, long useful life, and high unit cost. In addition, these items are subject to centralized inventory control as fixed assets.

Capital Outlays and Other Debt Service

Capital outlays are made primarily for land acquisition or interests in land, construction of buildings, roads, bridges and other structures, and permanent improvements and additions. Other debt service includes payments on notes held by GDB to be paid from the General Fund and payments for the amortization of the principal of and interest on non-general obligations payable from Commonwealth appropriations.

Transfers to Agencies

These transfers include the repayment of loans and advances to other funds, certain refunds, advances from other funds and other receipts, repayment of advances from other funds, grants and contributions to other funds under the custody of the Secretary of the Treasury and other items. The major portion of grants and contributions in recent fiscal years has consisted of transfers to cover the costs of health reform and advances to the municipalities.

Other Expenditures

This category represents recurring General Fund expenditures not appropriately attributable to other expenditure line items, such as advances to government agencies and municipalities, which advances are to be reimbursed to the General Fund by law.

Federal Grants

Puerto Rico receives grants under numerous federal programs. Federal grants to the agencies and instrumentalities of the Commonwealth government, including public corporations, are estimated to be \$4.047 billion for fiscal year 2007, a decrease of \$8.6 million, or 0.2%, from fiscal year 2006. The

following table presents revenues from federal grants by broad program areas, which are accounted in the central accounting system of the Treasury. The figures for fiscal years 2004 through 2006 are actual figures. The figures for fiscal year 2007 are estimates based on the information submitted by each agency to OMB and the figures for fiscal year 2008 are the amounts included in the recommended budget.

Commonwealth of Puerto Rico					
Federal Grants					
(in thousands)					
	2004	2005	2006	2007⁽¹⁾	2008⁽⁴⁾
Education	\$ 1,081,236	\$ 963,032	\$ 1,042,023	\$ 991,218	\$ 954,054
Social Services	1,792,203	1,884,737	1,888,215	1,916,162	1,949,621
Health	444,348	383,635	394,945	397,702	400,390
Labor and Human Resources ⁽²⁾	204,679	218,280	197,296	211,907	162,085
Crime	37,988	29,313	41,461	28,417	28,417
Housing ⁽³⁾	366,408	505,856	371,104	391,541	428,821
Drug and Justice	31,349	6,941	38,459	33,083	22,189
Agriculture and Natural Resources	10,378	1,117	11,402	12,477	9,969
Contributions to Municipalities	59,002	64,293	53,744	48,531	47,882
Other	39,879	30,896	17,608	16,584	17,163
TOTAL	\$ 4,067,470	\$ 4,088,100	\$ 4,056,257	\$ 4,047,622	\$ 4,020,591

(1) Estimated.

(2) Amounts include grants to the Right to Work Administration and the Occupational Development and Human Resources Council.

(3) Amounts include grants to the Public Housing Administration.

(4) Recommended.

Source: Office of Management and Budget

BUDGET OF THE COMMONWEALTH OF PUERTO RICO

Office of Management and Budget

OMB's predominant mission is to assist the Governor in overseeing the preparation of the budget of the Commonwealth and supervise its administration in the agencies of the Executive Branch. In helping to formulate the Governor's budget, OMB evaluates the effectiveness of agency programs, policies, and procedures, assesses competing funding demands among agencies, and sets funding priorities.

In addition, OMB oversees and coordinates the Administration's initiatives in financial management, information technology, general management and organizational structure, and supervises the agencies' compliance with the Governor's program and regulatory policies. In each of these areas, OMB's role is to help improve administrative management, develop better performance measures and coordinating mechanisms, and promote efficiency in the use of public funds.

Budgetary Process

The fiscal year of the Commonwealth begins each July 1. The Governor is constitutionally required to submit to the Legislative Assembly an annual balanced budget of revenues, capital improvements, and operating expenses of the central government for the ensuing fiscal year. The annual budget is prepared by OMB, in coordination with the Planning Board, the Treasury, and other government offices and agencies. Section 7 of Article VI of the Constitution provides that "The appropriations made for any fiscal year shall not exceed the total revenues, including available surplus,

estimated for said fiscal year unless the imposition of taxes sufficient to cover said appropriations is provided by law.”

The annual budget, which is developed utilizing elements of program budgeting, includes an estimate of revenues and other resources for the ensuing fiscal year under (i) laws existing at the time the budget is submitted, and (ii) legislative measures proposed by the Governor and submitted with the proposed budget, as well as the Governor’s recommendations as to appropriations that in his judgment are necessary, convenient, and in conformity with the four-year investment plan prepared by the Planning Board.

The Legislative Assembly may amend the budget submitted by the Governor but may not increase any items so as to cause a deficit without imposing taxes to cover such deficit. Upon passage by the Legislative Assembly, the budget is referred to the Governor, who may decrease or eliminate any item but may not increase or insert any new item in the budget. The Governor may also veto the budget in its entirety and return it to the Legislative Assembly with the Governor’s objections. The Legislative Assembly, by a two-thirds majority in each house, may override the Governor’s veto. If a budget is not adopted prior to the succeeding fiscal year, as was the case for fiscal year 2006, the annual budget for the preceding fiscal year as originally approved by the Legislative Assembly and the Governor is automatically renewed for the ensuing fiscal year until a new budget is approved by the Legislative Assembly and the Governor. This permits the Commonwealth to continue making payments of its operating and other expenses until a new budget is approved.

Fiscal Reform

On May 25, 2006, the Governor signed Act No. 103 providing for a fiscal reform of the Commonwealth government (the “Fiscal Reform Legislation”). The Fiscal Reform Legislation applies to every instrumentality and entity of the Executive Branch funded, in whole or in part, from the General Fund and sets forth, as the public policy of the Commonwealth, the reduction of government spending, the elimination or consolidation of redundant agencies, the reduction of government payroll without causing the layoff of regular employees or increasing the actuarial liability of the retirement systems, the limitation of unnecessary, extravagant or excessive spending, and the limitation of public relations and other similar expenses. Despite his approval of the Fiscal Reform Legislation, the Governor has stated that certain of its provisions may be unconstitutional because they infringe on Executive Branch prerogatives. As such, the Governor has informed the Legislative Assembly that certain provisions of the Fiscal Reform Legislation will be implemented at the Executive Branch’s discretion and through the use of the Executive Branch’s prerogatives. There is no assurance that the Fiscal Reform Legislation will result in the intended reduction of expenditures or that it will be implemented as enacted or that it will not be judicially challenged.

Financial Control and Adjustment Procedures

Revenue estimates for budgetary purposes are prepared by the Treasury, except for estimates of federal grants, which are prepared by OMB based on information received from the various departments and other recipients of such grants. Revenue and federal grant estimates are under continuous review and, if necessary, are revised at least quarterly during the fiscal year. Fiscal control over expenditures is exercised by the Governor, through the Director of OMB, and the Secretary of the Treasury. Monthly reviews and expenditure cut-off procedures are followed to prevent expenditures in excess of appropriations.

During any fiscal year in which the resources available to the Commonwealth are insufficient to cover the appropriations approved for such year, the Governor may take administrative measures to

reduce expenses and submit to both houses of the Legislative Assembly a detailed report of any adjustment necessary to balance the budget, or make recommendations to the Legislative Assembly for new taxes or authorize borrowings under provisions of existing legislation or take any other necessary action to meet the estimated deficiency. Any such proposed adjustments shall give effect to the “priority norms” established by law for the disbursement of public funds in the following order of priority; first, the payment of the interest on and amortization requirements for public debt (Commonwealth general obligations and guaranteed debt for which the Commonwealth’s guarantee has been exercised); second, the fulfillment of obligations arising out of legally binding contracts, court decisions on eminent domain, and other unavoidable obligations to protect the name, credit and good faith of the Commonwealth; third, current expenditures in the areas of health, protection of persons and property, education, welfare and retirement systems; and fourth, all other purposes.

A Budgetary Fund was created by Act No. 147 of June 18, 1980, as amended (the “Budgetary Fund”), to cover the appropriations approved in any fiscal year in which the revenues available for such fiscal year are insufficient, to secure the payment of public debt, and to provide for unforeseen circumstances in the provision of public service. Currently, an amount equal to one percent of the General Fund net revenues of the preceding fiscal year is deposited annually into the Fund. In addition, other income (not classified as revenues) that is not assigned by law to a specific purpose is also required to be deposited in the Budgetary Fund. The maximum balance of the Budgetary Fund may not exceed 6% of the total appropriations included in the budget for the preceding fiscal year. As of June 30, 2007, the Budgetary Fund balance was \$300,000.

An Emergency Fund was created by Act No. 91 of June 21, 1966, as amended (the “Emergency Fund”), to cover unexpected public needs caused by calamities, such as wars, hurricanes, earthquakes, droughts, floods and plagues, and to protect people’s lives and property and the public sector credit. The Emergency Fund is capitalized annually with an amount totaling no less than one percent of the General Fund net revenues of the preceding fiscal year. Act No. 91 was amended in 2003 to set an upper limit to the Emergency Fund of \$150 million at the beginning of the fiscal year and was further amended in 2005 to authorize the disbursement of funds from the Emergency Fund to cover certain General Fund expenditures and operational costs of the State Emergency Management Agency. The 2005 amendment also authorizes GDB to lend to the Commonwealth up to \$150 million to replenish the Emergency Fund to provide funding for emergency and disaster needs. As of June 30, 2007, the balance in the Emergency Fund was less than \$1 million.

Appropriations

Appropriations in the central government budget of Puerto Rico consist of the following:

(i) General Fund appropriations for recurring ordinary operating expenses of the central government and of the Legislative Assembly are made by a single annual law known as the Joint Resolution of the General Budget.

(ii) General Fund appropriations for special operating expenses, for contributions to municipalities, the University of Puerto Rico and the Judiciary Branch and for capital expenditures are authorized by separate law for one or more years for special programs or activities, which may be permanent or transitory.

(iii) Disbursements of Special Funds for operating purposes and for capital improvements. For the most part, such disbursements do not require annual legislative authorization, because they are authorized by previous legislation or by the United States Congress. Federal grants constitute the major part of the resources of the Special Funds.

(iv) Bond Fund appropriations for capital expenditures financed by bonds. Such expenditures occur in one or more years.

In Puerto Rico, the central government performs many functions, which in the fifty states are the responsibility of local governments, such as providing public education, police and fire protection. The central government also provides significant annual grants to the University of Puerto Rico and to the municipalities.

For fiscal year 2006, approximately 53% of the General Fund was committed for payment of the central government payroll. In addition, approximately 25% of the General Fund was committed to the payment of fixed charges such as municipal subsidies, grants to the University of Puerto Rico, funding for the judicial branch, deposits to the Budgetary and Emergency Funds, among others, and debt service on the direct debt of the Commonwealth. For fiscal year 2007, it is proposed that approximately 56% and 6% of the General Fund be committed for payment of the central government payroll and debt service on the direct debt of the Commonwealth, respectively. Commencing with fiscal year 2004, the Commonwealth appropriates annually to the judicial branch an amount initially equal to 3.3% of the average annual revenue from internal sources for each of the two preceding fiscal years. This percentage will increase until it reaches 4% in fiscal year 2008, and may be further increased upon review, with scheduled reviews every five years.

Budget for Fiscal Year 2007

The consolidated budget for fiscal year 2007 totals \$26.5 billion. Of this amount, \$14.3 billion is assigned to the central government. This includes General Fund total resources and appropriations of \$9.488 billion, which represents a decrease of \$108 million over actual expenditures for fiscal year 2006. The following table presents a summary of the Commonwealth's proposed central government budget appropriations for the fiscal year ending June 30, 2007.

Commonwealth of Puerto Rico
Summary of Central Government Annual Budget
Fiscal Year Ending June 30, 2007
(in thousands)*

	<u>General Fund</u>	<u>Bond Fund</u>	<u>Special Funds</u>	<u>Total</u>
Revenues from internal sources:				
Property taxes	-	-	\$ 119,121	\$ 119,121
Personal income taxes	\$ 3,042,000	-	-	3,042,000
Retained non-resident income tax	871,000	-	-	871,000
Corporate income taxes	1,964,000	-	-	1,964,000
Partnership income taxes	3,000	-	-	3,000
Tollgate taxes	15,000	-	-	15,000
17% withholding tax on interest	13,000	-	-	13,000
10% withholding tax on dividends	66,000	-	-	66,000
Inheritance and gift taxes	4,000	-	-	4,000
Excise taxes:				
Alcoholic beverages	283,000	-	-	283,000
Motor vehicles and accessories	415,000	-	-	415,000
Cigarettes	136,000	-	-	136,000
Sales tax	576,000	-	-	576,000
Other (excise taxes)	318,000	-	37,385	355,385
Licenses	97,000	-	-	97,000
Miscellaneous non-tax revenues:				
Contributions from lottery fund	63,000	-	-	63,000
Electronic lottery	58,000	-	-	58,000
Registration and document certification fees	214,000	-	-	214,000
Other	105,000	-	323,145	428,145
Total revenues from internal sources	<u>8,243,000</u>	<u>-</u>	<u>479,651</u>	<u>8,722,651</u>
Revenues from non-Commonwealth sources:				
Federal excise taxes on off-shore shipments	361,000	-	-	361,000
Federal grants	-	-	4,039,107	4,039,107
Customs	15,000	-	-	15,000
Total revenues from non-Commonwealth sources	<u>376,000</u>	<u>-</u>	<u>4,039,107</u>	<u>4,415,107</u>
Total revenues	<u>8,619,000</u>	<u>-</u>	<u>4,518,758</u>	<u>13,137,758</u>
Other:				
Other Income	506,000	-	-	506,000
Balance from previous year	-	-	735,095	735,095
Bonds authorized	-	-	-	-
Total other sources	<u>506,000</u>	<u>-</u>	<u>735,095</u>	<u>1,241,095</u>
Total resources	<u>9,125,000</u>	<u>-</u>	<u>5,253,853</u>	<u>14,378,853</u>
Appropriations:				
Current expenses:				
General government	\$ 830,243	-	\$ 58,823	\$ 889,066
Education	3,382,053	-	1,234,632	4,616,685
Health	1,513,697	-	446,357	1,960,054
Welfare	487,296	-	2,191,475	2,678,771
Economic development	212,442	-	70,723	283,165
Public safety and protection	1,669,803	-	90,733	1,760,536
Transportation and communication	84,940	-	58,343	143,283
Housing	26,139	-	246,693	272,832
Contributions to municipalities	387,120	-	1,781	388,901
Special pension contributions	272,000	-	-	272,000
Debt service	512,197	-	119,121	631,318
Other debt service (appropriations)	97,570	-	56,100	153,670
Total appropriations – current expenses	<u>9,475,500</u>	<u>-</u>	<u>4,574,781</u>	<u>14,050,281</u>
Capital improvements	12,500	-	197,230	209,730
Total appropriations	<u>9,488,000</u>	<u>-</u>	<u>4,772,011</u>	<u>14,260,011</u>
Year-end balance	(363,000)	-	481,842	118,842
Total appropriations and year-end balance	<u>\$ 9,125,000</u>	<u>-</u>	<u>\$ 5,253,853</u>	<u>\$ 14,378,853</u>

* Totals may not add due to rounding.

- (1) Does not include grants received by agencies whose accounting systems are not centralized in the Treasury.
- (2) Act No. 93 of August 20, 1997 establishes that resources that do not represent revenues become part of the Budgetary Fund.

Sources: Department of the Treasury and Office of Management and Budget

Projected expenses and capital improvements of all budgetary funds total \$14.3 billion, a decrease of approximately \$1.3 billion from fiscal year 2006. The major changes in General Fund expenditures by program in fiscal year 2007 are mainly due to increases in welfare (up \$57.7 million), Transportation and Communication (up \$11.6 million), economic development (up \$24.8 million), public safety and protection (up \$36.1 million), debt service on Commonwealth's general obligation and guaranteed debt (up \$400.7 million), and decreases in housing (down \$70.4 million), health (down \$216.9 million), education (down \$126 million), and other debt service, consisting principally of Commonwealth appropriation debt (down \$488.4 million). The budget for fiscal year 2007 excludes approximately \$522 million of debt service payments. Of this amount, GDB advanced and, on July 15, 2006, deposited with the trustee \$303 million corresponding to debt service of the Public Finance Corporation. Additional debt service requirements for fiscal year 2007 will be covered with amounts to be deposited in the Dedicated Sales Tax Fund. Amounts not covered by the Dedicated Sales Tax Fund, if any, would have to be covered by additional legislative appropriations from the Commonwealth's General Fund. For a discussion of the Dedicated Sales Tax Fund, see "Tax Reform" under *Puerto Rico Taxes, Other Revenues, and Expenditures* above.

The Commonwealth has authorized the issuance of \$500 million of general obligation bonds for fiscal year 2007.

Budget for Fiscal Year 2008

The consolidated budget for fiscal year 2008 totals \$26.7 billion. Of this amount, \$14.1 billion is assigned to the central government. This includes General Fund total resources and appropriations of \$9.227 billion, which represents a decrease of \$261 million over approved expenditures for fiscal year 2007. The following table presents a summary of the Commonwealth's proposed central government budget appropriations for the fiscal year ending June 30, 2008.

Commonwealth of Puerto Rico
Summary of Central Government Annual Budget
Fiscal Year Ending June 30, 2008
(in thousands)*

	<u>General Fund</u>	<u>Bond Fund</u>	<u>Special Funds</u>	<u>Total</u>
Revenues from internal sources:				
Property taxes	-	-	\$ 119,716	\$ 119,716
Personal income taxes	\$ 3,067,000	-	-	3,067,000
Retained non-resident income tax	1,206,000	-	-	1,206,000
Corporate income taxes	1,922,000	-	-	1,922,000
Partnership income taxes	3,000	-	-	3,000
Tollgate taxes	10,000	-	-	10,000
17% withholding tax on interest	13,000	-	-	13,000
10% withholding tax on dividends	66,000	-	-	66,000
Inheritance and gift taxes	4,000	-	-	4,000
Excise taxes:				
Alcoholic beverages	288,000	-	-	288,000
Motor vehicles and accessories	429,000	-	-	429,000
Cigarettes	128,000	-	-	128,000
Sales tax	911,000	-	-	911,000
Other (excise taxes)	94,000	-	36,000	130,300
Licenses	107,000	-	-	107,000
Miscellaneous non-tax revenues:				
Contributions from lottery fund	63,000	-	-	63,000
Electronic lottery	60,000	-	-	60,000
Registration and document certification fees	221,000	-	-	221,000
Other	110,000	-	341,723	451,723
Total revenues from internal sources	<u>8,702,000</u>	<u>-</u>	<u>497,739</u>	<u>9,199,739</u>
Revenues from non-Commonwealth sources:				
Federal excise taxes on off-shore shipments	361,000	-	-	361,000
Federal grants	-	-	4,020,591	4,020,591
Customs	14,000	-	-	14,000
Total revenues from non-Commonwealth sources	<u>375,000</u>	<u>-</u>	<u>4,020,591</u>	<u>4,395,591</u>
Total revenues	<u>9,077,000</u>	<u>-</u>	<u>4,518,330</u>	<u>13,595,330</u>
Other:				
Other Income	-	-	-	-
Balance from previous year	150,000	-	481,842	631,842
Bonds authorized	-	-	-	-
Total other sources	<u>150,000</u>	<u>-</u>	<u>481,842</u>	<u>631,842</u>
Total resources	<u>9,227,000</u>	<u>-</u>	<u>5,000,172</u>	<u>14,227,172</u>
Appropriations:				
Current expenses:				
General government	\$ 826,435	-	\$ 58,934	\$ 885,369
Education	3,339,534	-	1,267,173	4,606,707
Health	1,480,300	-	453,373	1,933,673
Welfare	365,041	-	2,231,433	2,596,474
Economic development	187,576	-	81,980	269,556
Public safety and protection	1,692,498	-	91,011	1,783,509
Transportation and communication	86,440	-	60,800	147,240
Housing	26,139	-	251,188	277,327
Contributions to municipalities	360,779	-	1,781	362,560
Special pension contributions	296,132	-	-	296,132
Debt service	450,702	-	119,716	570,418
Other debt service (appropriations)	103,424	-	56,376	159,800
Total appropriations – current expenses	<u>9,215,000</u>	<u>-</u>	<u>4,673,765</u>	<u>13,888,765</u>
Capital improvements	12,000	-	191,017	203,017
Total appropriations	<u>9,227,000</u>	<u>-</u>	<u>4,864,782</u>	<u>14,091,782</u>
Year-end balance	-	-	135,390	135,390
Total appropriations and year-end balance	<u>\$ 9,227,000</u>	<u>-</u>	<u>\$ 5,000,172</u>	<u>\$ 14,227,172</u>

* Totals may not add due to rounding.

- (1) Does not include grants received by agencies whose accounting systems are not centralized in the Treasury.
- (2) Act No. 93 of August 20, 1997 establishes that resources that do not represent revenues become part of the Budgetary Fund.

Sources: Department of the Treasury and Office of Management and Budget

Projected expenses and capital improvements of all budgetary funds total \$14.1 billion, a decrease of approximately \$0.2 billion from fiscal year 2007. The major changes in General Fund expenditures by program in fiscal year 2008 are mainly due to increases in special pension contribution (up \$24.1 million), public safety and protection (up \$22.7 million), transportation and communication (up \$1.5 million), and other debt service (up \$5.9 million), and decreases in welfare (down \$122.3 million), debt service on Commonwealth's general obligation and guaranteed debt (down \$61.5 million), education (down \$42.5 million), health (down \$33.4 million), contributions to municipalities (down \$26.3 million), economic development (down \$24.9 million), and general government (down \$3.8 million).

The Governor has proposed the issuance of \$425 million of general obligation bonds for fiscal year 2008, but such bonds have not yet been authorized.

Differences between Budget and Basic Financial Statements

Revenues and expenditures, as reported by the Treasury in its Basic Financial Statements, may differ substantially from resources and appropriations in the annual budget for a number of reasons, including the following:

(i) The budgetary accounts are on a cash basis, while financial statements prepared by the Treasury include accruals and other adjustments as required by government accounting standards.

(ii) Expenditures for current purposes in a particular fiscal year may include amounts appropriated for earlier periods but not previously expended and, conversely, may exclude amounts appropriated for such fiscal year but not expended until later periods.

(iii) Bonds are authorized by the Commonwealth in accordance with a four-year capital improvement program. Since bond sales are determined by bond market conditions and other factors, the amounts of bonds sold for these improvements are financed by advances from the General Fund to the Capital Projects Fund, which are later reimbursed from proceeds of bond or notes sales.

LITIGATION

The Commonwealth is a defendant in numerous legal proceedings pertaining to matters incidental to the performance of routine governmental operations. Under Act No. 104 of June 25, 1955, as amended ("Act No. 104"), persons are authorized to sue the Commonwealth only for causes of actions specified in said Act. The Commonwealth may be liable under Act No. 104 for damages up to a maximum amount of \$75,000 or \$150,000 if the suit involves actions for damages to more than one person or where a single injured party is entitled to several causes of action. Under certain circumstances, as provided in Act No. 9 of November 26, 1975, as amended ("Act No. 9"), the Commonwealth may provide its officers and employees, including directors of public corporations and government instrumentalities and mayors of the municipalities of the Commonwealth, with legal representation, as well as assume the payment of any judgment that may be entered against them. There is no limitation on the amount of the judgment that may be paid under Act No. 9.

With respect to pending and threatened litigation, as of June 30, 2006, the Commonwealth has included in its financial statements reported liabilities of approximately \$306 million for awarded and anticipated unfavorable judgments. While amounts claimed exceed \$9 billion, such amount represents the amount estimated at the time as a probable liability or a liability with a fixed or expected due date, which would require future available financial resources for its payment. The Commonwealth believes that the ultimate liability in excess of amounts provided in the financial statements, if any, would not be significant.

The Commonwealth is a defendant in two lawsuits filed, one in Commonwealth court and one in the United States District Court for the District of Puerto Rico, by an association of primary care health centers seeking to recover from the Commonwealth \$800 million of Medicaid funds retained by the Department of Health since 1997. In June 2004, the Superior Court of the Commonwealth in San Juan determined that the Commonwealth must return those funds. The Supreme Court of Puerto Rico, however, upheld a partial ruling allowing the Commonwealth to deduct from the payments due to the centers certain of the payments received by the centers from the federal government. Currently, audits are being carried out on the plaintiff centers. As of June 30, 2006, the Commonwealth has accrued \$55 million for this legal contingency. With respect to the federal case, a preliminary injunction was issued by the court against the Commonwealth requiring it to disburse approximately \$20 million in six payments beginning in October 2005.

The Commonwealth is also a defendant in a class action presented by parents of special education students alleging deficient services to these students in the areas of education and health care before Commonwealth Courts. One court recently decided in favor of the parents' request to include damage claims in the same class action case. This court may now award damages to the class action members, and in doing so may consider the claims in groups or each case individually. This will require that the parents prove the damages suffered. The Commonwealth plans to defend vigorously each case. As of June 30, 2006, the Commonwealth had accrued \$440 million for this legal contingency.

This decision is appealable and thus, not final at this time. The Commonwealth does not anticipate any final determination or damages award, in any case, to be granted in this fiscal year.

The Commonwealth and various component units are defendants in other lawsuits alleging violations of civil rights, breach of contract, and other damage claims. Preliminary hearings and discovery proceedings are in progress. The amounts claimed exceed \$7.8 billion; however, the ultimate liability cannot be presently determined. It is the opinion of the Commonwealth that the claims are excessive. No provision for any liability that may result upon adjudication of these lawsuits has been recognized by the Commonwealth. The Commonwealth believes that the ultimate liability, if any, would not be significant.

FORM OF OPINION OF BOND COUNSEL

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

_____, 2007

Hon. Juan C. Mendez Torres
Secretary of the Treasury of Puerto Rico
San Juan, Puerto Rico

Dear Sir:

We have served as bond counsel in connection with the issuance by the Commonwealth of Puerto Rico of its \$926,570,000 principal amount of Public Improvement Refunding Bonds, Series 2007A (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, 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 Commonwealth of Puerto Rico relating to the issuance of the Bonds, including, without limitation, Act No. 2 of the Legislature of Puerto Rico, approved October 10, 1985, and Joint Resolution No. 57 of the Legislature of Puerto Rico, approved July 12, 1993 (collectively, the "Act") and a resolution adopted on October 3, 2007 by the Secretary of the Treasury of Puerto Rico and approved by the Governor of Puerto Rico (the "Resolution"), and such other documents as we have deemed necessary to render this opinion.

We have also examined a copy of one of the Bonds as executed and authenticated. We assume that all other Bonds have been similarly executed and authenticated.

From such examination, we are of the opinion that:

1. The Act is valid.
2. Said proceedings have been validly and legally taken.
3. The Act and said proceedings show lawful authority for the issuance and sale of the Bonds, and the Bonds constitute valid and binding general obligations of the Commonwealth of Puerto Rico for the prompt payment of the principal of and the interest on which the good faith, credit and taxing power of the Commonwealth of Puerto Rico are pledged.

4. 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 federal alternative minimum tax imposed on individuals and corporations. The Bonds and the interest thereon are exempt from state, Commonwealth of Puerto Rico and local income taxation. We express no opinion as to any other tax consequences regarding the Bonds.

In giving the opinion set forth in numbered paragraph 4. hereof, we have assumed and relied upon compliance with the Commonwealth of Puerto Rico’s covenants and the accuracy, which we have not independently verified, of the Commonwealth of Puerto Rico’s representations and certifications, all as contained in the Transcript. The accuracy of those representations and certifications, and compliance by the Commonwealth of Puerto Rico with those covenants, may be necessary for the interest on the Bonds to be and to remain excluded from gross income for federal income tax purposes. Failure to comply with certain of those covenants subsequent to issuance of the Bonds could cause interest on the Bonds to be included in gross income for federal income tax purposes retroactively to the date of issuance of the Bonds. The Commonwealth of Puerto Rico has covenanted to comply with the requirements of the Code to the extent permitted by the Constitution and laws of the Commonwealth of Puerto Rico. We are not aware of any provisions of the Constitution or laws of the Commonwealth of Puerto Rico that would prevent the Commonwealth of Puerto Rico 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 Commonwealth of Puerto Rico 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 Resolution and 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.”]

AUCTION PROCEDURES

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Any modification to the Definitions in Article I and the Auction Procedures in Article II are set forth in Schedule I. In the event of any conflict between Article I or Article II and Schedule I, Schedule I shall prevail. Any reference herein to “Series” such as “a Series of Bonds” or “Bonds of a Series” shall not apply if there is only one Series of Bonds. References to “Series” include for purposes of this Official Statement subseries of Bonds. Unless otherwise noted in this Exhibit B, the terms and provisions of Exhibit B shall be deemed to refer and apply separately to each one or more subseries of the Variable Rate Bonds while such Bonds are in an ARS Rate Period.

ARTICLE I

Definitions

The following words and terms as used in this Appendix III (hereinafter “this Appendix”) and elsewhere in this Official Statement have the following meanings with respect to Bonds in an ARS Rate Period unless the context or use indicates another or different meaning or intent or the definition has been changed, modified or expanded in Schedule I:

“Agent Member” means a member of, or participant in, the Securities Depository who shall act on behalf of a Bidder.

“All Hold Rate” has the meaning set forth in Schedule I.

“ARS Conversion Date” means with respect to Bonds, the date on which the Bonds of such Series convert from an interest rate period other than an ARS Rate Period and begin to bear interest at the Auction Period Rate.

“ARS Rate Period” means, for each Series of Bonds, any period of time commencing on the day following the Initial Period and ending on the earlier of the Conversion Date or the day preceding the final maturity date of such Bonds.

“Auction” means each periodic implementation of the Auction Procedures.

“Auction Agent” means the Person appointed as Auction Agent in accordance with the Auction Agreement. The Auction Agent shall initially be the party named in Schedule I.

“Auction Agreement” means an agreement between the Auction Agent and the Trustee pursuant to which the Auction Agent agrees to follow the procedures specified in this Appendix with respect to the Bonds while such Bonds bear interest at the Auction Period Rate, as such agreement may from time to time be amended or supplemented.

“Auction Date” means with respect to any Series of Bonds:

(a) Daily Auction Period. If the Bonds are in a daily Auction Period, each Business Day unless such day is the Business Day prior to the conversion from a daily Auction Period to another Auction Period,

(b) Flexible Auction Period. If the Bonds are in a Flexible Auction Period, the last Business Day of the Flexible Auction Period, and

(c) Other Auction Periods. If the Bonds are in any other Auction Period, the Business Day next preceding each Interest Payment Date for such Bonds (whether or not an Auction shall be conducted on such date);

provided, however, that the last Auction Date with respect to the Bonds in an Auction Period other than a daily Auction Period or Flexible Auction Period shall be the earlier of (i) the Business Day next preceding the Interest Payment Date next preceding the Conversion Date for the Bonds and (ii) the Business Day next preceding the Interest Payment Date next preceding the final maturity date for the Bonds; and

provided, further, that if the Bonds are in a daily Auction Period, the last Auction Date shall be the earlier of (x) the second Business Day next preceding the Conversion Date for the Bonds and (y) the Business Day next preceding the final maturity date for the Bonds. The last Business Day of a Flexible Auction Period shall be the Auction Date for the Auction Period which begins on the next succeeding Business Day, if any. On the second Business Day preceding the conversion from a daily Auction Period to another Auction Period, there shall be an Auction for the last daily Auction Period. On the Business Day preceding the conversion from a daily Auction Period to another Auction Period, there shall be one Auction for the first Auction Period following the conversion.

The first Auction Date for each Series of Bonds is set forth in Schedule I.

“Auction Desk” means the business unit of a Broker-Dealer that fulfills the responsibilities of the Broker-Dealer under a Broker-Dealer Agreement, including soliciting Bids for the Bonds, and units of the Broker-Dealer which are not separated from such business unit by information controls appropriate to control, limit and monitor the inappropriate dissemination and use of information about Bids.

“Auction Period” means with respect to each Series of Bonds:

(a) Flexible Auction Period. A Flexible Auction Period;

(b) Daily Auction Period. With respect to a Series of Bonds in a daily Auction Period, a period beginning on each Business Day and extending to but not including the next succeeding Business Day unless such Business Day is the second Business Day preceding the conversion from a daily Auction Period to another Auction Period, in which case the daily Auction Period shall extend to, but not include, the next Interest Payment Date;

(c) Seven day Auction Period. With respect to a Series of Bonds in a seven-day Auction Period, if Auctions generally are conducted on the day of the week specified in column A of the table below, a period of generally seven days beginning on the day of the week specified in column B of the table below (or the day following the last day of the prior Auction Period if the prior Auction Period does not end on the day of the week specified in column C of the table below) and ending on the day of the week specified in column C of the table below in

the next succeeding week (unless such day is not followed by a Business Day, in which case on the next succeeding day which is followed by a Business Day):

(A)	(B)	(C)
When Auctions Occur on this day	Auction Period Generally Begins this day	Auction Period Generally Ends this day
Friday	Monday	Sunday
Monday	Tuesday	Monday
Tuesday	Wednesday	Tuesday
Wednesday	Thursday	Wednesday
Thursday	Friday	Thursday

(d) 28-day Auction Period. With respect to a Series of Bonds in a 28-day Auction Period, if Auctions generally are conducted on the day of the week specified in column A of the table above, a period of generally 28 days beginning on the day of the week specified in column B of the table above (or the day following the last day of the prior Auction Period if the prior Auction Period does not end on the day of the week specified in column C of the table above) and ending on the same day of the week specified in column C of the table above four weeks later (unless such day is not followed by a Business Day, in which case on the next succeeding day which is followed by a Business Day).

(e) 35-day Auction Period. With respect to a Series of Bonds in a 35-day Auction Period, if Auctions generally are conducted on the day of the week specified in column A of the table above, a period of generally 35 days beginning on the day of the week specified in column B of the table above (or the day following the last day of the prior Auction Period if the prior Auction Period does not end on the day of the week specified in column C of the table above) and ending on the day of the week specified in column C of the table above five weeks later (unless such day is not followed by a Business Day, in which case on the next succeeding day which is followed by a Business Day).

(f) *Three-month Auction Period.* With respect to a Series of Bonds in a three-month Auction Period, a period of generally three months (or shorter period upon a conversion from another Auction Period or following an ARS Conversion Date) beginning on the day following the last day of the prior Auction Period and ending on the calendar day immediately preceding the first Business Day of the month that is the third calendar month following the beginning date of such Auction Period; and

(g) Six-month Auction Period. With respect to a Series of Bonds in a six-month Auction Period, a period of generally six months (or shorter period upon a conversion from another Auction Period or following an ARS Conversion Date) beginning on the day following the last day of the prior Auction Period and ending on the next succeeding date set forth in Schedule I;

Provided, however, that if there is a conversion of a Series of Bonds with Auctions generally conducted on the day of the week specified in column A of the table above, (i) from a

daily Auction Period to a seven-day Auction Period, the next Auction Period shall begin on the date of the conversion (i.e. the Interest Payment Date for the prior Auction Period) and shall end on the next succeeding day of the week specified in column C of the table above (unless such day is not followed by a Business Day, in which case on the next succeeding day which is followed by a Business Day), (ii) from a daily Auction Period to a 28-day Auction Period, the next Auction Period shall begin on the date of the conversion (i.e., the Interest Payment Date for the prior Auction Period) and shall end of the day of the week specified in column C of the table above (unless such day is not followed by a Business Day, in which case on the next succeeding day which is followed by a Business Day) which is more than 21 days but not more than 28 days from such date of conversion, and (iii) from a daily Auction Period to a 35-day Auction Period, the next Auction Period shall begin on the date of the conversion (i.e. the Interest Payment Date for the prior Auction Period) and shall end on the day of the week specified in column C of the table above (unless such day is not followed by a Business Day, in which case on the next succeeding day which is followed by a Business Day) which is more than 28 days but no more than 35 days from such date of conversion.

Notwithstanding the foregoing, if an Auction is for an Auction Period of more than seven days and the Auction Rate on such Auction Date is the Maximum Rate as the result of a lack of Sufficient Clearing Bids, the Auction Period shall automatically convert to a seven-day Auction Period. On the following Auction Date, the Auction shall be conducted for an Auction Period of the same length as the Auction Period prior to such automatic conversion. If such Auction is successful, the Auction Period shall revert to the length prior to the automatic conversion, and, if such Auction is not successful, the Auction Period shall be another seven-day period.

“Auction Period Rate” means the Auction Rate or any other rate of interest to be borne by the Bonds during each Auction Period determined in accordance with Section 2.04 of this Appendix; provided, however, in no event may the Auction Period Rate exceed the Maximum Rate.

“Auction Procedures” means the procedures for conducting Auctions for Bonds during an ARS Rate Period set forth in this Appendix.

“Auction Rate” means for each Series of Bonds for each Auction Period, (i) if Sufficient Clearing Bids exist, the Winning Bid Rate, provided, however, if all of the Bonds are the subject of Submitted Hold Orders, the All Hold Rate for such Series of Bonds and (ii) if Sufficient Clearing Bids do not exist, the Maximum Rate for such Series of Bonds.

“Authorized Denomination” means \$25,000, or such other amount specified in Schedule I, and integral multiples thereof so long as the Bonds bear interest at the Auction Period Rate, notwithstanding anything else in the Authorizing Document to the contrary.

“Authorizing Document” has the meaning set forth in Schedule I.

“Available Bonds” means, for each Series of Bonds on each Auction Date, the number of Units of Bonds that are not the subject of Submitted Hold Orders.

“Bid” has the meaning specified in subsection (a) of Section 2.01 of this Appendix.

“Bidder” means each Existing Owner and Potential Owner who places an Order.

“Bonds” has the meaning set forth in Schedule I.

“Broker-Dealer” means any entity that is permitted by law to perform the function required of a Broker-Dealer described in this Appendix, that is a member of, or a direct participant in, the Securities Depository, that has been selected by the Corporation and that is a party to a Broker-Dealer Agreement with the Auction Agent and the Corporation. The “Broker-Dealer of record” with respect to any Bond is the Broker-Dealer which placed the Order for such Bond or whom the Existing Owner of such Bond has designated as its Broker-Dealer with respect to such Bond, in each case as reflected in the records of the Auction Agent. The Broker-Dealer(s) shall initially be the party(ies) named in Schedule I.

“Broker-Dealer Agreement” means an agreement among the Auction Agent, the Corporation and a Broker-Dealer pursuant to which such Broker-Dealer agrees to follow the procedures described in this Appendix, as such agreement may from time to time be amended or supplemented.

“Broker-Dealer Deadline” means, with respect to an Order, the internal deadline established by the Broker-Dealer through which the Order was placed after which it will not accept Orders or any change in any Order previously placed with such Broker-Dealer; provided, however, that nothing shall prevent the Broker-Dealer from correcting Clerical Errors by the Broker-Dealer with respect to Orders from Bidders after the Broker-Dealer Deadline pursuant to the provisions herein. Any Broker-Dealer may change the time or times of its Broker-Dealer Deadline as it relates to such Broker-Dealer by giving notice not less than two Business Days prior to the date such change is to take effect to Bidders who place Orders through such Broker-Dealer.

“Business Day” in addition to any other definition of “Business Day” included in the Authorizing Document, while Bonds bear interest at the Auction Period Rate, the term Business Day shall not include Saturdays, Sundays, days on which the New York Stock Exchange or its successor is not open for business, days on which the Federal Reserve Bank of New York is not open for business, days on which banking institutions or trust companies located in the state in which the operations of the Auction Agent are conducted are authorized or required to be closed by law, regulation or executive order of the state in which the Auction Agent conducts operations with respect to the Bonds.

“Clerical Error” means a clerical error in the processing of an Order, and includes, but is not limited to, the following: (i) a transmission error, including but not limited to, an Order sent to the wrong address or number, failure to transmit certain pages or illegible transmission, (ii) failure to transmit an Order received from one or more Existing Owners or Potential Owners (including Orders from the Broker-Dealer which were not originated by the Auction Desk) prior to the Broker-Dealer Deadline or generated by the Broker-Dealer’s Auction Desk for its own account prior to the Submission Deadline or (iii) a typographical error. Determining whether an error is a “Clerical Error” is within the reasonable judgment of the Broker-Dealer, provided that the Broker-Dealer has a record of the correct Order that shows it was so received or so generated prior to the Broker-Dealer Deadline or the Submission Deadline, as applicable.

“Conversion Date” means the date on which any Series of the Bonds begin to bear interest at a rate which is determined other than by means of the Auction Procedures.

“Corporation” has the meaning set forth in Schedule I.

“Electronic Means” means, facsimile transmission, email transmission or other similar electronic means of communication providing evidence of transmission, including a telephone communication confirmed by any other method set forth in this definition.

“Error Correction Deadline” means one hour after the Auction Agent completes the dissemination of the results of the Auction to Broker-Dealers without regard to the time of receipt of such results by any Broker-Dealer; provided, however, in no event shall the Error Correction Deadline extend past 4:00 p.m., New York City time, unless the Auction Agent experiences technological failure or force majeure in disseminating the Auction results which causes a delay in dissemination past 3:00 p.m., New York City time.

“Existing Owner” means a Person who is the beneficial owner of Bonds; provided, however, that for purposes of conducting an Auction, the Auction Agent may consider a Broker-Dealer acting on behalf of its customer as an Existing Owner.

“Flexible Auction Period” means with respect to a Series of Bonds,

(a) any period of 182 days or less which is divisible by seven and which begins on an Interest Payment Date and ends (i) in the case of a Series of Bonds with Auctions generally conducted on Fridays, on a Sunday unless such Sunday is not followed by a Business Day, in which case on the next succeeding day which is followed by a Business Day, (ii) in the case of a Series of Bonds with Auctions generally conducted on Mondays, on a Monday unless such Monday is not followed by a Business Day, in which case on the next succeeding day which is followed by a Business Day, (iii) in the case of a Series of Bonds with Auctions generally conducted on Tuesdays, on a Tuesday unless such Tuesday is not followed by a Business Day, in which case on the next succeeding day which is followed by a Business Day, (iv) in the case of a Series of Bonds with Auctions generally conducted on Wednesdays, on a Wednesday unless such Wednesday is not followed by a Business Day, in which case on the next succeeding day which is followed by a Business Day, and (v) in the case of a Series of Bonds with Auctions generally conducted on Thursdays, on a Thursday unless such Thursday is not followed by a Business Day, in which case on the next succeeding day which is followed by a Business Day or

(b) any period which is longer than 182 days which begins on an Interest Payment Date and ends not later than the final scheduled maturity date of such Series of Bonds.

“Hold Order” means an Order to hold the Bonds as provided in Section 2.01(a) of this Appendix or such an Order deemed to have been submitted as provided in Section 2.01(c) of this Appendix.

“Index” has the meaning set forth in Schedule I.

“Initial Period” has the meaning set forth in Schedule I.

“Initial Period Rate” has the meaning set forth in Schedule I.

“Interest Payment Date” with respect to Bonds of a Series bearing interest at Auction Period Rates, means, notwithstanding anything else in the Authorizing Document to the contrary, the first Interest Payment Date for such Series of Bonds as set forth in Schedule I and thereafter (unless changed by Schedule I) (a) when used with respect to any Auction Period other than a daily Auction Period or a Flexible Auction Period, the Business Day immediately following such Auction Period, (b) when used with respect to a daily Auction Period, the first Business Day of the month immediately succeeding the first day of such Auction Period, (c) when used with respect to a Flexible Auction Period of (i) seven or more but fewer than 183 days, the Business Day immediately following such Flexible Auction Period, or (ii) 183 or more days, each semiannual date on which interest on the Bonds would be payable if such Bonds bore interest at a fixed rate of interest and on the Business Day immediately following such Flexible Auction Period, and (d) the date when the final payment of principal of the Bonds of such Series becomes due and payable (whether at stated maturity, upon redemption or acceleration, or otherwise).

“Issuer” has the meaning set forth in Schedule I.

“Maximum Rate” has the meaning set forth in Schedule I.

“Order” means a Hold Order, Bid or Sell Order.

“Person” has the meaning set forth in Schedule I.

“Potential Owner” means any Person, including any Existing Owner, who may be interested in acquiring a beneficial interest in the Bonds in addition to the Bonds currently owned by such Person, if any; provided, however, that for purposes of conducting an Auction, the Auction Agent may consider a Broker-Dealer acting on behalf of its customer as a Potential Owner.

“Record Date” means, notwithstanding anything else in the Authorizing Document, while the Bonds bear interest at the Auction Period Rate, the Business Day immediately preceding an Interest Payment Date.

“Schedule I” means Schedule I to this Appendix.

“Securities Depository” means, notwithstanding anything else in the Authorizing Document to the contrary, The Depository Trust Company and its successors and assigns or any other securities depository selected by the Corporation.

“Sell Order” has the meaning specified in subsection (a) of Section 2.01 of this Appendix.

“Submission Deadline” means, unless changed by Schedule I, 1:00 p.m., New York City time, on each Auction Date not in a daily Auction Period and 11:00 a.m., New York City time, on each Auction Date in a daily Auction Period, or such other time on such date as shall be specified from time to time by the Auction Agent if directed in writing by the Trustee or the Corporation pursuant to the Auction Agreement as the time by which Broker-Dealers are

required to submit Orders to the Auction Agent. Notwithstanding the foregoing, the Auction Agent will follow the Securities Industry and Financial Markets Association's Early Market Close Recommendations for shortened trading days for the bond markets (the "SIFMA Recommendation") unless the Auction Agent is instructed otherwise in writing by the Trustee or the Corporation. In the event of a SIFMA Recommendation with respect to an Auction Date, the Submission Deadline will be 11:30 a.m., instead of 1:00 p.m., New York City time.

"Submitted Bid" has the meaning specified in subsection (b) of Section 2.04 of this Appendix.

"Submitted Hold Order" has the meaning specified in subsection (b) of Section 2.04 of this Appendix.

"Submitted Order" has the meaning specified in subsection (b) of Section 2.04 of this Appendix.

"Submitted Sell Order" has the meaning specified in subsection (b) of Section 2.04 of this Appendix.

"Sufficient Clearing Bids" means for each Series of Bonds, an Auction for which the number of Units of such Bonds that are the subject of Submitted Bids by Potential Owners specifying one or more rates not higher than the Maximum Rate is not less than the number of Units of such Bonds that are the subject of Submitted Sell Orders and of Submitted Bids by Existing Owners specifying rates higher than the Maximum Rate.

"Units" has the meaning set forth in Section 2.02(a)(iii) of this Appendix.

"Winning Bid Rate" means for each Series of Bonds, the lowest rate specified in any Submitted Bid of such Series which if calculated by the Auction Agent as the Auction Rate would cause the number of Units of such Bonds that are the subject of Submitted Bids specifying a rate not greater than such rate to be not less than the number of Units of Available Bonds of such Series.

ARTICLE II

Auction Procedures

Section 2.01. Orders by Existing Owners and Potential Owners. (a) Prior to the Broker-Dealer Deadline for each Series of Bonds on each Auction Date:

(i) each Existing Owner may submit to a Broker-Dealer, in writing or by such other method as shall be reasonably acceptable to such Broker-Dealer, one or more Orders as to:

(A) the principal amount of Bonds, if any, held by such Existing Owner which such Existing Owner commits to continue to hold for the next succeeding Auction Period without regard to the Auction Rate for such Auction Period,

(B) the principal amount of Bonds, if any, held by such Existing Owner which such Existing Owner commits to continue to hold for the next succeeding Auction Period if the Auction Rate for the next succeeding Auction Period is not less than the rate per annum specified in such Order (and if the Auction Rate is less than such specified rate, the effect of the Order shall be as set forth in paragraph (b)(i)(A) of this Section), and/or

(C) the principal amount of Bonds, if any, held by such Existing Owner which such Existing Owner offers to sell on the first Business Day of the next succeeding Auction Period (or on the same day in the case of a daily Auction Period) without regard to the Auction Rate for the next succeeding Auction Period; and

(ii) each Potential Owner may submit to a Broker-Dealer, in writing or by such other method as shall be reasonably acceptable to such Broker-Dealer, an Order as to the principal amount of Bonds, which each such Potential Owner offers to purchase if the Auction Rate for the next succeeding Auction Period is not less than the rate per annum then specified by such Potential Owner.

For the purposes of the Auction Procedures an Order containing the information referred to in clause (i)(A) above is referred to as a “Hold Order,” an Order containing the information referred to in clause (i)(B) or (ii) above is referred to as a “Bid,” and an Order containing the information referred to in clause (i)(C) above is referred to as a “Sell Order.”

No Auction Desk of a Broker-Dealer shall accept as an Order a submission (whether received from an Existing Owner or a Potential Owner or generated by the Broker-Dealer for its own account) which does not conform to the requirements of the Auction Procedures, including, but not limited to, submissions which are not in Authorized Denominations, specify a rate which contains more than three figures to the right of the decimal point or specify an amount greater than the amount of Outstanding Bonds. No Auction Desk of a Broker-Dealer shall accept a Bid or Sell Order which is conditioned on being filled in whole or a Bid which does not specify a specific interest rate.

(b) (i) A Bid by an Existing Owner shall constitute an offer to sell on the first Business Day of the next succeeding Auction Period (or the same day in the case of a daily Auction Period):

(A) the principal amount of Bonds specified in such Bid if the Auction Rate for the next succeeding Auction Period shall be less than the rate specified in such Bid; or

(B) such principal amount or a lesser principal amount of Bonds to be determined as described in subsection (a)(v) of Section 2.05 hereof if the Auction Rate for the next succeeding Auction Period shall be equal to such specified rate; or

(C) a lesser principal amount of Bonds to be determined as described in subsection (b)(iv) of Section 2.05 hereof if such specified rate shall be higher than the Maximum Rate and Sufficient Clearing Bids do not exist.

(ii) A Sell Order by an Existing Owner shall constitute an offer to sell:

(A) the principal amount of Bonds specified in such Sell Order; or

(B) such principal amount or a lesser principal amount of Bonds as described in subsection (b)(iv) of Section 2.05 hereof if Sufficient Clearing Bids do not exist.

(iii) A Bid by a Potential Owner shall constitute an offer to purchase:

(A) the principal amount of Bonds specified in such Bid if the Auction Rate for the next succeeding Auction Period shall be higher than the rate specified therein; or

(B) such principal amount or a lesser principal amount of Bonds as described in subsection (a)(vi) of Section 2.05 hereof if the Auction Rate for the next succeeding Auction Period shall be equal to such specified rate.

(c) Anything herein to the contrary notwithstanding:

(i) If an Order or Orders covering all of the Bonds of a particular Series held by an Existing Owner is not submitted to the Broker-Dealer of record for such Existing Owner prior to the Broker-Dealer Deadline, such Broker-Dealer shall deem a Hold Order to have been submitted on behalf of such Existing Owner covering the principal amount of Bonds held by such Existing Owner and not subject to Orders submitted to such Broker-Dealer; provided, however, that if there is a conversion from one Auction Period to a longer Auction Period and Orders have not been submitted to such Broker-Dealer prior to the Broker-Dealer Deadline covering the aggregate principal amount of Bonds of a particular Series to be converted held by such Existing Owner, such Broker-Dealer shall deem a Sell Order to have been submitted on behalf of such Existing Owner covering the principal amount of Bonds to be converted held by such Existing Owner not subject to Orders submitted to such Broker-Dealer.

(ii) for purposes of any Auction, any Order by any Existing Owner or Potential Owner shall be revocable until the Broker-Dealer Deadline, and after the Broker-Dealer Deadline, all such Orders shall be irrevocable, except as provided in Sections 2.02(e)(ii) and 2.02(f); and

(iii) for purposes of any Auction other than during a daily Auction Period, any Bonds sold or purchased pursuant to subsection (b)(i), (ii) or (iii) above shall be sold or purchased at a price equal to 100% of the principal amount thereof; provided that, for purposes of any Auction during a daily Auction Period, such sale or purchase price shall be 100% of the principal amount thereof plus accrued interest to the date of sale or purchase.

Section 2.02. Submission of Orders by Broker-Dealers to Auction Agent.

(a) Each Broker-Dealer shall submit to the Auction Agent in writing, or by such Electronic Means as shall be reasonably acceptable to the Auction Agent, prior to the Submission Deadline on each Auction Date for Bonds of a Series, all Orders with respect to Bonds of such Series accepted by such Broker-Dealer in accordance with Section 2.01 above and specifying with respect to each Order or aggregation of Orders pursuant to Section 2.02(b) below:

(i) the name of the Broker-Dealer;

(ii) the number of Bidders placing Orders, if requested by the Auction Agent;

(iii) the aggregate number of Units of Bonds of such Series, if any, that are the subject of such Order, where each Unit is equal to the principal amount of the minimum Authorized Denomination of the Bonds;

(iv) to the extent that such Bidder is an Existing Owner:

(A) the number of Units of Bonds of such Series, if any, subject to any Hold Order placed by such Existing Owner;

(B) the number of Units of Bonds of such Series, if any, subject to any Bid placed by such Existing Owner and the rate specified in such Bid; and

(C) the number of Units of Bonds of such Series, if any, subject to any Sell Order placed by such Existing Owner; and

(v) to the extent such Bidder is a Potential Owner, the rate specified in such Bid.

(b) If more than one Bid is submitted to a Broker-Dealer on behalf of any single Potential Owner, the Broker-Dealer shall aggregate each Bid on behalf of such Potential Owner submitted with the same rate and consider such Bids as a single Bid and shall consider each Bid submitted with a different rate a separate Bid with the rate and the number of Units of Bonds specified therein.

A Broker-Dealer may aggregate the Orders of different Potential Owners with those of other Potential Owners on whose behalf the Broker-Dealer is submitting Orders and may aggregate the Orders of different Existing Owners with other Existing Owners on whose behalf the Broker-Dealer is submitting Orders; provided, however, Bids may only be aggregated if the interest rates on the Bids are the same.

(c) None of the Issuer, the Corporation, the Trustee or the Auction Agent shall be responsible for the failure of any Broker-Dealer to submit an Order to the Auction Agent on behalf of any Existing Owner or Potential Owner.

(d) Nothing contained herein shall preclude a Broker-Dealer from placing an Order for some or all of the Bonds for its own account.

(e) Until the Submission Deadline, a Broker-Dealer may withdraw or modify any Order previously submitted to the Auction Agent (i) for any reason if the Order was generated by the Auction Desk of the Broker-Dealer for the account of the Broker-Dealer or (ii) to correct a Clerical Error on the part of the Broker-Dealer in the case of any other Order, including Orders from the Broker-Dealer which were not originated by the Auction Desk.

(f) After the Submission Deadline and prior to the Error Correction Deadline, a Broker-Dealer may:

(i) submit to the Auction Agent an Order received from an Existing Owner, Potential Owner or a Broker-Dealer which is not an Order originated by the Auction Desk, in each case prior to the Broker-Dealer Deadline, or an Order generated by the Broker-Dealer's Auction Desk for its own account prior to the Submission Deadline (provided that in each case the Broker-Dealer has a record of such Order and the time when such Order was received or generated) and not submitted to the Auction Agent prior to the Submission Deadline as a result of (A) an event of force majeure or a technological failure which made delivery prior to the Submission Deadline impossible or, under the conditions then prevailing, impracticable or (B) a Clerical Error on the part of the Broker-Dealer; or

(ii) modify or withdraw an Order received from an Existing Owner or Potential Owner or generated by the Broker-Dealer (whether generated by the Broker-Dealer's Auction Desk or elsewhere within the Broker-Dealer) for its own account and submitted to the Auction Agent prior to the Submission Deadline or pursuant to clause (i) above, if the Broker-Dealer determines that such Order contained a Clerical Error on the part of the Broker-Dealer.

In the event a Broker-Dealer makes a submission, modification or withdrawal pursuant to this Section 2.02(f) and the Auction Agent has already run the Auction, the Auction Agent shall rerun the Auction, taking into account such submission, modification or withdrawal. Each submission, modification or withdrawal of an Order submitted pursuant to this Section 2.02(f) by a Broker-Dealer after the Submission Deadline and prior to the Error Correction Deadline shall constitute a representation by the Broker-Dealer that (A) in the case of a newly submitted Order or portion thereof or revised Order, the failure to submit such Order prior to the Submission Deadline resulted from an event described in clause (i) above and such Order was received from an Existing Owner or Potential Owner or is an Order received from the Broker-Dealer that was not originated by the Auction Desk, in each case, prior to the Broker-Dealer Deadline, or generated internally by such Broker-Dealer's Auction Desk for its own account prior to the Submission Deadline or (B) in the case of a modified or withdrawn Order, such Order was received from an Existing Owner, a Potential Owner or the Broker-Dealer which was not originated by the Auction Desk prior to the Broker-Dealer Deadline, or generated internally by such Broker-Dealer's Auction Desk for its own account prior to the Submission Deadline and such Order as submitted to the Auction Agent contained a Clerical Error on the part of the Broker-Dealer and that such Order has been modified or withdrawn solely to effect a correction

of such Clerical Error, and in the case of either (A) or (B), as applicable, the Broker-Dealer has a record of such Order and the time when such Order was received or generated. The Auction Agent shall be entitled to rely conclusively (and shall have no liability for relying) on such representation for any and all purposes of the Auction Procedures.

(g) If after the Auction Agent announces the results of an Auction, a Broker-Dealer becomes aware that an error was made by the Auction Agent, the Broker-Dealer shall communicate such awareness to the Auction Agent prior to 5:00 p.m. New York City time on the Auction Date (or 2:00 pm. New York City time in the case of Bonds in a daily Auction Period). If the Auction Agent determines there has been such an error (as a result of either a communication from a Broker-Dealer or its own discovery) prior to 3:00 p.m. New York City time on the first day of the Auction Period with respect to which such Auction was conducted, the Auction Agent shall correct the error and notify each Broker-Dealer that submitted Bids or held a position in Bonds in such Auction of the corrected results.

(h) Nothing contained herein shall preclude the Auction Agent from:

(i) advising a Broker-Dealer prior to the Submission Deadline that it has not received Sufficient Clearing Bids for the Bonds; provided, however, that if the Auction Agent so advises any Broker-Dealer, it shall so advise all Broker-Dealers; or

(ii) verifying the Orders of a Broker-Dealer prior to or after the Submission Deadline; provided, however, that if the Auction Agent verifies the Orders of any Broker-Dealer, it shall verify the Orders of all Broker-Dealers requesting such verification.

Section 2.03. Treatment of Orders by the Auction Agent. Anything herein to the contrary notwithstanding:

(a) If the Auction Agent receives an Order which does not conform to the requirements of the Auction Procedures, the Auction Agent may contact the Broker-Dealer submitting such Order until one hour after the Submission Deadline and inform such Broker-Dealer that it may resubmit such Order so that it conforms to the requirements of the Auction Procedures. Upon being so informed, such Broker-Dealer may correct and resubmit to the Auction Agent any such Order that, solely as a result of a Clerical Error on the part of such Broker-Dealer, did not conform to the requirements of the Auction Procedures when previously submitted to the Auction Agent. Any such resubmission by a Broker-Dealer shall constitute a representation by such Broker-Dealer that the failure of such Order to have so conformed was solely as a result of a Clerical Error on the part of such Broker-Dealer. If the Auction Agent has not received a corrected conforming Order within one hour and fifteen minutes of the Submission Deadline, the Auction Agent shall, if and to the extent applicable, adjust or apply such Order, as the case may be, in conformity with the provisions of subsections (b), (c) or (d) of this Section 2.03 and, if the Auction Agent is unable to so adjust or apply such Order, the Auction Agent shall reject such Order.

(b) If any rate specified in any Bid contains more than three figures to the right of the decimal point, the Auction Agent shall round such rate up to the next highest one thousandth of one percent (0.001%).

(c) If one or more Orders covering in the aggregate more than the number of Units of Outstanding Bonds of a particular Series are submitted by a Broker-Dealer to the Auction Agent, such Orders shall be considered valid in the following order of priority:

(i) all Hold Orders shall be considered Hold Orders, but only up to and including in the aggregate the number of Units of Bonds of such Series for which such Broker-Dealer is the Broker-Dealer of record;

(ii) (A) any Bid of a Broker-Dealer shall be considered valid as a Bid of an Existing Owner up to and including the excess of the number of Units of Bonds of such Series for which such Broker-Dealer is the Broker-Dealer of record over the number of Units of the Bonds of such Series subject to Hold Orders referred to in clause (i) above;

(B) subject to clause (A) above, all Bids of a Broker-Dealer with the same rate shall be aggregated and considered a single Bid of an Existing Owner up to and including the excess of the number of Units of Bonds of such Series for which such Broker-Dealer is the Broker-Dealer of record over the number of Units of Bonds of such Series for which such Broker-Dealer is the Broker-Dealer of record subject to Hold Orders referred to in clause (i) above;

(C) subject to clause (A) above, if more than one Bid with different rates is submitted by a Broker-Dealer, such Bids shall be considered Bids of an Existing Owner in the ascending order of their respective rates up to the amount of the excess of the number of Units of Bonds of such Series for which such Broker-Dealer is the Broker-Dealer of record over the number of Units of Bonds of such Series for which such Broker-Dealer is the Broker-Dealer of record subject to Hold Orders referred to in clause (i) above; and

(D) the number of Units, if any, of such Bonds of such Series subject to Bids not considered to be Bids for which such Broker-Dealer is the Broker-Dealer of record under this clause (ii) shall be treated as the subject of a Bid by a Potential Owner;

(iii) all Sell Orders shall be considered Sell Orders, but only up to and including the number of Units of Bonds of such Series equal to the excess of the number of Units of Bonds of such Series for which such Broker-Dealer is the Broker-Dealer of record over the sum of the number of Units of the Bonds of such Series considered to be subject to Hold Orders pursuant to clause (i) above and the number of Units of Bonds of such Series considered to be subject to Bids for which such Broker-Dealer is the Broker-Dealer of record pursuant to clause (ii) above.

(d) If any Order is for other than an integral number of Units, then the Auction Agent shall round the amount down to the nearest number of whole Units, and the Auction Agent shall conduct the Auction Procedures as if such Order had been submitted in such number of Units.

(e) For purposes of any Auction other than during a daily Auction Period, if an Auction Agent has been notified by the Trustee, Issuer or Corporation that any portion of an Order by a Broker-Dealer relates to a Bond which has been called for redemption on or prior to

the Interest Payment Date next succeeding such Auction, the Order shall be invalid with respect to such portion and the Auction Agent shall conduct the Auction Procedures as if such portion of such Order had not been submitted.

(f) For purposes of any Auction other than during a daily Auction Period, no portion of a Bond which the Auction Agent has been notified by the Trustee, Issuer or Corporation has been called for redemption on or prior to the Interest Payment Date next succeeding such Auction shall be included in the calculation of Available Bonds for such Auction.

(g) If an Order or Orders covering all of the Bonds of a particular Series is not submitted by a Broker-Dealer of record prior to the Submission Deadline, the Auction Agent shall deem a Hold Order to have been submitted on behalf of such Broker-Dealer covering the number of Units of Bonds for which such Broker-Dealer is the Broker-Dealer of record and not subject to Orders submitted to the Auction Agent; provided, however, that if there is a conversion from one Auction Period to a longer Auction Period and Orders have not been submitted by such Broker-Dealer prior to the Submission Deadline covering the number of Units of Bonds of a particular Series to be converted for which such Broker-Dealer is the Broker-Dealer of record, the Auction Agent shall deem a Sell Order to have been submitted on behalf of such Broker-Dealer covering the number of Units of Bonds to be converted for which such Broker-Dealer is the Broker-Dealer of record not subject to Orders submitted by such Broker-Dealer.

(h) Any Bid specifying a rate higher than the Maximum Rate will (i) be treated as a Sell Order if submitted by an Existing Owner and (ii) not accepted if submitted by a Potential Owner.

Section 2.04. Determination of Auction Period Rate. (a) If requested by the Trustee or a Broker-Dealer, not later than 10:30 a.m., New York City time (or such other time as may be agreed to by the Auction Agent and all Broker-Dealers), on each Auction Date for each Series of Bonds, the Auction Agent shall advise such Broker-Dealer (and thereafter confirm to the Trustee, if requested) of the All Hold Rate, the Index and, if the Maximum Rate is not a fixed interest rate, the Maximum Rate. Such advice, and confirmation, shall be made by telephone or other Electronic Means acceptable to the Auction Agent.

(b) Promptly after the Submission Deadline for each Series of Bonds on each Auction Date, the Auction Agent shall assemble all Orders submitted or deemed submitted to it by the Broker-Dealers (each such Order as submitted or deemed submitted by a Broker-Dealer being hereinafter referred to as a "Submitted Hold Order," a "Submitted Bid" or a "Submitted Sell Order," as the case may be, and collectively as a "Submitted Order") and shall determine (i) the Available Bonds, (ii) whether there are Sufficient Clearing Bids, and (iii) the Auction Rate.

(c) In the event the Auction Agent shall fail to calculate or, for any reason, fails to provide the Auction Rate on the Auction Date, for any Auction Period (i) if the preceding Auction Period was a period of 35 days or less, (A) a new Auction Period shall be established for the same length of time as the preceding Auction Period, if the failure to make such calculation was because there was not at the time a duly appointed and acting Auction Agent or Broker-

Dealer, and the Auction Period Rate for the new Auction Period shall be the percentage of the Index set forth in Schedule I under “Determination of Auction Period Rate” if the Index is ascertainable on such date (by the Auction Agent, if there is at the time an Auction Agent, or the Trustee, if at the time there is no Auction Agent) or, (B) if the failure to make such calculation was for any other reason or if the Index is not ascertainable on such date, the prior Auction Period shall be extended to the seventh day following the day that would have been the last day of the preceding Auction Period (or if such seventh day is not followed by a Business Day then to the next succeeding day that is followed by a Business Day) and the Auction Period Rate for the period as so extended shall be the same as the Auction Period Rate for the Auction Period prior to the extension, and (ii) if the preceding Auction Period was a period of greater than 35 days, (A) a new Auction Period shall be established for a period that ends on the seventh day following the day that was the last day of the preceding Auction Period, (or if such seventh day is not followed by a Business Day then to the next succeeding day which is followed by a Business Day) if the failure to make such calculation was because there was not at the time a duly appointed and acting Auction Agent or Broker-Dealer, and the Auction Period Rate for the new Auction Period shall be the percentage of the Index set forth in Schedule I under “Determination of Auction Period Rate” if the Index is ascertainable on such date (by the Auction Agent, if there is at the time an Auction Agent, or the Trustee, if at the time there is no Auction Agent) or, (B) if the failure to make such calculation was for any other reason or if the Index is not ascertainable on such date, the prior Auction Period shall be extended to the seventh day following the day that would have been the last day of the preceding Auction Period (or if such seventh day is not followed by a Business Day then to the next succeeding day that is followed by a Business Day) and the Auction Period Rate for the period as so extended shall be the same as the Auction Period Rate for the Auction Period prior to the extension. In the event a new Auction Period is established as set forth in clause (ii) (A) above, an Auction shall be held on the last Business Day of the new Auction Period to determine an Auction Rate for an Auction Period beginning on the Business Day immediately following the last day of the new Auction Period and ending on the date on which the Auction Period otherwise would have ended had there been no new Auction Period or Auction Periods subsequent to the last Auction Period for which a Winning Bid Rate or an All Hold Rate had been determined. In the event an Auction Period is extended as set forth in clause (i) (B) or (ii) (B) above, an Auction shall be held on the last Business Day of the Auction Period as so extended to determine an Auction Rate for an Auction Period beginning on the Business Day immediately following the last day of the extended Auction Period and ending on the date on which the Auction Period otherwise would have ended had there been no extension of the prior Auction Period.

Notwithstanding the foregoing, neither new nor extended Auction Periods shall total more than 35 days in the aggregate. If at the end of the 35 days the Auction Agent fails to calculate or provide the Auction Rate, or there is not at the time a duly appointed and acting Auction Agent or Broker-Dealer, the Auction Period Rate shall be the Maximum Rate.

(d) In the event of a failed conversion from an Auction Period to any other period or in the event of a failure to change the length of the current Auction Period due to the lack of Sufficient Clearing Bids at the Auction on the Auction Date for the first new Auction Period, the Auction Period Rate for the next Auction Period shall be the Maximum Rate and the Auction Period shall be a seven-day Auction Period.

(e) If the Bonds are no longer maintained in book-entry-only form by the Securities Depository, then the Auctions shall cease and the Auction Period Rate shall be the Maximum Rate.

Section 2.05. Allocation of Bonds.

(a) In the event of Sufficient Clearing Bids for a Series of Bonds, subject to the further provisions of subsections (c) and (d) below, Submitted Orders for each Series of Bonds shall be accepted or rejected as follows in the following order of priority:

(i) the Submitted Hold Order of each Existing Owner shall be accepted, thus requiring each such Existing Owner to continue to hold the Bonds that are the subject of such Submitted Hold Order;

(ii) the Submitted Sell Order of each Existing Owner shall be accepted and the Submitted Bid of each Existing Owner specifying any rate that is higher than the Winning Bid Rate shall be rejected, thus requiring each such Existing Owner to sell the Bonds that are the subject of such Submitted Sell Order or Submitted Bid;

(iii) the Submitted Bid of each Existing Owner specifying any rate that is lower than the Winning Bid Rate shall be accepted, thus requiring each such Existing Owner to continue to hold the Bonds that are the subject of such Submitted Bid;

(iv) the Submitted Bid of each Potential Owner specifying any rate that is lower than the Winning Bid Rate shall be accepted, thus requiring each such Potential Owner to purchase the Bonds that are the subject of such Submitted Bid;

(v) the Submitted Bid of each Existing Owner specifying a rate that is equal to the Winning Bid Rate shall be accepted, thus requiring each such Existing Owner to continue to hold the Bonds that are the subject of such Submitted Bid, but only up to and including the number of Units of Bonds obtained by multiplying (A) the aggregate number of Units of Outstanding Bonds which are not the subject of Submitted Hold Orders described in clause (i) above or of Submitted Bids described in clauses (iii) or (iv) above by (B) a fraction the numerator of which shall be the number of Units of Outstanding Bonds held by such Existing Owner subject to such Submitted Bid and the denominator of which shall be the aggregate number of Units of Outstanding Bonds subject to such Submitted Bids made by all such Existing Owners that specified a rate equal to the Winning Bid Rate, and the remainder, if any, of such Submitted Bid shall be rejected, thus requiring each such Existing Owner to sell any excess amount of Bonds;

(vi) the Submitted Bid of each Potential Owner specifying a rate that is equal to the Winning Bid Rate shall be accepted, thus requiring each such Potential Owner to purchase the Bonds that are the subject of such Submitted Bid, but only in an amount equal to the number of Units of Bonds obtained by multiplying (A) the aggregate number of Units of Outstanding Bonds which are not the subject of Submitted Hold Orders described in clause (i) above or of Submitted Bids described in clauses (iii), (iv) or (v) above by (B) a fraction the numerator of which shall be the number of Units of Outstanding Bonds subject to such Submitted Bid and the denominator of which shall be

the sum of the aggregate number of Units of Outstanding Bonds subject to such Submitted Bids made by all such Potential Owners that specified a rate equal to the Winning Bid Rate, and the remainder of such Submitted Bid shall be rejected; and

(vii) the Submitted Bid of each Potential Owner specifying any rate that is higher than the Winning Bid Rate shall be rejected.

(b) In the event there are not Sufficient Clearing Bids for a Series of Bonds, Submitted Orders for each Series of Bonds shall be accepted or rejected as follows in the following order of priority:

(i) the Submitted Hold Order of each Existing Owner shall be accepted, thus requiring each such Existing Owner to continue to hold the Bonds that are the subject of such Submitted Hold Order;

(ii) the Submitted Bid of each Existing Owner specifying any rate that is not higher than the Maximum Rate shall be accepted, thus requiring each such Existing Owner to continue to hold the Bonds that are the subject of such Submitted Bid;

(iii) the Submitted Bid of each Potential Owner specifying any rate that is not higher than the Maximum Rate shall be accepted, thus requiring each such Potential Owner to purchase the Bonds that are the subject of such Submitted Bid;

(iv) the Submitted Sell Orders of each Existing Owner shall be accepted as Submitted Sell Orders and the Submitted Bids of each Existing Owner specifying any rate that is higher than the Maximum Rate shall be deemed to be and shall be accepted as Submitted Sell Orders, in both cases only up to and including the number of Units of Bonds obtained by multiplying (A) the aggregate number of Units of Bonds subject to Submitted Bids described in clause (iii) of this subsection (b) by (B) a fraction the numerator of which shall be the number of Units of Outstanding Bonds held by such Existing Owner subject to such Submitted Sell Order or such Submitted Bid deemed to be a Submitted Sell Order and the denominator of which shall be the number of Units of Outstanding Bonds subject to all such Submitted Sell Orders and such Submitted Bids deemed to be Submitted Sell Orders, and the remainder of each such Submitted Sell Order or Submitted Bid shall be deemed to be and shall be accepted as a Hold Order and each such Existing Owner shall be required to continue to hold such excess amount of Bonds; and

(v) the Submitted Bid of each Potential Owner specifying any rate that is higher than the Maximum Rate shall be rejected.

(c) If, as a result of the undertakings described in Section 2.05(a) or (b) above, any Existing Owner or Potential Owner would be required to purchase or sell an aggregate principal amount of the Bonds that is not an integral multiple of an Authorized Denomination on any Auction Date, the Auction Agent shall by lot, in such manner as it shall determine in its sole discretion, round up or down the principal amount of the Bonds to be purchased or sold by any Existing Owner or Potential Owner on such Auction Date so that the aggregate principal amount of the Bonds purchased or sold by each Existing Owner or Potential Owner on such Auction

Date shall be an integral multiple of such Authorized Denomination, even if such allocation results in one or more of such Existing Owners or Potential Owners not purchasing or selling any Bonds on such Auction Date.

(d) If, as a result of the undertakings described in Section 2.05(a) above, any Potential Owner would be required to purchase less than an Authorized Denomination in principal amount of the Bonds on any Auction Date, the Auction Agent shall by lot, in such manner as it shall determine in its sole discretion, allocate the Bonds for purchase among Potential Owners so that the principal amount of the Bonds purchased on such Auction Date by any Potential Owner shall be an integral multiple of such Authorized Denomination, even if such allocation results in one or more of such Potential Owners not purchasing the Bonds on such Auction Date.

Section 2.06. Notice of Auction Period Rate. (a) On each Auction Date, the Auction Agent shall notify each Broker-Dealer that participated in the Auction held on such Auction Date by Electronic Means acceptable to the Auction Agent and the applicable Broker-Dealer of the following, with respect to each Series of Bonds for which an Auction was held on such Auction Date:

(i) the Auction Period Rate determined on such Auction Date for the succeeding Auction Period;

(ii) whether Sufficient Clearing Bids existed for the determination of the Winning Bid Rate;

(iii) if such Broker-Dealer submitted a Bid or a Sell Order on behalf of an Existing Owner, whether such Bid or Sell Order was accepted or rejected and the number of Units of Bonds, if any, to be sold by such Existing Owner;

(iv) if such Broker-Dealer submitted a Bid on behalf of a Potential Owner, whether such Bid was accepted or rejected and the number of Units of Bonds, if any, to be purchased by such Potential Owner;

(v) if the aggregate number of Units of the Bonds to be sold by all Existing Owners on whose behalf such Broker-Dealer submitted Bids or Sell Orders is different from the aggregate number of Units of Bonds to be purchased by all Potential Owners on whose behalf such Broker-Dealer submitted a Bid, the name or names of one or more Broker-Dealers (and the Agent Member, if any, of each such other Broker-Dealer) and the number of Units of Bonds to be (A) purchased from one or more Existing Owners on whose behalf such other Broker-Dealers submitted Bids or Sell Orders or (B) sold to one or more Potential Owners on whose behalf such Broker-Dealer submitted Bids; and

(vi) the amount of dividend or interest payable per Unit on each Interest Payment Date with respect to such Auction Period; and

(vii) the immediately succeeding Auction Date.

(b) On each Auction Date, with respect to each Series of Bonds for which an Auction was held on such Auction Date, each Broker-Dealer that submitted an Order on behalf of any Existing Owner or Potential Owner shall: (i) if requested by an Existing Owner or a Potential Owner, advise such Existing Owner or Potential Owner on whose behalf such Broker-Dealer submitted an Order as to (A) the Auction Period Rate determined on such Auction Date, (B) whether any Bid or Sell Order submitted on behalf of such Owner was accepted or rejected and (C) the immediately succeeding Auction Date; (ii) instruct each Potential Owner on whose behalf such Broker-Dealer submitted a Bid that was accepted, in whole or in part, to instruct such Potential Owner's Agent Member to pay to such Broker-Dealer (or its Agent Member) through the Securities Depository the amount necessary to purchase the number of Units of Bonds to be purchased pursuant to such Bid (including, with respect to the Bonds in a daily Auction Period, accrued interest if the purchase date is not an Interest Payment Date for such Bond) against receipt of such Bonds; and (iii) instruct each Existing Owner on whose behalf such Broker-Dealer submitted a Sell Order that was accepted or a Bid that was rejected in whole or in part, to instruct such Existing Owner's Agent Member to deliver to such Broker-Dealer (or its Agent Member) through the Securities Depository the number of Units of Bonds to be sold pursuant to such Bid or Sell Order against payment therefor.

(c) The Auction Agent shall give notice of the Auction Rate to the Corporation, Issuer and Trustee by mutually acceptable Electronic Means and the Trustee shall promptly give notice of such Auction Rate to the Securities Depository.

Section 2.07. Index.

(a) If for any reason on any Auction Date the Index shall not be determined as provided in Schedule I, the Index shall be the Index for the prior Business Day.

(b) The determination of the Index as provided in Schedule I and herein shall be conclusive and binding upon the Issuer, the Corporation, the Trustee, the Broker-Dealers, the Auction Agent and the Owners of the Bonds.

Section 2.08. Miscellaneous Provisions Regarding Auctions.

(a) In this Appendix, each reference to the purchase, sale or holding of Bonds shall refer to beneficial interests in Bonds, unless the context clearly requires otherwise.

(b) During an ARS Rate Period with respect to each Series of Bonds, the provisions of the Authorizing Document and the definitions contained therein and described in this Appendix, including without limitation the definitions of All Hold Rate, Index, Interest Payment Date, Maximum Rate, Auction Period Rate and Auction Rate, may be amended pursuant to the Authorizing Document by obtaining the consent of the owners of all affected Outstanding Bonds bearing interest at the Auction Period Rate as follows. If on the first Auction Date occurring at least 20 days after the date on which the Trustee mailed notice of such proposed amendment to the registered owners of the affected Outstanding Bonds as required by the Authorizing Document, (i) the Auction Period Rate which is determined on such date is the Winning Bid Rate or the All Hold Rate and (ii) there is delivered to the Corporation and the Trustee an opinion of Bond Counsel to the effect that such amendment shall not adversely affect

the validity of the Bonds or any exemption from federal income taxation to which the interest on the Bonds would otherwise be entitled, the proposed amendment shall be deemed to have been consented to by the registered owners of all affected Outstanding Bonds bearing interest at an Auction Period Rate.

(c) If the Securities Depository notifies the Issuer that it is unwilling or unable to continue as registered owner of the Bonds or if at any time the Securities Depository shall no longer be registered or in good standing under the Securities Exchange Act of 1934, as amended, or other applicable statute or regulation and a successor to the Securities Depository is not appointed by the Issuer within 90 days after the Issuer receives notice or becomes aware of such condition, as the case may be, the Auctions shall cease and the Issuer shall execute and the Trustee shall authenticate and deliver certificates representing the Bonds. Such Bonds shall be registered in such names and Authorized Denominations as the Securities Depository, pursuant to instructions from the Agent Members or otherwise, shall instruct the Issuer and the Trustee.

During an ARS Rate Period, so long as the ownership of the Bonds is maintained in book-entry form by the Securities Depository, an Existing Owner or a beneficial owner may sell, transfer or otherwise dispose of a Bond only pursuant to a Bid or Sell Order in accordance with the Auction Procedures or to or through a Broker-Dealer, provided that (i) in the case of all transfers other than pursuant to Auctions, such Existing Owner or its Broker-Dealer or its Agent Member advises the Auction Agent of such transfer and (ii) a sale, transfer or other disposition of Bonds from a customer of a Broker-Dealer who is listed on the records of that Broker-Dealer as the holder of such Bonds to that Broker-Dealer or another customer of that Broker-Dealer shall not be deemed to be a sale, transfer or other disposition for purposes of this paragraph if such Broker-Dealer remains the Existing Owner of the Bonds so sold, transferred or disposed of immediately after such sale, transfer or disposition.

(d) Unless specifically provided otherwise in Schedule I, the Auction Agent shall continue to implement the Auction Procedures notwithstanding the occurrence of an Event of Default under the Authorizing Document.

Section 2.09. Changes in Auction Period or Auction Date.

(a) Changes in Auction Period.

(i) During any ARS Rate Period, the Corporation, may, from time to time on the Interest Payment Date immediately following the end of any Auction Period, change the length of the Auction Period with respect to all of the Bonds of a Series among daily, seven-days, 28-days, 35-days, three months, six months or a Flexible Auction Period in order to accommodate economic and financial factors that may affect or be relevant to the length of the Auction Period and the interest rate borne by such Bonds. The Corporation shall initiate the change in the length of the Auction Period by giving written notice to the Issuer, the Trustee, the Auction Agent, the Broker-Dealers and the Securities Depository that the Auction Period shall change if the conditions described herein are satisfied and the proposed effective date of the change, at least 10 Business Days prior to the Auction Date for such Auction Period.

(ii) Any such changed Auction Period shall be for a period of one day, seven-days, 28-days, 35-days, three months, six months or a Flexible Auction Period and shall be for all of the Bonds of such Series.

(iii) The change in length of the Auction Period shall take effect only if Sufficient Clearing Bids exist at the Auction on the Auction Date for such new Auction Period. For purposes of the Auction for such new Auction Period only, except to the extent any Existing Owner submits an Order with respect to such Bonds of any Series, each Existing Owner shall be deemed to have submitted Sell Orders with respect to all of its Bonds of such Series if the change is to a longer Auction Period and a Hold Order if the change is to a shorter Auction Period. If there are not Sufficient Clearing Bids for the first Auction Period, the Auction Rate for the new Auction Period shall be the Maximum Rate, and the Auction Period shall be a seven-day Auction Period.

(b) Changes in Auction Date. During any ARS Rate Period, the Auction Agent, at the direction of the Corporation, may specify an earlier or later Auction Date (but in no event more than five Business Days earlier or later) than the Auction Date that would otherwise be determined in accordance with the definition of “Auction Date” in order to conform with then current market practice with respect to similar securities or to accommodate economic and financial factors that may affect or be relevant to the day of the week constituting an Auction Date and the interest rate borne by the Bonds. The Auction Agent shall provide notice of the Corporation’s direction to specify an earlier Auction Date for an Auction Period by means of a written notice delivered at least 45 days prior to the proposed changed Auction Date to the Trustee, the Issuer, the Corporation and the Broker-Dealers with a copy to the Securities Depository. In the event the Auction Agent is instructed to specify an earlier or later Auction Date, the days of the week on which an Auction Period begins and ends, the day of the week on which an Auction Period ends and the Interest Payment Dates relating to such Auction Period shall be adjusted accordingly.

(c) Changes Resulting from Unscheduled Holidays. If, in the opinion of the Auction Agent and the Broker-Dealers, there is insufficient notice of an unscheduled holiday to allow the efficient implementation of the Auction Procedures set forth herein, the Auction Agent and the Broker-Dealers may, as they deem appropriate, set a different Auction Date and adjust any Interest Payment Dates and Auction Periods affected by such unscheduled holiday. In the event there is not agreement among the Broker-Dealers, the Auction Agent shall set the different Auction Date and make such adjustments as directed by the Broker-Dealer for a majority of the outstanding Units (based on the number of Units for which a Broker-Dealer is listed as the Broker-Dealer in the Existing Owner Registry maintained by the Auction Agent pursuant to Section 2.2(a) of the Auction Agreement), and, if there is not a majority so directing, the Auction Date shall be moved to the next succeeding Business Day following the scheduled Auction Date, and the Interest Payment Date and the Auction Period shall be adjusted accordingly.

SCHEDULE I

to

AUCTION PROCEDURES

In the event of any conflict between this Schedule I and rest of Appendix III, this Schedule I shall prevail.

DEFINITIONS

“All Hold Rate” means, as of any Auction Date (i) if the interest on the Bonds is not includable in gross income of the beneficial owner of such Bond for federal income tax purposes, 80% of the Index in effect on such Auction Date for any Bond if the Auction Period is seven days, 90% of the Index on such Auction Date for any Bond if the Auction Period is 28 days or 35 days, and 70% of the Index on such Auction Date for any Bond if the Auction Period exceeds 35 days, and (ii) if the interest on the Bonds is includable in gross income of the beneficial owner of such Bond, 90% of the Index in effect on such Auction Date for any Bond; provided, however, that the All Hold Rate shall not exceed the Maximum Rate.

“Auction Agent” shall initially be Wells Fargo Bank, National Association.

“Auction Date” shall include as part of the definition the first Auction Date which shall be October 22, 2007 for subseries 2007A-6, October 25, 2007 for subseries 2007A-7, October 24, 2007 for subseries 2007A-8 and October 23, 2007 for subseries 2007A-9.

“Authorized Denomination” means \$25,000 unless another amount is specified here.

“Authorizing Document” means the Bond Resolution.

“Bonds” means Commonwealth of Puerto Rico Public Improvement Refunding Bonds, subseries 2007A-6 through 2007A-9, inclusive.

“Broker-Dealer” means (a) initially, (i) with respect to subseries 2007A-6 and the subseries 2007A-7, UBS Securities LLC, (ii) with respect to subseries 2007A-8, Lehman Brothers Inc. and (iii) with respect to subseries 2007A-9, Morgan Stanley & Co. Incorporated, and (b) each other Person qualified under Section 8(b) of the bond Resolution to act as Broker-Dealer for a subseries of Variable Rate Bonds that are ARS and appointed by the Secretary with the consent of the applicable Bond Insurer from time to time.

“Corporation” means the Issuer.

“Index” means: (i) if the interest on the Bonds is not includable in gross income of the beneficial owner of such Bond for federal income tax purposes, on any Auction Date with respect to Bonds in any Auction Period of 35 days or less, the S&P Weekly Index and, with respect to Bonds in any Auction Period of more than 35 days, the rate on United States Treasury Securities having a maturity which most closely approximates the length of the Auction Period as last published in The Wall Street Journal or such other source as may be mutually agreed upon by the Issuer and the Broker-Dealers; and (ii) if the interest on the Bonds is includable in gross income of the beneficial owner of such Bond for federal income tax purposes, on any Auction Date with respect to Bonds in any Auction Period of 35 days or less, One-Month LIBOR and, and, with respect to Bonds in any Auction Period of more than 35 days, the rate on United States Treasury Securities having a maturity which most closely approximates the length of the Auction Period as

last published in The Wall Street Journal or such other source as may be mutually agreed upon by the Issuer and the Broker-Dealers. If any of these rates is unavailable, the Index shall be an index or rate agreed to by all Broker-Dealers and consented to by the Issuer. For the purpose of this definition an Auction Period of 35 days or less means a 35-day Auction Period or shorter Auction Period, i.e., a 35-day Auction Period which is extended because of a holiday would still be considered an Auction Period of 35 days or less.

“Initial Period” means the period from the Closing Date to but not including October 23, 2007 for subseries 2007A-6, October 26, 2007 for subseries 2007A-7, October 25, 2007 for subseries 2007A-8 and October 24, 2007 for subseries 2007A-9 with respect to the Bonds.

“Initial Period Rate” means, with respect to each of subseries 2007A-6, subseries 2007A-7, subseries 2007A-8 and subseries 2007A-9, the interest rate established therefor on or about October 15, 2007, which shall remain in effect during the Initial Period for each such subseries.

“Interest Payment Date” includes the first Interest Payment Date which shall be October 23, 2007 for subseries 2007A-6, October 26, 2007 for subseries 2007A-7, October 25, 2007 for subseries 2007A-8 and October 24, 2007 for the Series 2007A-9 for the Bonds.

“Issuer” means Commonwealth of Puerto Rico.

“Maximum Rate” means 12% per annum.

“One-Month LIBOR” means the offered rate (rounded up to the next highest one one thousandth of one percent (0.001%)) for deposits in U.S. dollars for a one-month period which appears on the Reuters Screen LIBOR01 Page at approximately 11:00 a.m., London time, on such date, or if such date is not a date on which dealings in U.S. dollars are transacted in the London Interbank market, then on the next preceding day on which such dealings were transacted in such market.

“Person” means any individual, partnership, association, corporation, joint venture, joint-stock company, unincorporated organization or government or any agency or political subdivision thereof.

“S&P Weekly Index” means the Standard & Poor’s Weekly High Grade Index which is composed of thirty-four MIG-1 rated municipal tax-exempt notes that are not subject to alternative minimum taxes and the coupon of each issue is adjusted to price that component on par and track the high-grade weekly tax-exempt levels.

Auction Procedures

Determination of Auction Period Rate. The percentage of the Index in Section 2.04(c) is 100% for any Bond the interest on which is not includable in gross income of the beneficial owner of such Bond for federal income tax purposes and 100% for any

Bond the interest on which is includable in gross income of the beneficial owner of such Bond for federal income tax purposes.

Modification of Section 2.08(b). Clause (ii) of the last sentence of Section 2.08(b) is modified by adding “(A)” after the phrase “to the Corporation and the Trustee” and the phrase “and (B) the written consent of the Insurer(s) of such Series of Bonds” prior to the phrase “the proposed amendment shall be deemed”.



Assured Guaranty Corp.
 1325 Avenue of the Americas
 New York, NY 10019
 t. 212.974.0100
 www.assuredguaranty.com

Financial Guaranty Insurance Policy

Issuer: _____ **Policy No.:** _____
Obligations: _____ **Premium:** _____
 _____ **Effective Date:** _____

Assured Guaranty Corp., a Maryland corporation ("**Assured Guaranty**"), in consideration of the payment of the Premium and on the terms and subject to the conditions of this Policy (which includes each endorsement hereto), hereby unconditionally and irrevocably agrees to pay to the trustee (the "**Trustee**") or the paying agent (the "**Paying Agent**") for the Obligations (as set forth in the documentation providing for the issuance of and securing the Obligations) for the benefit of the Holders, that portion of the Insured Payments which shall become Due for Payment but shall be unpaid by reason of Nonpayment.

Assured Guaranty will make such Insured Payments to the Trustee or the Paying Agent on the later to occur of (i) the date applicable principal or interest becomes Due for Payment, or (ii) the Business Day next following the day on which Assured Guaranty shall have Received a completed Notice of Nonpayment. If a Notice of Nonpayment by Assured Guaranty is incomplete or does not in any instance conform to the terms and conditions of this Policy, it shall be deemed not Received, and Assured Guaranty shall promptly give notice to the Trustee or the Paying Agent. Upon receipt of such notice, the Trustee or the Paying Agent may submit an amended Notice of Nonpayment. The Trustee or the Paying Agent will disburse the Insured Payments to the Holders only upon receipt by the Trustee or the Paying Agent, in form reasonably satisfactory to it of (i) evidence of the Holder's right to receive such payments, and (ii) evidence, including without limitation any appropriate instruments of assignment, that all of the Holder's rights to payment of such principal or interest Due for Payment shall thereupon vest in Assured Guaranty. Upon and to the extent of such disbursement, Assured Guaranty shall become the Holder of the Obligations, any appurtenant coupon thereto and right to receipt of payment of principal thereof or interest thereon, and shall be fully subrogated to all of the Holder's right, title and interest thereunder, including without limitation the right to receive payments in respect of the Obligations. Payment by Assured Guaranty to the Trustee or the Paying Agent for the benefit of the Holders shall discharge the obligation of Assured Guaranty under this Policy to the extent of such payment.

This Policy is non-cancelable by Assured Guaranty for any reason. The Premium on this Policy is not refundable for any reason. This Policy does not insure against loss of any prepayment premium or other acceleration payment which at any time may become due in respect of any Obligation, other than at the sole option of Assured Guaranty, nor against any risk other than Nonpayment.

Except to the extent expressly modified by any endorsement hereto, the following terms shall have the meanings specified for all purposes of this Policy. "**Avoided Payment**" means any amount previously distributed to a Holder in respect of any Insured Payment by or on behalf of the Issuer, which amount has been recovered from such Holder pursuant to the United States Bankruptcy Code in accordance with a final, nonappealable order of a court having competent jurisdiction that such payment constitutes an avoidable preference with respect to such Holder. "**Business Day**" means any day other than (i) a Saturday or Sunday, (ii) any day on which the offices of the Trustee, the Paying Agent or Assured Guaranty are closed, or (iii) any day on which banking institutions are authorized or required by law, executive order or governmental decree to be closed in the City of New York or in the State of Maryland. "**Due for Payment**" means (i) when referring to the principal of an Obligation, the stated maturity date thereof, or the date on which such Obligation shall have been duly called for mandatory sinking fund redemption, and does not refer to any earlier date on which payment is due by reason of a call for redemption (other than by mandatory sinking fund redemption), acceleration or other advancement of maturity (unless Assured Guaranty in its sole discretion elects to make any principal payment, in whole or in part, on such earlier date) and (ii) when referring to interest on an Obligation, the stated date for payment of such interest. "**Holder**" means, in respect of any Obligation, the person or entity who, at the time of Nonpayment, is entitled under the terms of such Obligation to payment of principal or interest thereunder, except that Holder shall not include the Issuer or any person or entity whose direct or indirect obligation constitutes the underlying security for the Obligations. "**Insured Payments**" means that portion of the principal of and interest on the Obligations that shall become Due for Payment but shall be unpaid by reason of Nonpayment. Insured Payments shall not include any additional amounts owing by the Issuer solely as a result of the failure by the Trustee or the Paying Agent to pay such amount when due and payable, including without limitation any such additional amounts as may be attributable to penalties or to interest accruing at a default rate, to amounts payable in respect of indemnification, or to any other additional amounts payable by the Trustee or the Paying Agent by reason of such failure. "**Nonpayment**" means, in respect of an Obligation, the failure of the Issuer to have provided sufficient funds to the Trustee or the Paying Agent for payment in full of all principal and interest Due for Payment on such Obligation. It is further understood that the term "Nonpayment" in respect of an Obligation includes any Avoided Payment. "**Receipt**" or "**Received**" means actual receipt or notice of or, if notice is given by overnight or other delivery service, or by certified or registered United States mail, by a delivery receipt signed by a person authorized to accept delivery on behalf of the person to whom the notice was given. Notices to Assured Guaranty may be mailed by registered mail or personally delivered or telecopied to it at 1325 Avenue of the Americas, New York, New York 10019, Telephone Number: (212) 974-0100, Facsimile Number: (212) 581-3268, Attention: Risk Management Department - Public Finance Surveillance, with a copy to the General Counsel, or to such other address as shall be specified by Assured Guaranty to the Trustee or the Paying Agent in writing. A Notice of Nonpayment will be deemed to be Received by Assured Guaranty on a given Business Day if it is Received prior to 12:00 noon (New York City time) on such Business Day; otherwise it will be deemed Received on the

next Business Day. "Term" means the period from and including the Effective Date until the earlier of (i) the maturity date for the Obligations, or (ii) the date on which the Issuer has made all payments required to be made on the Obligations.

At any time during the Term of this Policy, Assured Guaranty may appoint a fiscal agent (the "Fiscal Agent") for purposes of this Policy by written notice to the Trustee or the Paying Agent, specifying the name and notice address of such Fiscal Agent. From and after the date of Receipt of such notice by the Trustee or the Paying Agent, copies of all notices and documents required to be delivered to Assured Guaranty pursuant to this Policy shall be delivered simultaneously to the Fiscal Agent and to Assured Guaranty. All payments required to be made by Assured Guaranty under this Policy may be made directly by Assured Guaranty or by the Fiscal Agent on behalf of Assured Guaranty. The Fiscal Agent is the agent of Assured Guaranty only, and the Fiscal Agent shall in no event be liable to the Trustee or the Paying Agent for any acts of the Fiscal Agent or any failure of Assured Guaranty to deposit, or cause to be deposited, sufficient funds to make payments due under this Policy.

To the fullest extent permitted by applicable law, Assured Guaranty hereby waives, in each case for the benefit of the Holders only, all rights and defenses of any kind (including, without limitation, the defense of fraud in the inducement or in fact or any other circumstance that would have the effect of discharging a surety, guarantor or any other person in law or in equity) that may be available to Assured Guaranty to deny or avoid payment of its obligations under this Policy in accordance with the express provisions hereof. Nothing in this paragraph will be construed (i) to waive, limit or otherwise impair, and Assured Guaranty expressly reserves, Assured Guaranty's rights and remedies, including, without limitation, its right to assert any claim or to pursue recoveries (based on contractual rights, securities law violations, fraud or other causes of action) against any person or entity, in each case, whether directly or acquired as a subrogee, assignee or otherwise, subsequent to making any payment to the Trustee or the Paying Agent, in accordance with the express provisions hereof, and/or (ii) to require payment by Assured Guaranty of any amounts that have been previously paid or that are not otherwise due in accordance with the express provisions of this Policy.

This Policy (which includes each endorsement hereto) sets forth in full the undertaking of Assured Guaranty with respect to the subject matter hereof, and may not be modified, altered or affected by any other agreement or instrument, including, without limitation, any modification thereto or amendment thereof. THIS POLICY IS NOT COVERED BY THE PROPERTY/CASUALTY INSURANCE SECURITY FUND SPECIFIED IN ARTICLE 76 OF THE NEW YORK INSURANCE LAW. This Policy will be governed by, and shall be construed in accordance with, the laws of the State of New York.

IN WITNESS WHEREOF, Assured Guaranty has caused this Policy to be affixed with its corporate seal, to be signed by its duly authorized officer, and to become effective and binding upon Assured Guaranty by virtue of such signature.

ASSURED GUARANTY CORP.

(SEAL)

By: _____
[Insert Authorized Signatory Name]
[Insert Authorized Signatory Title]

Signature attested to by:

Counsel



Financial Guaranty Insurance Company
 125 Park Avenue
 New York, NY 10017
 T 212-312-3000
 T 800-352-0001

Municipal Bond New Issue Insurance Policy

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

Financial Guaranty Insurance Company (“Financial Guaranty”), a New York stock insurance company, in consideration of the payment of the premium and subject to the terms of this Policy, hereby unconditionally and irrevocably agrees to pay to U.S. Bank Trust National Association or its successor, as its agent (the “Fiscal Agent”), for the benefit of Bondholders, that portion of the principal and interest on the above-described debt obligations (the “Bonds”) which shall become Due for Payment but shall be unpaid by reason of Nonpayment by the Issuer.

Financial Guaranty will make such payments to the Fiscal Agent on the date such principal or interest becomes Due for Payment or on the Business Day next following the day on which Financial Guaranty shall have received Notice of Nonpayment, whichever is later. The Fiscal Agent will disburse to the Bondholder the face amount of principal and interest which is then Due for Payment but is unpaid by reason of Nonpayment by the Issuer but only upon receipt by the Fiscal Agent, in form reasonably satisfactory to it, of (i) evidence of the Bondholder’s right to receive payment of the principal or interest Due for Payment and (ii) evidence, including any appropriate instruments of assignment, that all of the Bondholder’s rights to payment of such principal or interest Due for Payment shall thereupon vest in Financial Guaranty. Upon such disbursement, Financial Guaranty shall become the owner of the Bond, appurtenant coupon or right to payment of principal or interest on such Bond and shall be fully subrogated to all of the Bondholder’s rights thereunder, including the Bondholder’s right to payment thereof.

This Policy is non-cancellable for any reason. The premium on this Policy is not refundable for any reason, including the payment of the Bonds prior to their maturity. This Policy does not insure against loss of any prepayment premium which may at any time be payable with respect to any Bond.

As used herein, the term “Bondholder” means, as to a particular Bond, the person other than the Issuer who, at the time of Nonpayment, is entitled under the terms of such Bond to payment thereof. “Due for Payment” means, when referring to the principal of a Bond, the stated maturity date thereof or the date on which the same shall have been duly called for mandatory sinking fund redemption and does not refer to any earlier date on which payment is due by reason of call for redemption (other than by mandatory sinking fund redemption), acceleration or other advancement of maturity and means, when referring to interest on a Bond, the stated date for payment of interest. “Nonpayment” in respect of a Bond means the failure of the Issuer to have provided sufficient funds to the paying agent for payment in full of all



Financial Guaranty Insurance Company
 125 Park Avenue
 New York, NY 10017
 T 212-312-3000
 T 800-352-0001

Municipal Bond New Issue Insurance Policy

principal and interest Due for Payment on such Bond. "Notice" means telephonic or telegraphic notice, subsequently confirmed in writing, or written notice by registered or certified mail, from a Bondholder or a paying agent for the Bonds to Financial Guaranty. "Business Day" means any day other than a Saturday, Sunday or a day on which the Fiscal Agent is authorized by law to remain closed.

In Witness Whereof, Financial Guaranty has caused this Policy to be affixed with its corporate seal and to be signed by its duly authorized officer in facsimile to become effective and binding upon Financial Guaranty by virtue of the countersignature of its duly authorized representative.

President

Effective Date:

Authorized Representative

U.S. Bank Trust National Association, acknowledges that it has agreed to perform the duties of Fiscal Agent under this Policy.

Authorized Officer

SPECIMEN



Financial Guaranty Insurance Company
 125 Park Avenue
 New York, NY 10017
 T 212-312-3000
 T 800-352-0001

Endorsement
To Financial Guaranty Insurance Company
Insurance Policy

Policy Number: _____ **Control Number:** 0010001

It is further understood that the term "Nonpayment" in respect of a Bond includes any payment of principal or interest made to a Bondholder by or on behalf of the issuer of such Bond which has been recovered from such Bondholder pursuant to the United States Bankruptcy Code by a trustee in bankruptcy in accordance with a final, nonappealable order of a court having competent jurisdiction.

SPECIMEN

NOTHING HEREIN SHALL BE CONSTRUED TO WAIVE, ALTER, REDUCE OR AMEND COVERAGE IN ANY OTHER SECTION OF THE POLICY. IF FOUND CONTRARY TO THE POLICY LANGUAGE, THE TERMS OF THIS ENDORSEMENT SUPERSEDE THE POLICY LANGUAGE.

In Witness Whereof, Financial Guaranty has caused this Endorsement to be affixed with its corporate seal and to be signed by its duly authorized officer in facsimile to become effective and binding upon Financial Guaranty by virtue of the countersignature of its duly authorized representative.

President

Effective Date:

Authorized Representative

Acknowledged as of the Effective Date written above:

Authorized Officer
U.S. Bank Trust National Association, as Fiscal Agent

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**FINANCIAL
SECURITY
ASSURANCE®**

**MUNICIPAL BOND
INSURANCE POLICY**

ISSUER:

BONDS:

Policy No.: -N

Effective Date:

Premium: \$

FINANCIAL SECURITY ASSURANCE INC. ("Financial Security"), for consideration received, hereby UNCONDITIONALLY AND IRREVOCABLY agrees to pay to the trustee (the "Trustee") or paying agent (the "Paying Agent") (as set forth in the documentation providing for the issuance of and securing the Bonds) for the Bonds, for the benefit of the Owners or, at the election of Financial Security, directly to each Owner, subject only to the terms of this Policy (which includes each endorsement hereto), that portion of the principal of and interest on the Bonds that shall become Due for Payment but shall be unpaid by reason of Nonpayment by the Issuer.

On the later of the day on which such principal and interest becomes Due for Payment on the Business Day next following the Business Day on which Financial Security shall have received Notice of Nonpayment, Financial Security will disburse to or for the benefit of each Owner of a Bond the face amount of principal of and interest on the Bond that is then Due for Payment but is then unpaid by reason of Nonpayment by the Issuer, but only upon receipt by Financial Security, in a form reasonably satisfactory to it, of (a) evidence of the Owner's right to receive payment of the principal or interest then Due for Payment and (b) evidence, including any appropriate instruments of assignment, that all of the Owner's rights with respect to payment of such principal or interest that is Due for Payment shall thereupon vest in Financial Security. A Notice of Nonpayment will be deemed received on a given Business Day if it is received prior to 1:00 p.m. (New York time) on such Business Day; otherwise, it will be deemed received on the next Business Day. If any Notice of Nonpayment received by Financial Security is incomplete, it shall be deemed not to have been received by Financial Security for purposes of the preceding sentence and Financial Security shall promptly so advise the Trustee, Paying Agent or Owner, as appropriate, who may submit an amended Notice of Nonpayment. Upon disbursement in respect of a Bond, Financial Security shall become the owner of the Bond, any appurtenant coupon to the Bond or right to receipt of payment of principal of or interest on the Bond and shall be fully subrogated to the rights of the Owner, including the Owner's right to receive payments under the Bond, to the extent of any payment by Financial Security hereunder. Payment by Financial Security to the Trustee or Paying Agent for the benefit of the Owners shall, to the extent thereof, discharge the obligation of Financial Security under this Policy.

Except to the extent expressly modified by an endorsement hereto, the following terms shall have the meanings specified for all purposes of this Policy. "Business Day" means any day other than (a) a Saturday or Sunday or (b) a day on which banking institutions in the State of New York or the Insurer's Fiscal Agent are authorized or required by law or executive order to remain closed. "Due for Payment" means (a) when referring to the principal of a Bond, payable on the stated maturity date thereof or the date on which the same shall have been duly called for mandatory sinking fund redemption and does not refer to any earlier date on which payment is due by reason of call for redemption (other than by mandatory sinking fund redemption), acceleration or other advancement of maturity unless Financial Security shall elect, in its sole discretion, to pay such principal due upon such acceleration together with any accrued interest to the date of acceleration and (b) when referring to interest on a Bond, payable on the stated date for payment of interest. "Nonpayment" means, in respect of a Bond, the failure of the Issuer to have provided sufficient funds to the Trustee or, if there is no Trustee, to the Paying Agent for payment in full of all principal and interest that is Due for Payment on such Bond. "Nonpayment" shall also include, in respect of a Bond, any payment of principal or interest that is Due for Payment

made to an Owner by or on behalf of the Issuer which has been recovered from such Owner pursuant to the United States Bankruptcy Code by a trustee in bankruptcy in accordance with a final, nonappealable order of a court having competent jurisdiction. "Notice" means telephonic or telecopied notice, subsequently confirmed in a signed writing, or written notice by registered or certified mail, from an Owner, the Trustee or the Paying Agent to Financial Security which notice shall specify (a) the person or entity making the claim, (b) the Policy Number, (c) the claimed amount and (d) the date such claimed amount became Due for Payment. "Owner" means, in respect of a Bond, the person or entity who, at the time of Nonpayment, is entitled under the terms of such Bond to payment thereof except that "Owner" shall not include the Issuer or any person or entity whose direct or indirect obligation constitutes the underlying security for the Bonds.

Financial Security may appoint a fiscal agent (the "Insurer's Fiscal Agent") for purposes of this Policy by giving written notice to the Trustee and the Paying Agent specifying the name and notice address of the Insurer's Fiscal Agent. From and after the date of receipt of such notice by the Trustee and the Paying Agent, (a) copies of all notices required to be delivered to Financial Security pursuant to this Policy shall be simultaneously delivered to the Insurer's Fiscal Agent and to Financial Security and shall not be deemed received until received by both and (b) all payments required to be made by Financial Security under this Policy may be made directly by Financial Security or by the Insurer's Fiscal Agent on behalf of Financial Security. The Insurer's Fiscal Agent is the agent of Financial Security only and the Insurer's Fiscal Agent shall in no event be liable to any Owner for any act of the Insurer's Fiscal Agent or any failure of Financial Security to deposit or cause to be deposited sufficient funds to make payments due under this Policy.

To the fullest extent permitted by applicable law, Financial Security agrees not to assert, and hereby waives, only for the benefit of each Owner, all rights (whether by counterclaim, setoff or otherwise) and defenses (including, without limitation, the defense of fraud), whether acquired by subrogation, assignment or otherwise, to the extent that such rights and defenses may be available to Financial Security to avoid payment of its obligations under this Policy in accordance with the express provisions of this Policy.

This Policy sets forth in full the undertaking of Financial Security, and shall not be modified, altered or affected by any other agreement or instrument, including any modification or amendment thereto. Except to the extent expressly modified by an endorsement hereto, (a) any premium paid in respect of this Policy is nonrefundable for any reason whatsoever, including payment, or provision being made for payment, of the Bonds prior to maturity and (b) this Policy may not be canceled or revoked. THIS POLICY IS NOT COVERED BY THE PROPERTY/CASUALTY INSURANCE SECURITY FUND SPECIFIED IN ARTICLE 76 OF THE NEW YORK INSURANCE LAW.

In witness whereof, FINANCIAL SECURITY ASSURANCE INC. has caused this Policy to be executed on its behalf by its Authorized Officer.

[Countersignature]

FINANCIAL SECURITY ASSURANCE INC.

By _____

By _____
Authorized Officer

A subsidiary of Financial Security Assurance Holdings Ltd.
31 West 52nd Street, New York, N.Y. 10019

(212) 826-0100

Form 500NY (5/90)

FINANCIAL GUARANTY INSURANCE POLICY

APPENDIX VII

**MBIA Insurance Corporation
Armonk, New York 10504**

Policy No. [NUMBER]

MBIA Insurance Corporation (the "Insurer"), in consideration of the payment of the premium and subject to the terms of this policy, hereby unconditionally and irrevocably guarantees to any owner, as hereinafter defined, of the following described obligations, the full and complete payment required to be made by or on behalf of the Issuer to [PAYING AGENT/TRUSTEE] or its successor (the "Paying Agent") of an amount equal to (i) the principal of (either at the stated maturity or by any advancement of maturity pursuant to a mandatory sinking fund payment) and interest on, the Obligations (as that term is defined below) as such payments shall become due but shall not be so paid (except that in the event of any acceleration of the due date of such principal by reason of mandatory or optional redemption or acceleration resulting from default or otherwise, other than any advancement of maturity pursuant to a mandatory sinking fund payment, the payments guaranteed hereby shall be made in such amounts and at such times as such payments of principal would have been due had there not been any such acceleration, unless the Insurer elects, in its sole discretion, to pay in whole or in part any principal due by reason of such acceleration); and (ii) the reimbursement of any such payment which is subsequently recovered from any owner pursuant to a final judgment by a court of competent jurisdiction that such payment constitutes an avoidable preference to such owner within the meaning of any applicable bankruptcy law. The amounts referred to in clauses (i) and (ii) of the preceding sentence shall be referred to herein collectively as the "Insured Amounts." "Obligations" shall mean:

**[PAR]
[LEGAL NAME OF ISSUE]**

Upon receipt of telephonic or telegraphic notice, such notice subsequently confirmed in writing by registered or certified mail, or upon receipt of written notice by registered or certified mail, by the Insurer from the Paying Agent or any owner of an Obligation the payment of an Insured Amount for which is then due, that such required payment has not been made, the Insurer on the due date of such payment or within one business day after receipt of notice of such nonpayment, whichever is later, will make a deposit of funds, in an account with U.S. Bank Trust National Association, in New York, New York, or its successor, sufficient for the payment of any such Insured Amounts which are then due. Upon presentment and surrender of such Obligations or presentment of such other proof of ownership of the Obligations, together with any appropriate instruments of assignment to evidence the assignment of the Insured Amounts due on the Obligations as are paid by the Insurer, and appropriate instruments to effect the appointment of the Insurer as agent for such owners of the Obligations in any legal proceeding related to payment of Insured Amounts on the Obligations, such instruments being in a form satisfactory to U.S. Bank Trust National Association, U.S. Bank Trust National Association shall disburse to such owners, or the Paying Agent payment of the Insured Amounts due on such Obligations, less any amount held by the Paying Agent for the payment of such Insured Amounts and legally available therefor. This policy does not insure against loss of any prepayment premium which may at any time be payable with respect to any Obligation.

As used herein, the term "owner" shall mean the registered owner of any Obligation as indicated in the books maintained by the Paying Agent, the Issuer, or any designee of the Issuer for such purpose. The term owner shall not include the Issuer or any party whose agreement with the Issuer constitutes the underlying security for the Obligations.

Any service of process on the Insurer may be made to the Insurer at its offices located at 113 King Street, Armonk, New York 10504 and such service of process shall be valid and binding.

This policy is non-cancellable for any reason. The premium on this policy is not refundable for any reason including the payment prior to maturity of the Obligations.

IN WITNESS WHEREOF, the Insurer has caused this policy to be executed in facsimile on its behalf by its duly authorized officers, this [DAY] day of [MONTH, YEAR].

COUNTERSIGNED:

SPECIMEN

Resident Licensed Agent

City, State

STD-RCS-7
01/05

MBIA Insurance Corporation

SPECIMEN

resident

Attest:

Assistant Secretary

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