



**\$407,595,000**  
**Commonwealth of Puerto Rico**

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**\$57,155,000**  
**Public Improvement Refunding Bonds, Series 1996**

| <u>Year</u> | <u>Amount</u> | <u>Interest Rate</u> | <u>Price or Yield</u> |
|-------------|---------------|----------------------|-----------------------|
| 1997        | \$ 420,000    | 3.875%               | 3.95%                 |
| 1998        | 435,000       | 4.10                 | 4.15                  |
| 1999        | 455,000*      | 4                    | 4.10                  |
| 2000        | 470,000*      | 4¾                   | 4.20                  |
| 2001        | 8,185,000*    | 5                    | 4.33                  |
| 2002        | 8,600,000*    | 4.40                 | 4.50                  |
| 2003        | 8,990,000*    | 4½                   | 4.60                  |
| 2004        | 9,390,000*    | 4.60                 | 4.70                  |
| 2005        | 9,830,000*    | 5½                   | 4.75                  |
| 2006        | 10,380,000*   | 5½                   | 4.80                  |

**\$350,440,000**  
**Public Improvement Bonds of 1996**

| <u>Year</u> | <u>Amount</u> | <u>Interest Rate</u> | <u>Price or Yield</u> |
|-------------|---------------|----------------------|-----------------------|
| 1996        | \$ 5,065,000  | 4 %                  | 3.882%                |
| 1997        | 5,265,000     | 3.875                | 3.95                  |
| 1998        | 5,470,000     | 4.10                 | 4.15                  |
| 1999        | 5,695,000*    | 4                    | 4.10                  |
| 2000        | 5,925,000*    | 4¾                   | 4.20                  |
| 2001        | 6,205,000*    | 5                    | 4.33                  |
| 2002        | 6,515,000*    | 4.40                 | 4.50                  |
| 2003        | 6,800,000*    | 4½                   | 4.60                  |
| 2004        | 7,110,000*    | 4.60                 | 4.70                  |
| 2005        | 7,435,000*    | 5½                   | 4.75                  |
| 2006        | 7,845,000*    | 5½                   | 4.80                  |
| 2007        | 8,275,000*    | 6½                   | 4.85                  |
| 2008        | 8,815,000*    | 6½                   | 4.93                  |
| 2012        | 11,185,000    | 6½                   | 5.33                  |
| 2013        | 11,915,000    | 6½                   | 5.38                  |
| 2014        | 12,690,000    | 6½                   | 5.43                  |
| 2015        | 13,510,000    | 6½                   | 5.45                  |

\$15,000,000\* Auction Rate Securities<sup>SM</sup> due July 1, 2011      \$15,000,000\* Inverse Rate Securities<sup>SM</sup> due July 1, 2011

Price of ARS and IRS: NRO†

\$ 29,570,000 5½% Term Bonds due July 1, 2017 — Price — 98.266%  
\$155,150,000 5.40% Term Bonds due July 1, 2025 — Price — 95.739%

\* Insured by MBIA Insurance Corp.

<sup>SM</sup> Service mark of Smith Barney Inc.

† Not reoffered.

*Commonwealth of Puerto Rico*

*Governor*

PEDRO J. ROSSELLÓ

*Members of the Cabinet*

PEDRO R. PIERLUISI  
Secretary of Justice

MANUEL DÍAZ SALDAÑA  
Secretary of the Treasury

NORMA E. BURGOS ANDUJAR  
Secretary of State

VICTOR FAJARDO  
Secretary of Education

CÉSAR ALMODÓVAR MARCHANY  
Secretary of Labor and Human  
Resources

CARMEN FELICIANO DE MELECIO  
Secretary of Health

NEFTALÍ SOTO SANTIAGO  
Secretary of Agriculture

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Secretary of Transportation and  
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Secretary of Family Affairs

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Secretary of Housing

PEDRO A. GELABERT  
Secretary of Natural and  
Environmental Resources

JOSÉ A. ALICEA  
Secretary of Consumer Affairs

ERIC R. LABRADOR ROSA  
Secretary of Sports and Recreation

NYDIA COTTO VIVES  
Secretary of Corrections  
and Rehabilitation

PEDRO TOLEDO  
Commissioner of  
Protection and Public Safety

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*Legislative Officers*

ROBERTO REXACH BENÍTEZ  
President, Senate

ZAIDA HERNÁNDEZ TORRES  
Speaker, House of  
Representatives

*Fiscal Officers*

JORGE E. APONTE HERNÁNDEZ  
Office of Management and Budget

MARCOS RODRÍGUEZ-EMA  
President, Government Development  
Bank for Puerto Rico

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

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**\$407,595,000**

**Commonwealth of Puerto Rico**

**\$57,155,000 Public Improvement Refunding Bonds, Series 1996**

**\$350,440,000 Public Improvement Bonds of 1996**

**(General Obligation Bonds)**

**INTRODUCTORY STATEMENT**

This Official Statement of the Commonwealth of Puerto Rico (the "Commonwealth" or "Puerto Rico"), which includes the cover pages and the appendices, provides certain information in connection with the sale of \$57,155,000 Commonwealth of Puerto Rico Public Improvement Refunding Bonds, Series 1996 (the "Refunding Bonds") and \$350,440,000 Commonwealth of Puerto Rico Public Improvement Bonds of 1996 (the "Public Improvement Bonds" and, together with the Refunding Bonds, the "Bonds"). The Public Improvement Bonds maturing July 1, 2011 will be delivered as \$15,000,000 principal amount of Auction Rate Securities<sup>SM</sup> (the "ARS") and \$15,000,000 principal amount of Inverse Rate Securities<sup>SM</sup> (the "IRS"; the ARS and the IRS when referred to collectively are called the "AIRS"). The Refunding Bonds maturing July 1 of the years 1999 through 2006 and the Public Improvement Bonds maturing July 1 of the years 1999 through 2008 and the AIRS (collectively, the "Insured Bonds") are insured by a municipal bond insurance policy (the "MBIA Policy") issued by MBIA Insurance Corporation (the "Insurer").

The Refunding 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, "Act No. 2"), and pursuant to a resolution authorizing the issuance of the Refunding Bonds (the "Refunding Bond Resolution") adopted by the Secretary of the Treasury and approved by the Governor of Puerto Rico on January 18, 1996. The Public Improvement Bonds are being issued under the provisions of Act No. 119 of the Legislature of Puerto Rico, approved August 9, 1995 ("Act No. 119" and, together with Act No. 2, the "Act"), and pursuant to a resolution authorizing the issuance of the Public Improvement Bonds (the "Public Improvement Bond Resolution" and, together with the Refunding Bond Resolution, the "Bond Resolution") adopted by the Secretary of the Treasury and approved by the Governor of Puerto Rico on January 18, 1996.

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 the interest on the Bonds. The Constitution of Puerto Rico provides that public debt of the Commonwealth, including the Bonds, constitutes a first claim on available Commonwealth revenues.

**OVERVIEW**

The following is a summary of certain information regarding the Commonwealth contained in *Appendix I* and does not purport to be complete. This summary is qualified in its entirety by reference to the more detailed information appearing in *Appendix I*, which should be read in its entirety.

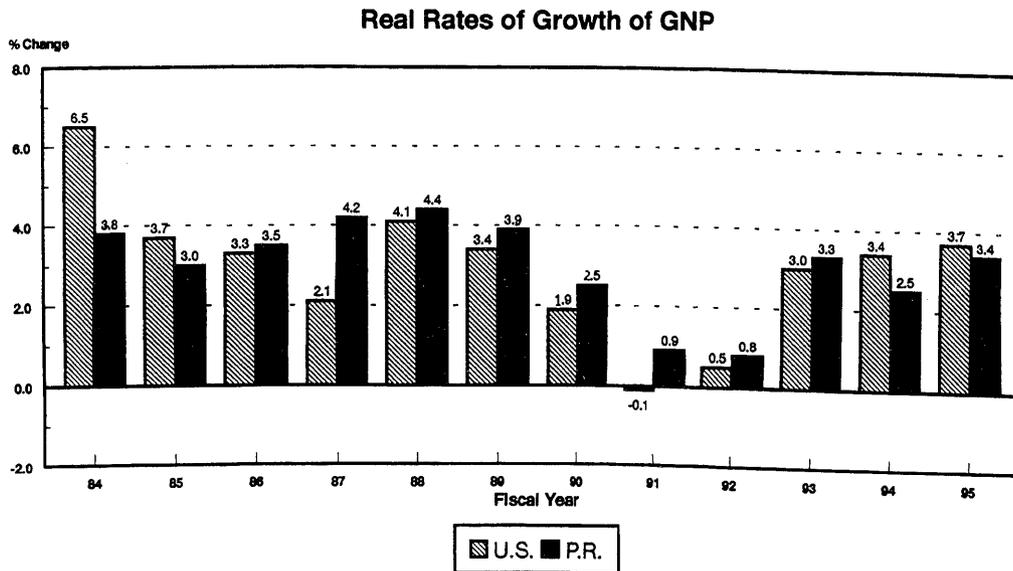
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<sup>SM</sup> Service mark of Smith Barney Inc.

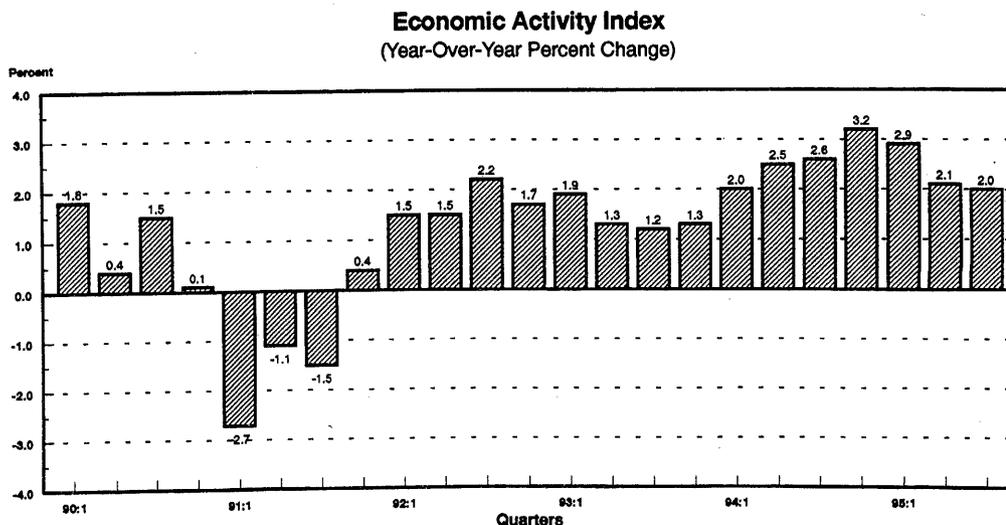
Puerto Rico is located in the Caribbean approximately 1,600 miles southeast of New York City. Its population was, according to the United States Census Bureau, just under 3,522,000 in 1990, and, according to estimates of the Puerto Rico Planning Board, increased to 3,703,000 in fiscal 1995. Puerto Rico's constitutional status is that of an unincorporated territory of the United States and the ultimate source of power over Puerto Rico, pursuant to the Territory Clause of the Federal Constitution, is the United States Congress. The relationship between the United States and Puerto Rico is referred to herein as commonwealth status. The government of the Commonwealth exercises virtually the same control over its internal affairs as do the fifty states, with similar separation of powers among the executive, legislative and judicial branches. The official languages of Puerto Rico are Spanish and English.

### Economic Trends

Puerto Rico has experienced a wide ranging expansion since 1983 with growth in almost every sector of its economy and record levels of employment. Although the increase in real gross product slowed to 0.9% in fiscal 1991 and 0.8% in fiscal 1992, reflecting the effects of the recession in the United States economy, the growth pattern has since continued with real gross product increases of 2.5% and 3.4% for the fiscal years 1994 and 1995, respectively, corresponding to the continuing economic rebound in the United States. While trends in the Puerto Rico economy normally follow those in the United States, Puerto Rico did not experience a recession during fiscal 1991 as did the United States primarily because its manufacturing base is comprised of certain industries less prone to business cycle fluctuations. Other factors contributing to Puerto Rico's decade-long expansion include Commonwealth-sponsored economic development programs, the relatively stable prices of oil imports, the continued growth in the United States economy, declines in the exchange value of the United States dollar and the relatively low cost of borrowing during the period. For November 1995, employment (Household Employment Survey) increased to a record level of 1,095,000 (seasonally adjusted), representing the addition of 63,000 new jobs over the prior twelve months. This job increase resulted in an unemployment rate, seasonally adjusted, of 13.4% as of November 1995.



In the first four months of fiscal 1996, the Economic Activity Index, a composite index of thirteen coincident economic indicators prepared by the Puerto Rico Planning Board, increased 1.8% compared to the same period of fiscal 1995. The Index may not necessarily change at the same percentage rate as the real gross product of Puerto Rico. However, as shown by the graph, over the last two years, the Economic Activity Index has been an accurate indicator of short-term economic trends in Puerto Rico. This increase in the Economic Activity Index suggests that economic growth will continue for fiscal 1996.



Puerto Rico has a diversified economy with the manufacturing and service sectors comprising the principal sectors. Manufacturing is the largest sector in terms of gross domestic product. In fiscal 1995, manufacturing generated \$17.7 billion, or 41.8%, of gross domestic product and accounted for 16.4% of total employment; and in fiscal 1994, it generated \$16.6 billion, or 41.9%, of gross domestic product and accounted for 16.4% of total employment. See "Economic Performance by Sector" under *The Economy in Appendix I*. 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 two 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 the heavy investment in the pharmaceutical, scientific instruments, computer, microprocessor, medical product and electrical product industries over the last decade. One of the factors assisting the development of the manufacturing sector has been the tax incentives offered by the federal and Commonwealth governments. The Federal Omnibus Budget Reconciliation Act of 1993 amended Internal Revenue Code Section 936 to reduce certain federal income tax incentives. On November 17, 1995, the United States Congress adopted, as part of its larger federal income tax legislative package, a substantial modification of the current 936 credit. When the President vetoed on December 7, 1995 the legislation submitted by the Congress, the Administration made its own proposal to modify the current 936 credit. For a description of these proposals, see "Tax Incentives – Section 936" under *The Economy in Appendix I*.

The service sector, which includes hotel and related services, and which currently accounts for 47.2% of total employment, accounted for \$15.9 billion, or 37.5%, of Puerto Rico's gross domestic product in fiscal 1995, as compared with \$15.1 billion, or 38.2%, of gross domestic product in fiscal 1994. The service sector, particularly the wholesale and retail trade and finance, insurance and real estate, has experienced significant growth partly in response to the expansion of the manufacturing sector.

Growth in construction and tourism has also contributed to increased economic activity in fiscal 1995. The growth in the construction industry has been evidenced by an increase of 10.5% in construction investment for fiscal 1995 over fiscal 1994. Tourism has grown in each fiscal year since fiscal 1985. More than 4.1 million visitors spent over \$1.8 billion in Puerto Rico in fiscal 1995. San Juan has become the largest home port for cruise ships

in the Caribbean and the second largest home port for cruise ships in the world. Twenty-eight U.S. and international airlines offer scheduled service to and from San Juan, and a major U.S. airline uses San Juan as a hub for its intra-Caribbean operations. This reflects the importance of Puerto Rico as a tourist destination and as a transportation hub in the Caribbean basin.

### **Fiscal Management**

Fiscal responsibility for the Commonwealth is shared among the Department of the Treasury, the Office of Management and Budget (the "Office of Management and Budget") and Government Development Bank for Puerto Rico ("Government Development 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. The Office of Management and Budget prepares the Commonwealth's budget and has the responsibility 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.

The Department of the Treasury has made significant progress in establishing programs to increase its ability to account for and collect tax revenues. Since fiscal 1990 the complete financial statements of the Commonwealth have been audited. The financial statements for the Commonwealth for fiscal 1994 have been audited by Deloitte & Touche LLP whose report thereon is set forth in *Appendix II*. For a summary of the Commonwealth's significant accounting policies, see Note 1 to *Appendix II*. Preparation of the audited financial statements of the Commonwealth involves the collection and consolidation of audited financial statements from 44 separate reporting entities.

### **Debt Management**

The Constitution of Puerto Rico provides a limitation on the amount of general obligation debt that can be issued. 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. See "Debt Limitation" under *The Bonds*.

Historically, the Commonwealth has maintained a fiscal policy which provides for a prudent relationship between the growth of public sector debt and the growth of the economic base required to service that debt. The Commonwealth also has sought opportunities to realize debt service savings by refunding outstanding debt with obligations bearing lower interest rates. In certain years, this policy has resulted in the rate of growth of public sector debt exceeding the rate of growth of gross product. Over fiscal years 1991 to 1995, public sector debt increased 24.7% while gross product rose 24.4%. Although the rate of increase of public sector debt slightly exceeded the corresponding rate of increase of gross product for the period, these increases were principally the result of refinancings to achieve debt service savings. Short-term debt outstanding relative to total debt was 7.5% as of November 30, 1995.

## **PLAN OF FINANCING**

### **The Public Improvement Bonds**

The net proceeds of the Public Improvement Bonds will be deposited in the 1996 Public Improvements Fund established under Act No. 119 to carry out the capital improvement programs authorized by the Legislature in Act No. 119, including but not limited to highways and transportation facilities, aqueduct and sewer facilities, schools, housing, park and other recreation facilities and other governmental purposes. See "Authorization" under *The Bonds*.

**The Refunding Bonds**

The Refunding Bonds will be issued under the provisions of Act No. 2 for the purpose of refunding \$54,760,000 of the \$75,000,000 aggregate principal amount of the Commonwealth of Puerto Rico Public Improvement Bonds of 1987 maturing July 1, 2006, which will be called for redemption on July 1, 1997 at a redemption price of 102% of the principal amount thereof plus accrued interest (the "Refunded Bonds").

The refunding will permit the Commonwealth to realize savings on its aggregate debt service requirements on its general obligation bonds. The Secretary of the Treasury will deposit the net proceeds of the Refunding Bonds and certain other available moneys with State Street Bank and Trust Company, N.A., as Escrow Agent. A portion of the net proceeds and such other available moneys will be invested in noncallable direct obligations of the United States, the principal of and interest on which, with other uninvested net proceeds, will be sufficient to pay the principal of and premium on the Refunded Bonds on the redemption date set forth above, which redemption date has been irrevocably designated by the Secretary of the Treasury in the Refunding Bond Resolution, and to pay interest accrued thereon to such date. The sufficiency of the amount so deposited, with the investment earnings thereon, to accomplish the refunding of the Refunded Bonds will be verified by Deloitte & Touche LLP, the verification agent. Upon the deposit with the Escrow Agent referred to above, the Refunded Bonds will cease to be outstanding under the terms of their authorizing resolution. Under Act No. 2, 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.

**Sources and Uses of Funds**

Sources:

|   |                      |
|---|----------------------|
| Principal amount of the Bonds . . . . . | \$407,595,000        |
| Net original issue premium . . . . .    | <u>6,981,243</u>     |
| Total sources . . . . .                 | <u>\$414,576,243</u> |

Uses:

|  |                      |
|--|----------------------|
| Deposit to Escrow Fund . . . . .   | \$ 57,345,569        |
| Payment into the 1996 Public Improvements Fund . . . . .   | 351,500,000          |
| Underwriting discount, bond insurance premium, and legal, printing, and other financing expenses . . . . . | <u>5,730,674</u>     |
| Total uses . . . . .   | <u>\$414,576,243</u> |

**THE BONDS**

**General**

The Bonds will be dated, will bear interest at such rates, payable at such times, and will mature on the dates and in the principal amounts set forth on the cover or the inside cover page of this Official Statement. The Refunding Bonds are not subject to redemption prior to maturity. The Public Improvement Bonds are subject to redemption at the times and at the prices set forth below in "Redemption" and in "ARS and IRS". The ARS are subject to mandatory tender for purchase as described herein. See "ARS and IRS" and *Appendix III* hereto.

## **Book-Entry Only System**

The following information concerning The Depository Trust Company ("DTC"), New York, New York and DTC's book-entry system has been obtained from DTC; and neither the Commonwealth nor the Underwriters 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 in the name of Cede & Co. (DTC's partnership nominee). One fully registered Bond of each maturity will be issued for each maturity of the Bonds (except for the ARS and the IRS), each in the aggregate principal amount of such maturity, and will be deposited with DTC. The ARS and the IRS will be registered in the name of Cede & Co. and deposited with The Bank of New York, auction agent.

DTC is a limited-purpose trust company organized under the New York Banking Law, a "banking organization" within the meaning of the New York Banking Law, a member of the Federal Reserve System, a "clearing corporation" within the meaning of the New York Uniform Commercial Code, and a "clearing agency" registered pursuant to the provisions of Section 17A of the Securities Exchange Act of 1934. DTC holds securities that its participants (the "Participants") deposit with DTC. DTC also facilitates the settlement among Participants of securities transactions, such as transfers and pledges, in deposited securities through electronic computerized book-entry changes in Participants' accounts, thereby eliminating the need for physical movement of securities certificates. Direct Participants include securities brokers and dealers, banks, trust companies, clearing corporations, and certain other organizations (the "Direct Participants"). DTC is owned by a number of its Direct Participants and by the New York Stock Exchange, Inc., the American Stock Exchange, Inc. and the National Association of Securities Dealers, Inc. Access to the DTC system is also available to others such as securities brokers and dealers, banks and trust companies that clear through or maintain a custodial relationship with a DTC Participant, either directly or indirectly (the "Indirect Participants"). The Rules applicable to DTC and its Participants are on file with the Securities and Exchange Commission.

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

To facilitate subsequent transfers all Bonds deposited by Participants with DTC are registered in the name of DTC's partnership nominee, Cede & Co. The deposit of Bonds with DTC and their registration in the name of Cede & Co. effect no 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 not be the Beneficial Owners. The Participants will remain responsible for keeping account of their holdings on behalf of their customers.

Conveyance of notices and other communications by DTC to Direct Participants, by Direct Participants to Indirect Participants, and by Direct Participants and Indirect Participants to Beneficial Owners will be governed by arrangements among them, subject to any statutory or regulatory requirements as may be in effect from time to time.

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

Neither DTC nor Cede & Co. will consent or vote with respect to the Bonds. 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 the record date (identified in a listing attached to the Omnibus Proxy).

Principal, redemption premium, if any, and interest payments on the Bonds will be made to DTC. DTC's practice is to credit Direct Participants' accounts on the payable date in accordance with their respective holdings shown on DTC's records unless DTC has reason to believe that it will not receive payment on the payable date. Payments by Participants to Beneficial Owners will be governed by standing instructions and customary practices, as is the case with securities held for the accounts of customers in bearer form or registered in "street name", and will be the responsibility of such Participant and not of DTC, the Commonwealth, or Banco Popular de Puerto Rico as paying agent and registrar (the "Registrar"), 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 DTC is the responsibility of the Commonwealth or the Registrar, disbursement of such payments to Direct Participants shall be the responsibility of DTC, and disbursement of such payments to the Beneficial Owners shall be the responsibility of Direct and Indirect Participants.

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 are required to be printed and delivered.

The Commonwealth may decide to discontinue use of the system of book-entry transfers through DTC (or a successor securities depository). In that event, definitive Bonds will also 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 such 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 thereof as shown on the registration books of the Commonwealth maintained by the Registrar. The Bonds will be issued only as registered Bonds without coupons in denominations of \$5,000 or any multiple thereof (\$100,000 or any multiple thereof in respect of the ARS and IRS (other than Permanently Linked AIRS which will be issued in denominations of \$5,000 or any multiple thereof)). The transfer of the Bonds will be registrable and they may be exchanged at the principal 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 Legislature. Pursuant to this power, the Legislature enacted the Act, which authorizes the issuance of the Bonds.

## ARS and IRS

The following description of the ARS and the IRS is intended to summarize certain basic provisions with respect thereto. For a more complete discussion of the ARS and the IRS, including specifically the Auction Procedures, and for definitions of certain capitalized terms used herein, see *Appendix III* hereto.

Pursuant to the Public Improvement Bond Resolution, the Registrar and the Commonwealth are entitled to treat each Owner (as hereinafter defined) of ARS or IRS (including Cede & Co. or any other nominee of DTC as to any such ARS or IRS registered in the name thereof) as the owner of such ARS or IRS, as applicable, for all purposes. Neither the Registrar nor the Commonwealth shall have any duty or responsibility to recognize the beneficial ownership interests of a Beneficial Owner who has acquired a beneficial ownership interest in ARS or IRS registered in the name of Cede & Co. or any other beneficial ownership interest in ARS or IRS registered in the name of Cede & Co. or any other nominee of DTC. The procedures established by DTC, the Auction Agent and the Broker-Dealers for trading, exchanging and registering beneficial ownership interests in ARS and IRS shall be implemented by such persons consistent with the terms of the relevant agreements. The Public Improvement Bond Resolution provides that it is intended that, to the extent consistent with such agreements, the rights granted therein to the Owners of the ARS and IRS relating to the Auction Procedures, mandatory tender provisions and certain other provisions may be exercised by Beneficial Owners of the ARS and IRS. To that extent, each reference herein to the purchase, sale or holding of ARS and IRS shall refer to beneficial ownership interests in ARS and IRS, unless the context clearly requires otherwise.

### *General*

The ARS and IRS will be dated the date of delivery thereof, will mature on July 1, 2011 in the principal amounts as set forth on the inside cover of this Official Statement and will bear interest from their date payable on July 1, 1996 and on each January 1 and July 1 thereafter (each such January 1 and July 1 being herein called an "Interest Payment Date"). If any such January 1 or July 1 is not a Business Day, then the Interest Payment Date will be the Business Day next succeeding such January 1 or July 1.

### *Interest and Service Charge*

**ARS Interest Rate.** The ARS will bear interest for each Rate Period at the ARS Rate, which will be computed on the basis of actual number of days elapsed in a 360-day year. The ARS Rate will be equal to the sum of (a) the Auction Rate determined for each Rate Period in accordance with the Auction Procedures, as described in *Appendix III*, and (b) an amount equal to the Service Charge in effect for such Rate Period. Notwithstanding the foregoing, (i) if the Auction Agent shall have failed to determine the Auction Rate for any Rate Period (including the circumstance where there is no Auction Agent or no Broker-Dealer), the ARS Rate for such Rate Period shall be the No Auction Rate determined for such Rate Period plus the Service Charge then in effect; (ii) if a failure to pay principal, interest or premium on any Bond when due shall have occurred under the Bond Resolution, the ARS Rate for the Rate Period during which such failure shall have occurred and each Rate Period thereafter commencing prior to the date on which such failure shall have ceased to be continuing shall be the Default Rate for such Rate Period plus the Service Charge; and (iii) in no event shall the ARS Rate exceed 12% per annum.

**Service Charge.** The Service Charge with respect to any Auction Date is the sum of the Auction Agent Fee and the Broker-Dealer Fee with respect to such Auction Date. The Auction Agent Fee and the Broker-Dealer Fee are payable out of each interest payment on the Regular ARS and Special Linked ARS and IRS. Each Owner of Regular ARS and Special Linked ARS and IRS, by its acceptance thereof, expressly consents to the deduction by the Registrar of the Service Charge from the interest payment to be paid to such Owner on each Interest Payment Date. Owners of Linked ARS and IRS, Permanently Linked AIRS and Special ARS are not obligated to pay the Service Charge, and there is no deduction of the Service Charge with respect to Linked ARS and IRS, Permanently Linked AIRS or Special ARS. See "*Linkage of IRS and ARS*" below. Each Owner of ARS and IRS, by its acceptance thereof, expressly acknowledges that in the event the Service Charge is not deducted, but is paid to such

Owner, in a case in which the Service Charge is owed, the Broker-Dealers (for themselves and on behalf of the Auction Agent) are entitled to collect such Service Charge from the Owners who owe such Service Charge.

On each Interest Payment Date, the Registrar is to pay to the Auction Agent and the Broker-Dealer the Auction Agent Fee and the Broker-Dealer Fee from the Service Charge.

The initial Service Charge is .28 percent per annum. The Service Charge will be computed on the basis of the actual number of days elapsed in a 360-day year. The Auction Agent Fee Rate and the Broker-Dealer Fee Rate may be adjusted from time to time with the approval of the Commonwealth upon a written request of the Auction Agent or a Broker-Dealer, as the case may be, delivered to the Commonwealth and the Registrar. Pursuant to the Public Improvement Bond Resolution, the Commonwealth shall approve such a request if it finds that the proposed Auction Agent Fee Rate or Broker-Dealer Fee Rate, as the case may be, does not exceed the prevailing rate received by such entities for rendering comparable services to others. Notice of any change in the Auction Agent Fee Rate or the Broker-Dealer Fee Rate is to be mailed to all Owners of ARS and IRS by the Auction Agent at least six Business Days prior to the Auction Date for the Auction to which any such fee change is applicable.

Any increase in the Auction Agent Fee Rate or the Broker-Dealer Fee Rate would reduce the amount of interest payable on the IRS. See "Special Considerations for Purchasers of ARS and IRS" below.

*IRS Interest Rate.* The IRS will bear interest for each Rate Period at the IRS Rate, which will be computed on the basis of a 360-day year of twelve 30-day months. For each Rate Period the IRS Rate will equal the per annum rate of 12% *minus* the ARS Rate for such Rate Period.

#### *Linkage of IRS and ARS*

*Linking-Rate Lock Option.* An Owner may link IRS with an equal principal amount of Regular ARS or Special ARS by purchasing such IRS and Regular ARS or Special ARS and requesting:

- (a) its Direct Participant to deliver such IRS and Regular ARS or Special ARS free of charge by book-entry transfer from such Direct Participant's account at DTC into the Auction Agent's special account at DTC; and
- (b) its Broker-Dealer to deliver a Linkage Request to the Auction Agent.

HOWEVER, IRS AND REGULAR ARS OR SPECIAL ARS MAY NOT BE LINKED DURING EACH PERIOD (i) COMMENCING AT 11:00 A.M., NEW YORK CITY TIME, ON THE BUSINESS DAY IMMEDIATELY PRECEDING ANY RECORD DATE AND ENDING IMMEDIATELY PRIOR TO THE OPENING OF BUSINESS ON THE NEXT SUCCEEDING INTEREST PAYMENT DATE, AND (ii) COMMENCING IMMEDIATELY PRIOR TO THE OPENING OF BUSINESS ON THE SECOND BUSINESS DAY NEXT PRECEDING THE DATE ON WHICH A LOTTERY IS HELD TO SELECT ARS AND IRS FOR REDEMPTION AND ENDING IMMEDIATELY PRIOR TO THE OPENING OF BUSINESS ON THE DATE FIXED FOR SUCH REDEMPTION (EACH OF THE PERIODS DESCRIBED IN (i) AND (ii) IS HEREIN CALLED A "CLOSED PERIOD").

IN ADDITION, IF AT ANY TIME THE IRS AND ARS ARE NO LONGER EACH REPRESENTED BY A GLOBAL BOND REGISTERED IN THE NAME OF DTC OR ITS NOMINEE, IRS AND ARS MAY NOT BE LINKED, AND ANY LINKED ARS AND IRS AND ANY SPECIAL LINKED ARS AND IRS WILL THEREUPON AUTOMATICALLY BECOME UNLINKED AND THE SERVICE CHARGE WILL BE ASSESSED AGAINST EACH ARS.

The interest rate paid with respect to Linked ARS and IRS shall be 6% per annum.

The Auction Agent is to redeliver free of charge by book-entry transfer to the account at DTC of the Direct Participant specified in the Linkage Request the IRS and Regular ARS or Special ARS which have been delivered to the Auction Agent for linkage. When such IRS and Regular ARS or IRS and Special ARS are redelivered, the beneficial ownership of the resulting Special Linked ARS and IRS and Linked ARS and IRS, respectively, is to be recorded at DTC under separate CUSIP numbers.

Owners of Linked ARS and IRS and Special Linked ARS and IRS at the close of business on the Record Date immediately preceding any Auction Date may not participate (as to such Public Improvement Bonds) in the Auction held on such Auction Date and are not obligated to pay the Service Charge with respect to such Auction; provided that Owners of Special Linked ARS and IRS are obligated to pay the Service Charge for the Auction immediately preceding the date of linkage thereof which Service Charge will be deducted on the first Interest Payment Date following the date of linkage.

Linked ARS and IRS and Special Linked ARS and IRS may only be transferred as linked securities in minimum denominations of \$200,000 (\$100,000 principal amount of IRS and \$100,000 principal amount of ARS) and multiples thereof. Linked ARS and IRS and Special Linked ARS and IRS are not subject to the Auction Procedures and therefore are not subject to any transfer restrictions.

*Breaking Linkage of IRS and ARS.* An Owner of Linked ARS and IRS or Special Linked ARS and IRS may break such linkage at any time, other than during a Closed Period, by requesting:

(a) its Direct Participant to deliver such Linked ARS and IRS or Special Linked ARS and IRS free of charge by book-entry transfer from such Direct Participant's account at DTC into the Auction Agent's special account at DTC; and

(b) its Broker-Dealer to deliver a Request to Break Linkage to the Auction Agent.

The Auction Agent is to redeliver free of charge by book-entry transfer such Linked ARS and IRS or Special Linked ARS and IRS from its special account at DTC to the account at DTC of the Direct Participant specified in the Request to Break Linkage. When such Linked ARS and IRS or Special Linked ARS and IRS are redelivered, the beneficial ownership of the resulting Special ARS and IRS and Regular ARS and IRS, respectively, is to be recorded at DTC under a separate CUSIP number.

The Existing Owner of Special ARS will receive interest on such Special ARS for the Rate Period during which such Special ARS have become unlinked from Linked ARS and IRS at the ARS Rate then in effect without any Service Charge deduction.

*Rejecting IRS and ARS.* If the Auction Agent receives a Linkage Request or a Request to Break Linkage and does not receive delivery free of charge of the related IRS and ARS from the Direct Participant identified in such request prior to the beginning of the Closed Period next following the receipt thereof by the Auction Agent, the Auction Agent is directed to reject such IRS and ARS, thereby effecting the book-entry transfer of such IRS and ARS from the special account of the Auction Agent at DTC into the account of such Direct Participant at DTC. As a result, the requested linkage or the requested breaking of linkage, as the case may be, will not be made.

*Permanent Linking-Rate Lock Option.* An Owner of Linked ARS and IRS may permanently link such ARS and IRS by requesting:

(i) its Direct Participant to deliver such Linked ARS and IRS free of charge by book-entry transfer from such Direct Participant's account at DTC into the Auction Agent's special account at DTC; and

(ii) its Broker-Dealer to deliver a Permanent Linkage Request with respect to such Linked ARS and IRS to the Auction Agent.

HOWEVER, ARS AND IRS MAY NOT BE PERMANENTLY LINKED DURING A CLOSED PERIOD.

IN ADDITION, IF AT ANY TIME THE ARS AND IRS ARE NO LONGER EACH REPRESENTED BY A GLOBAL BOND REGISTERED IN THE NAME OF DTC OR ITS NOMINEE, ARS AND IRS MAY NOT BE PERMANENTLY LINKED, BUT ANY PERMANENTLY LINKED ARS AND IRS WILL NOT BECOME UNLINKED AND NO SERVICE CHARGE WILL BE ASSESSED.

The interest rate paid with respect to permanently Linked ARS and IRS shall be 6% per annum.

The Auction Agent shall redeliver free by book-entry transfer to the account at DTC of the Direct Participant specified in the Permanent Linkage Request the resulting Permanently Linked ARS and IRS. Upon such redelivery, the beneficial ownership of the resulting Permanently Linked ARS and IRS is to be recorded under the separate CUSIP number reserved for such securities.

Owners of Permanently Linked ARS and IRS at the close of business on the Record Date immediately preceding any Auction Date may not participate (as to such securities) in the Auction held on such Auction Date and may not participate (as to such securities) in any future Auctions.

Permanently Linked ARS and IRS shall be transferable only as linked securities in minimum denominations of \$5,000 and multiples thereof. Permanently Linked ARS and IRS shall not be subject to the Auction Procedures and therefore shall not be subject to any transfer restrictions. **Under no circumstances shall any Owners of Permanently Linked ARS and IRS be permitted to break the linkage of such ARS and IRS.**

*Special Considerations for Purchasers of ARS and IRS*

Prospective purchasers of IRS should note the following with respect to the IRS:

Because the interest rate on the IRS will be determined by subtracting the ARS Rate (which includes the Service Charge) from a fixed amount, the interest rate on the IRS will:

*decrease as the ARS Rate increases, and increase as the ARS Rate decreases.*

As a result, the interest rate on the IRS will be 0% if the ARS Rate is equal to 12% per annum.

The ARS may be affected by the ratings assigned by Standard & Poor's Ratings Group, a division of The McGraw-Hill Companies ("Standard & Poor's") and Moody's Investors Service, Inc. ("Moody's") to the Bonds. In the event of a downgrading of the ratings on the Bonds, the Maximum Rate may increase and the All Hold Rate may increase, which may result in an increase in the ARS Rate and a decrease in the interest rate on the IRS. The ARS Rate and, consequently, the IRS Rate may also be affected by any matter that might cause participants in the ARS Auctions to submit bids for ARS at higher or lower interest rates.

Initially, Smith Barney Inc. will be the sole Broker-Dealer and has advised the Commonwealth that it intends initially to make a market for IRS and for ARS between Auctions; however, Smith Barney Inc. is not obligated to make such market, and no assurance can be given that any secondary market therefor will develop.

The Public Improvement Bond Resolution provides that the Auction Agent may resign from its duties as Auction Agent or resign as a Direct Participant in DTC by giving at least 90 days' notice to the Registrar (who shall give notice of the same to each Broker-Dealer, DTC and the Commonwealth), and 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 Business Days' notice or immediately, in certain circumstances, and does not require, as a condition to the effectiveness of such resignation, that a replacement Broker-Dealer be in place. For any Rate Period during which there is no duly appointed Auction Agent or during which the Auction Agent shall fail to be a Direct Participant in DTC, 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 ARS will be the No Auction Rate plus the Service Charge. In addition, for any period during which there is no duly appointed Auction Agent or during which the Auction Agent shall fail to be a Direct Participant in DTC, no linking, permanent linking or breaking of linkage of IRS and ARS will be possible.

The Service Charge is applied to pay the Auction Agent Fee and the Broker-Dealer Fee. Such fees are subject to increase as discussed above under "Interest and Service Charge—Service Charge" herein. Any such increase will be binding upon the Owners of IRS and will reduce the amount of interest to be received by such Owners.

The Broker-Dealer Agreements will provide that a Broker-Dealer may submit Orders in Auctions for its own account. If a Broker-Dealer submits an Order for its own account in any Auction, it might have an advantage over other Bidders in that it would have knowledge of Orders placed through it in that Auction; such Broker-Dealer, however, would not have knowledge of Orders submitted by other Broker-Dealers (if any) in that Auction. In the Broker-Dealer Agreements, Broker-Dealers will agree to handle customer orders in accordance with their respective duties under applicable securities laws and rules.

If the book-entry only system is discontinued as described in "Book-Entry Only System" under *The Bonds*, it will no longer be possible to link ARS and IRS. ARS and IRS which are linked (but not permanently linked) at the time of the discontinuance of the book-entry only system will thereupon cease to be linked, and the Service Charge will be assessed against each ARS.

#### *Mandatory Tender of ARS*

An Owner of IRS may, at any time and from time to time, notify a Broker-Dealer that such Owner desires to purchase a specified principal amount of ARS at par plus accrued interest on any Business Day (except during a Closed Period) not less than fifteen Business Days after receipt by the Broker-Dealer of such notice (a "Tender Date") in order to link the same with such Owner's IRS. Such Broker-Dealer shall, on behalf of such Owner, require through DTC that ARS be tendered to such Owner for purchase and linkage on the Tender Date at a price equal to the principal amount of ARS being purchased plus accrued and unpaid interest to the Tender Date less the amount of the Service Charge for the period to the Tender Date, in the following manner and with the following effect.

*Tender Demand.* Such Broker-Dealer is to give DTC and the Auction Agent written notice (a "Tender Demand") of such tender stating that such IRS Owner is the Owner of a specified principal amount of IRS and that such Owner wishes to purchase an equal principal amount of ARS on the Tender Date for linkage with such IRS. Any Tender Demand shall be given to DTC no later than the Business Day following receipt by the Broker-Dealer.

*Tender Notices.* On the second Business Day following the day of DTC's receipt of a Tender Demand, DTC is to select the ARS to be tendered on such Tender Date by lot and give the Direct Participant for the ARS so selected and the Auction Agent written notice (a "Tender Notice") thereof specifying the Tender Date, the amount of ARS to be tendered by the Owner or Owners thereof on the Tender Date and the purchase price therefor. Each Tender Notice shall be mailed to such Direct Participant and the Auction Agent by first class mail, postage prepaid, no later than the second Business Day following the day of DTC's receipt of such Tender Demand.

*Tender and Purchase.* DTC is to deliver the ARS specified in the Tender Notice against payment therefor by the Broker-Dealer by book-entry transfer on the Tender Date to the account of the Broker-Dealer without any action on the part of or on behalf of the Owner or Owners of such ARS. Upon receipt of such ARS on the Tender Date, the Broker-Dealer is to deliver such ARS against payment therefor by book-entry transfer to the account of the Direct Participant specified by the IRS Owner if such Direct Participant is not such Broker-Dealer. On such Tender Date, the Owner of such IRS is obligated to forward such purchase price to the Direct Participant of such IRS Owner in immediately available funds by 2:00 p.m., New York City time. Upon such purchase, the IRS

specified in such Tender Demand and the ARS specified in such Tender Notice will become Special Linked ARS and IRS.

*Redemption Provisions of ARS and IRS*

*Optional Redemption -- ARS and IRS.* The ARS and the IRS are not subject to optional redemption prior to their maturity.

*Amortization Requirements.* The ARS and IRS shall be redeemed upon thirty (30) days' notice in part on July 1, 2009 and on each July 1 thereafter to the extent of the respective Amortization Requirements for the ARS and IRS set forth below (less the principal amount of any such ARS and IRS retired by purchase and otherwise subject to adjustment as described below) at a redemption price of par plus accrued interest to the date fixed for redemption:

| <b>ARS</b>                 |  | <b><u>Amortization<br/>Requirements for ARS</u></b> |
|----------------------------|--|---|
| <b><u>July 1</u></b>       |  |   |
| 2009 .....                 |  | \$4,700,000   |
| 2010 .....                 |  | 5,000,000   |
| 2011 .....                 |  | 5,300,000†  |
| Average life (years) ..... |  | 14.54   |

| <b>IRS</b>                 |  | <b><u>Amortization<br/>Requirements for IRS</u></b> |
|----------------------------|--|---|
| <b><u>July 1</u></b>       |  |   |
| 2009 .....                 |  | \$4,700,000   |
| 2010 .....                 |  | 5,000,000   |
| 2011 .....                 |  | 5,300,000†  |
| Average life (years) ..... |  | 14.54   |

† Final Maturity

If the amount of the ARS or IRS purchased or redeemed pursuant to an amortization requirement during any fiscal year exceeds the amount of the amortization requirement for such ARS or IRS for such fiscal year, the amortization requirements for such ARS or IRS 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, provided that each such decrease shall be the same for both the ARS and the IRS.

*Conditions to Redemptions of ARS and IRS.* No redemption of ARS or IRS prior to their maturity may occur unless an equal principal amount of both ARS and IRS in denominations of \$100,000 (\$5,000 in respect of Permanently Linked AIRS) or any multiple thereof are simultaneously redeemed or delivered to the Registrar for cancellation.

The aggregate amount of ARS and IRS to be redeemed in part shall be selected from ARS and IRS which are not linked or permanently linked together proportionately in accordance with the relative amounts of ARS and IRS which are and are not linked or permanently linked together, then from Linked ARS and IRS and Special

Linked ARS and IRS and then from Permanently Linked AIRS, all as of the Record Date immediately preceding the date of redemption.

ARS and IRS cannot be linked (including permanently linked) or unlinked, as described above under "Linkage of IRS and ARS", during the period commencing at the opening of business on the second Business Day next preceding the Lottery Date and ending immediately prior to the opening of business on the date fixed for redemption.

*Selection of ARS and IRS for Redemption.* If less than all of the ARS and IRS shall be called for redemption, a lottery shall be held to select the particular ARS and IRS to be redeemed, which lottery shall be held on the second Business Day (or if the ARS and IRS are no longer each represented by a global Public Improvement Bond registered in the name of DTC or its nominee, the fifth Business Day) (the "Lottery Date") prior to the last date on which the Registrar is required to give notice of such redemption. The portion of any ARS or IRS of a denomination of more than \$100,000 (\$5,000 in respect of Permanently Linked AIRS) to be redeemed will be in the principal amount of \$100,000 (\$5,000 in respect of Permanently Linked AIRS) or a multiple thereof, and in selecting portions of ARS and IRS for redemption, the Registrar shall treat the ARS and IRS as representing that number of ARS or IRS of \$100,000 (\$5,000 in respect of Permanently Linked AIRS) denomination which is obtained by dividing the principal amount of such ARS or IRS by \$100,000 (\$5,000 in respect of Permanently Linked AIRS).

*Notice and Effect of Redemption.* The provisions relating to the giving of notice of redemption and its effect are set forth below in "Notice and Effect of Redemption of Public Improvement Bonds."

## Redemption

The Refunding Bonds are not subject to redemption.

The ARS and the IRS are subject to redemption as described above under "ARS and IRS".

*Optional Redemption of Public Improvement Bonds other than ARS and IRS.* At the option of the Secretary of the Treasury and upon at least 30 days' notice, the Public Improvement Bonds maturing after July 1, 2015 are subject to redemption, from any moneys that may be available for that purpose (other than from moneys set aside in respect of an amortization requirement), prior to maturity, on or after July 1, 2006 as a whole or in part, on any date, as directed by the Secretary of the Treasury, at the redemption prices (expressed as a percentage of principal amount) set forth in the table below, together with accrued interest to the dates fixed for redemption:

| <u>Period During Which Redeemed</u>          | <u>Redemption Price</u> |
|--|-------------------------|
| July 1, 2006 through June 30, 2007 . . . . . | 101½ %                  |
| July 1, 2007 through June 30, 2008 . . . . . | 100¾                    |
| July 1, 2008 and thereafter . . . . .        | 100                     |

*Mandatory Redemption of Public Improvement Bonds other than ARS and IRS.* The Public Improvement Bonds maturing July 1, 2017 and 2025 are subject to redemption to the extent of the respective amortization requirements therefor set forth below (less the amount applied to the purchase of any such Public Improvement Bonds and otherwise subject to adjustment as described below), upon at least 30 days' notice, on July 1, 2016 and 2018, respectively, and on July 1 in each year thereafter at a redemption price of par plus accrued interest to the dates fixed for redemption:

| <u>July 1</u>                         | Amortization Requirements<br>for Term Public<br>Improvement Bonds<br><u>due July 1, 2017</u> | Amortization Requirements<br>for Term Public<br>Improvement Bonds<br><u>due July 1, 2025</u> |
|---------------------------------------|--|--|
| 2016 . . . . .                        | \$14,390,000   |  |
| 2017 . . . . .                        | 15,180,000*  |  |
| 2018 . . . . .                        |  | \$16,015,000   |
| 2019 . . . . .                        |  | 16,880,000   |
| 2020 . . . . .                        |  | 17,795,000   |
| 2021 . . . . .                        |  | 18,755,000   |
| 2022 . . . . .                        |  | 19,765,000   |
| 2023 . . . . .                        |  | 20,835,000   |
| 2024 . . . . .                        |  | 21,960,000   |
| 2025 . . . . .                        |  | 23,145,000*  |
| <b>Average life (years)</b> . . . . . | 21.01  | 26.28  |

\* Maturity

If the amount of the term Public Improvement Bonds of a particular maturity purchased or redeemed pursuant to an amortization requirement during any fiscal year exceeds the amount of the amortization requirement for such Public Improvement Bonds for such fiscal year, the amortization requirements for such Public Improvement 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.

**Notice and Effect of Redemption of Public Improvement Bonds**

Any redemption of the Public Improvement Bonds, either in whole or in part, shall be made upon at least thirty (30) days' prior notice by mail to DTC or, if the book-entry only system as described above has been discontinued, by first class mail, postage prepaid, to all registered owners in the manner and under the terms and conditions provided in the Public Improvement Bond Resolution. On the date designated for redemption, notice having been given as provided in the Public Improvement Bond Resolution and moneys for payment of the principal of and redemption premium, if any, and accrued interest on the Public improvement Bonds or portions thereof so called for redemption being held by the Registrar, interest on the Public Improvement Bonds or portions thereof so called for redemption shall cease to accrue. Subject to certain provisions of the Public Improvement Bond Resolution, Public Improvement Bonds and portions of Public Improvement Bonds which have been duly called for redemption under the provisions of the Public Improvement Bond Resolution, or with respect to which irrevocable instructions to call for redemption or to pay at maturity have been given, and for the payment of the principal of and redemption premium, if any, and the accrued interest on which sufficient moneys or investments permitted by law shall be held in separate trust for the owners of the Public Improvement Bonds or portions thereof to be paid or redeemed shall not be deemed to be outstanding under the Public Improvement Bond Resolution, and the registered owners thereof shall have no rights in respect thereof except to receive payment of the principal thereof and the redemption premium, if any, and the accrued interest thereon from said separate trust.

Each notice of redemption shall contain, among other things, the CUSIP identification number of the Public Improvement Bonds (or portions thereof) being called for redemption, the redemption date and price and the address

at which such Public Improvement 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 Public Improvement Bond will not affect the validity of the proceedings for the redemption of any other Public Improvement Bond.

If less than all the Public Improvement Bonds of any maturity are called for redemption, the particular Public Improvement Bonds so called for redemption shall be selected by the Registrar by such method as it deems fair and appropriate, except that so long as the book-entry only system shall remain in effect, in the event of any such partial redemption, DTC shall reduce the credit balances of the applicable DTC Participants in respect of the Public Improvement Bonds and such DTC Participants shall in turn select those Beneficial Owners whose ownership interests are to be extinguished by such partial redemption each by such method as DTC or such DTC Participant, as the case may be, in its sole discretion, deems fair and appropriate.

## **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 with the Department of the Treasury in the fiscal year in which such payment is due. The provisions contained in the Act regarding the payment of the principal of and interest on the Bonds are 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. Such payments 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 revenues. 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 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 applied such amounts to the payment of its public debt.

Since fiscal 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 first returned to the Commonwealth before being so pledged. 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 applied such amounts to the payment of its public debt.

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 revenues, including surplus, to the payment of principal of and interest on public debt when due.

### *Special Fund for General Obligation Debt Service*

Act No. 83, approved 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 Special Fund for the Amortization and Redemption of General Obligations Evidenced by Bonds and Promissory Notes (the "Redemption Fund"), for application to the payment of general obligation bonds and notes of the Commonwealth.

Act No. 39, approved 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 funds otherwise 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 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. On November 30, 1995, the amount on deposit in the Redemption Fund was \$168,488,850, which was the required amount.

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.

### **The MBIA Insurance Corporation Insurance Policy**

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

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 (either at the stated maturity or by an advancement of maturity pursuant to a mandatory sinking fund payment) and interest on the 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 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 payments of principal would have been due had there not been any such acceleration); and (ii) the reimbursement of any such payment which is subsequently recovered from any owner of the Insured Bonds pursuant to a final judgement 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 Insured Bond. The MBIA Policy does not, under any circumstance, insure against loss relating to: (i) optional or mandatory redemptions (other than mandatory sinking fund redemptions); (ii) any payments to be made on an accelerated basis; (iii) payments of the purchase price of 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 or interest on the Insured Bonds resulting from the insolvency, negligence or any other act or omission of the Registrar or any other paying agent for the 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 the Insurer from the Registrar or any owner of an Insured Bond 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 State Street Bank and Trust Company, N.A., 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 Insured Bonds or presentment of such other proof of ownership of the Insured Bonds, together with any appropriate instruments of assignment to evidence the assignment of the insured amounts due on the Insured Bonds as are paid by the Insurer, and appropriate instruments to effect the appointment of the Insurer as agent for such owners of the Insured Bonds in any legal proceeding related to payment of insured amounts on the Insured Bonds, such instruments being in a form satisfactory to State Street Bank and Trust Company, N.A., State Street Bank and Trust Company, N.A. shall disburse to such owners or Registrar payment of the insured amounts due on such Insured Bonds, less any amount held by the Registrar for the payment of such insured amounts and legally available therefor.

The Insurer, formerly known as Municipal Bond Investors Assurance Corporation, is the principal operating subsidiary of MBIA Inc., a New York Stock Exchange listed company. MBIA Inc. is not obligated to pay the debts of or claims against the Insurer. The Insurer is domiciled in the State of New York and licensed to do business in 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. The Insurer has one European branch in the Republic of France.

As of September 30, 1995 the Insurer had admitted assets of \$3.7 billion (unaudited), total liabilities of \$2.5 billion (unaudited), and total capital and surplus of \$1.2 billion (unaudited) determined in accordance with statutory accounting practices prescribed or permitted by insurance regulatory authorities. As of December 31, 1994, the Insurer had admitted assets of \$3.4 billion (audited), total liabilities of \$2.3 billion (audited), and total capital and surplus of \$1.1 billion (audited) determined in accordance with statutory accounting practices prescribed or permitted by insurance regulatory authorities. All information regarding the Insurer, a wholly owned subsidiary of MBIA Inc., including the financial statements of the Insurer for the year ended December 31, 1994, prepared in accordance with generally accepted accounting principles, included in the Annual Report on Form 10K of MBIA Inc. for the year ended December 31, 1994, is hereby incorporated by referenced into this Official Statement and shall be deemed to a part hereof. Any statement contained in a document incorporated by reference herein shall 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 incorporated by reference herein 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.

Furthermore, copies of the Insurer's year end financial statements prepared in accordance with statutory accounting practices are available from the Insurer. A copy of the Annual Report on Form 10K of MBIA Inc. is available from the Insurer or the Securities and Exchange Commission. The address of the Insurer is 113 King Street, Armonk, New York 10504.

Moody's rates the claims paying ability of the Insurer "Aaa".

Standard & Poor's rates the claims paying ability of the Insurer "AAA".

Fitch Investors Service, L.P., rates the claims paying ability of the Insurer "AAA".

Each rating of the Insurer should be evaluated independently. The ratings reflect the respective rating agency's current assessment of the creditworthiness of the Insurer 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 Insured Bonds, and such ratings may be subject to revisions 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 Insured Bonds. The Insurer does

not guaranty the market price of the Insured Bonds nor does it guaranty that the ratings on the Insured Bonds will not be revised or withdrawn.

### **Concerning the Insurer's Policy**

As provided in the Bond Resolution, the Insurer shall be deemed to be the owner of the Insured Bonds for purposes of (1) taking remedial actions under the Bond Resolution and (2) as long as the Insurer shall not then be in default on its obligations under the MBIA Policy, the giving of consents to the adoption of any resolutions supplemental to the Bond Resolution.

### **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 Commonwealth Treasury, 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 they may be available for the payment of debt service.

After giving effect to the issuance of the Bonds and the refunding of the Refunded Bonds, future maximum annual debt service for the Commonwealth's outstanding general obligation debt will be \$426,360,823 in the fiscal year ending June 30, 1996. See "Debt Service Requirements for Commonwealth General Obligation Bonds" under *Debt* in *Appendix I*. This amount is equal to 9.33% of \$4,569,021,000 (which is equal to the average of the adjusted internal revenues for the fiscal year ended June 30, 1994 and the estimated adjusted internal revenues for the fiscal year ended June 30, 1995). On December 21, 1995, Puerto Rico Aqueduct and Sewer Authority issued \$400,340,000 Puerto Rico Aqueduct and Sewer Authority Refunding Bonds, Guaranteed by the Commonwealth of Puerto Rico (the "PRASA Guaranteed Bonds"). The Commonwealth expects to make all payments on the PRASA Guaranteed Bonds under the full faith and credit guarantee of the Commonwealth. In the event the Commonwealth makes such payments, the amount paid will be taken into account in future years as an additional amount of debt service on the Commonwealth's general obligation debt for purposes of computing the above percentage.

### **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.

## **TAX EXEMPTION**

The Internal Revenue Code of 1986, as amended (the "Code"), includes requirements which the Commonwealth must continue to meet after the issuance of the Bonds in order that interest on the Bonds not be included in gross income for federal income tax purposes. The Commonwealth's failure to meet these requirements

may cause interest on the Bonds to be included in gross income for federal income tax purposes retroactive to their date of issuance. The Commonwealth has covenanted in the Bond Resolution to comply, to the extent permitted by the Constitution and the laws of the Commonwealth, with the requirements of the Code in order to maintain the exclusion from gross income for federal income tax purposes of interest on the Bonds. Bond Counsel is not aware of any provision of the Constitution or laws of the Commonwealth which would prevent the Commonwealth from complying with the requirements of the Code.

In the opinion of Bond Counsel, subject to continuing compliance by the Commonwealth with the tax covenant referred to above, under the provisions of the Acts of Congress now in force and under existing regulations, rulings and court decisions, interest on the Bonds is not includable in gross income for federal income tax purposes. Interest on the Bonds is not an item of tax preference for purposes of the federal alternative minimum tax imposed on individuals and corporations; however, interest on the Bonds will be includable in the computation of the alternative minimum tax and environmental tax on corporations imposed by the Code. Bond Counsel is further of the opinion that the Bonds and the interest thereon are exempt from state, Commonwealth and local income taxation.

Ownership of tax-exempt obligations may result in collateral federal income tax consequences to certain taxpayers, including, without limitation, financial institutions, property and casualty insurance companies, certain foreign corporations, certain S Corporations with excess passive income, individual recipients of Social Security or Railroad Retirement benefits and taxpayers who may be deemed to have incurred or continued indebtedness to purchase or carry tax-exempt obligations. Companies which qualify for and which have elected the benefits of Section 936 of the Code should consult their tax advisors as to whether interest on the Bonds constitutes income eligible for the credit provided by Section 936 of the Code.

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

Prospective purchasers of the Bonds should consult their tax advisors as to the applicability and impact of any collateral consequences.

Legislation affecting municipal securities is constantly being considered by the United States Congress. There can be no assurance that legislation enacted after the date of issuance of the Bonds will not have an adverse effect on the tax-exempt status of the Bonds. Legislative or regulatory actions and proposals may also affect the economic value of tax exemption or the market price of the Bonds.

### **Discount Bonds**

Under the Code, the difference between the principal amount of the Bonds and the initial offering price to the public (excluding bond houses and brokers) at which price a substantial amount of such Bonds maturing July 1 of the years 1997 through 1999 and 2002 through 2004 was sold and the difference between the principal amount of the Public Improvement Bonds and such initial offering price to the public at which a substantial amount of such Public Improvement Bonds maturing July 1, 2017 and 2025 (collectively the "Discount Bonds"), was sold is original issue discount. Original issue discount on the Discount Bonds represents interest which is not includable in federal gross income. A portion of such interest that accrues to the Beneficial Owner of such Discount Bonds in each year, as described below, is, however, included in the calculation for determining a corporate taxpayer's alternative minimum tax and environmental tax and the distribution requirements of certain regulated investment companies and may result in some of the collateral federal income tax consequences described above under the caption "Tax Exemption" in the year of accrual. Consequently, Beneficial Owners of Discount Bonds should be aware that the accrual of original issue discount in each year may result in an alternative minimum tax liability, environmental tax liability, additional distribution requirements or other collateral federal income tax consequences although the Beneficial Owner may not have received cash in such year. Original issue discount on Discount Bonds will accrue over the terms of such Bonds at a constant interest rate compounded in a manner similar to that used in computing accreted values on capital appreciation bonds. Interest not includable in federal gross income equal to the original

issue discount accruing during the period a Beneficial Owner holds such Discount Bond will increase the adjusted basis in such Discount Bond by the amount of such accruing discount for purposes of determining taxable gain or loss on the sale or other disposition of such Discount Bond. The accrual of original issue discount and its effect on the redemption, sale or other disposition of Discount Bonds which are not purchased in the initial offering at the initial offering price may be determined according to rules which differ from those described above. Beneficial Owners of Discount Bonds should consult their tax advisors with respect to the precise determination for federal income tax purposes of interest accrued upon sale, redemption or other disposition of Discount Bonds and with respect to the state and local tax consequences of owning and disposing of Discount Bonds.

### **Premium Bonds**

The difference between the amount payable at maturity of the Bonds maturing July 1 of the years 1996, 2000, 2001, 2005 and 2006, the Public Improvement Bonds maturing July 1 of the years 2007, 2008 and 2012 through 2015 and the AIRS and the tax basis of such Bonds to a purchaser (other than a purchaser who holds such Bonds as inventory, stock in trade or for sale to customers in the ordinary course of business) is "bond premium". Bond premium is amortized over the term of such Bonds for federal income tax purposes. Beneficial Owners of such Bonds are required to decrease his adjusted basis in such Bonds by the amount of amortizable bond premium attributable to each taxable year such Bonds are held. The amortizable bond premium on such Bonds attributable to a taxable year is not deductible for federal income tax purposes. Beneficial Owners of such Bonds should consult their tax advisors with respect to the precise determination for federal income tax purposes of the treatment of bond premiums upon sale or other disposition of such Bonds and with respect to the state and local tax consequences of owning and disposing of such Bonds.

## **UNDERWRITING**

The Underwriters have jointly and severally agreed, subject to certain conditions, to purchase the Bonds from the Commonwealth at an aggregate discount of \$2,924,865.44 from the initial public offering prices of the Bonds set forth or derived from information set forth on the inside cover page hereof. The obligations of the Underwriters are subject to certain conditions precedent, and the Underwriters 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, and such offering prices may be changed, from time to time, by the Underwriters.

Morgan Stanley & Co. Incorporated ("Morgan Stanley"), a managing underwriter, has entered into a written agreement with BP Capital Markets, a subsidiary of Banco Popular de Puerto Rico, Registrar for the Bonds, ("BP Capital Markets") pursuant to which BP Capital Markets has agreed to cooperate in connection with Morgan Stanley's provision of underwriting and investment banking services to the Commonwealth with respect to the Bonds. Pursuant to these arrangements, the existence of which has been disclosed to the Commonwealth and Government Development Bank, BP Capital Markets will be entitled to receive a portion of Morgan Stanley's actual net profits, if any, in connection with the underwriting of the Bonds.

## **LEGAL MATTERS**

The proposed forms of opinion of Greenberg, Traurig, Hoffman, Lipoff, Rosen & Quentel, New York, New York, Bond Counsel, are set forth in *Appendix IV* to this Official Statement. Certain legal matters will be passed upon for the Underwriters by Brown & Wood, 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.

## VERIFICATION OF MATHEMATICAL COMPUTATIONS

Deloitte & Touche LLP will verify from the information provided to them the mathematical accuracy as of the date of the closing on the Bonds of (1) the computations contained in the provided schedules to determine that the anticipated receipts from the securities and cash deposits listed in such schedules, to be held in escrow, will be sufficient to pay, when due, the principal, interest and call premium payment requirements, if any, of the Refunded Bonds (see *Plan of Financing*), and (2) the computations of yield on both the securities and the Bonds contained in such schedules used by Bond Counsel in its determination that the interest on the Bonds is excludable from gross income for federal income tax purposes. Deloitte & Touche LLP will express no opinion on the assumptions provided to them, nor as to the exclusion from gross income for federal income tax purposes of the interest on the Bonds.

## 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 participate in other financial transactions with Government Development Bank.

## RATINGS

Moody's Investors Service and Standard & Poor's Ratings Group, a division of The McGraw-Hill Companies, have given the Bonds ratings of Baa1 and A, respectively. These ratings do not reflect the MBIA Policy. Moody's Investors Service and Standard & Poor's have given the Insured Bonds ratings of Aaa and AAA, respectively, based on the MBIA Policy. 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. See also, "The MBIA Insurance Corporation Insurance Policy" under *The Bonds*.

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

The Commonwealth has covenanted in the Bond Resolution for the benefit of the Beneficial Owners (as defined in such resolution and generally the tax owners of the Bonds):

1. to file within 305 days after the end of each fiscal year beginning after its fiscal year 1996, with each nationally recognized municipal securities information repository ("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 revenues, expenditures, financial operations and indebtedness generally found in this Official Statement; and

2. to file, in a timely manner, with each NRMSIR or with the Municipal Securities Rulemaking Board (the "MSRB") and with any Commonwealth SID, notice 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 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;
- k. rating changes; and
- l. any failure of the Commonwealth to comply with paragraph 1 above.

Events (c) 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) and (e) may not be applicable, since the terms of the Bonds do not provide for "debt service reserves" or "credit or liquidity providers". For a description of the Bonds, see "*The Bonds*". 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 Exemption*".

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 — ARS and IRS — Redemption Provisions of ARS and IRS*" and 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 Bond purchases.

The Commonwealth expects to provide the information described in paragraph 1 above by delivering its first bond official statement that includes its financial statements for the preceding fiscal year or, if no such official statement is issued by the 305-day deadline, by delivering its General Purpose Financial Statements by such deadline.

As of January 18, 1996, there is no Commonwealth SID, and the nationally recognized municipal securities information repositories are: Bloomberg Municipal Repository, P.O. Box 840, Princeton, New Jersey 08542-0840; Kenny Information Systems, Inc., 65 Broadway-16th Floor, New York, New York 10006; Disclosure, Inc., 5161

River Road, Bethesda, Maryland 20816, Attn: Document Acquisitions/Municipal Securities; Moody's NRMSIR Public Finance Information Center, 99 Church Street, New York, New York 10007; The Bond Buyer, 395 Hudson Street, New York, New York 10004, Attn: Municipal Disclosure and R.R. Donnelly Financial, Municipal Securities Disclosure Archive, 559 Main Street, Hudson, Massachusetts 01749.

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 hereunder.

No Beneficial Owner may institute any suit, action or proceeding at law or in equity ("Proceeding") for the enforcement of the foregoing covenants (the "Covenants") or for any remedy for breach thereof, unless such Beneficial Owner shall have filed with the 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 for the equal benefit of all Beneficial Owners of the outstanding Bonds benefitted 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 of Act No. 104, approved June 29, 1955, as amended (32 L.P.R.A. §3077 and §3077a), 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 parties 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.

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

These covenants have been made in order to assist the Underwriters in complying with the Rule.

#### MISCELLANEOUS

The foregoing summaries of or references to the various acts, the Bonds, the Bond Resolution, the MBIA Policy, the Auction Agreement and the Broker-Dealer Agreements and the summaries of or references to the various acts contained in *Appendix I*, 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 is certain information concerning the Commonwealth (*Appendix I*), the general purpose financial statements of the Commonwealth for the fiscal year ended June 30, 1994, together with the independent auditor's report thereon, dated February 3, 1995 (March 3, 1995 with respect to note 18 thereof), of Deloitte & Touche LLP, San Juan, Puerto Rico, certified public accountants (*Appendix II*), a summary of certain provisions of the Bond Resolution relating to ARS and IRS and the Auction Procedures (*Appendix III*), the proposed form of opinions of Bond Counsel (*Appendix IV*) and the specimen insurance policy (*Appendix V*).

The information set forth in this Official Statement, except for information pertaining to DTC and MBIA 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 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 and the information pertaining to MBIA was supplied by MBIA.

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

COMMONWEALTH OF PUERTO RICO

By: /s/ Manuel Díaz Saldaña  
*Secretary of the Treasury*

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## COMMONWEALTH OF PUERTO RICO

### Geography and Population

Puerto Rico, the fourth largest of the Caribbean islands, is located approximately 1,600 miles southeast of New York, New York and 1,000 miles east-southeast of Miami, Florida. It is approximately 100 miles long and 35 miles wide.

According to the United States Census Bureau, the population of Puerto Rico was approximately 3,522,000 in 1990 compared to 3,196,520 in 1980. According to estimates of the Planning Board, the population of Puerto Rico increased to 3,703,000 in fiscal 1995. As of 1990, the population of San Juan, the island's capital and largest city, was approximately 437,000.

### Relationship with the United States

Puerto Rico was discovered by Columbus in 1493, and the island was conquered and settled by the Spaniards shortly thereafter. It remained a Spanish possession for four centuries. Although the culture of Puerto Rico is primarily Hispanic, a considerable intermingling of Hispanic and United States cultures has occurred.

Puerto Rico came under United States sovereignty by the Treaty of Paris, signed on December 10, 1898, terminating the Spanish-American War. Puerto Ricans have been citizens of the United States since 1917. In July 1950, after a lengthy period of evolution toward greater self-government for Puerto Rico, the Congress of the United States enacted Public Law 600, which provided that those sections of existing law which defined the political, economic and fiscal relationship between Puerto Rico and the United States should remain in full force. It also authorized Puerto Rico to draft and approve its own Constitution in the same manner as is required by the United States Constitution for states. The Constitution was drafted by a popularly elected constitutional convention, approved in a special referendum by the people of Puerto Rico, amended and ratified by the United States Congress and subsequently approved by the President, becoming effective on July 25, 1952. Puerto Rico's constitutional status is that of a territory of the United States and the ultimate source of power over Puerto Rico, pursuant to the Territories Clause of the Federal Constitution, is the United States Congress. The relationship between the United States and Puerto Rico is referred to herein as commonwealth status. Notwithstanding the current relationship, Congress by statute and the United States federal courts by interpretation have modified and may modify this relationship.

The official languages of Puerto Rico are Spanish and English. The Commonwealth exercises virtually the same control over its internal affairs as do the fifty states; however, it differs from the states 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 and limited voting powers. Most federal taxes, except those such as social security taxes, are not levied in Puerto Rico. No federal income tax is collected from Commonwealth residents on ordinary income earned from sources in Puerto Rico, except for certain federal employees who are subject to taxes on their salaries. Income earned from sources outside of Puerto Rico is, however, subject to federal income tax. Federal excise taxes on shipments of alcoholic beverages from Puerto Rico at \$11.30 per gallon through October 1, 1998 and thereafter at \$10.50 per gallon and on shipments of tobacco products from Puerto Rico to the mainland are returned to the Commonwealth Treasury.

## **Governmental Structure**

The Commonwealth's Constitution provides for the separation of powers of the executive, legislative and judicial branches of government. The Governor is elected every four years. The bicameral Legislature consists of a Senate and a House of Representatives and is elected for four-year terms. The highest court within the local judicial branch is the Supreme Court of Puerto Rico. Decisions of the Supreme Court of Puerto Rico may be appealed to the Supreme Court of the United States in the same manner and under the same terms and conditions that decisions may be appealed from state courts. Puerto Rico has a District Court of the United States for the District of Puerto Rico. Decisions of this court may be appealed to the United States Court of Appeals for the First Circuit and to the Supreme Court of the United States.

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

Pedro J. Rosselló was sworn in as Governor of Puerto Rico on January 2, 1993. He obtained a medical degree from Yale University in 1970, after completing his undergraduate studies at Notre Dame University in 1966, and specialized in General and Pediatric Surgery at Harvard University. In 1985 he was appointed Director of San Juan's Health Department, a position which he held for three years. As a member of the New Progressive Party, he was the party's candidate for Resident Commissioner to the United States Congress in 1988. In 1991 he was elected President of the New Progressive Party.

Manuel Díaz Saldaña, Secretary of the Treasury, took office in January 1993. He is a certified public accountant and a graduate of the University of Puerto Rico where he obtained a bachelor's degree in Business Administration and Accounting. Prior to his appointment, he worked for nineteen years as an accountant and auditor for various accounting firms.

Jorge E. Aponte Hernández, Director of the Office of Budget and Management, took office in January 1993. He is a certified public accountant and a graduate of the University of Puerto Rico, where he obtained a bachelor's degree in Business Administration and Accounting. Prior to his appointment, he worked for 20 years as an accountant and auditor for various accounting firms.

Marcos Rodríguez-Ema, President of Government Development Bank, took office in January 1993. He obtained a Bachelor of Science degree (Cum Laude) in foreign service and a law degree from Georgetown University. Prior to his appointment, he worked for five years as a lawyer in a San Juan law firm and for six years as an investment banker for two major securities firms.

## **Political Trends**

For many years there have been two major views in Puerto Rico with respect to the island's relationship to the United States, one favoring statehood, represented by the New Progressive Party, and the other essentially favoring the existing commonwealth status, represented by the Popular Democratic Party. The following table shows the percentages of the total vote received by the gubernatorial candidates of the various parties in the last five elections by voter preference with respect to statehood, commonwealth status and independence. While the electoral choices of Puerto Rico's voters are not made solely on the basis of preferences regarding the island's relationship with the United States, candidates who support a continuing relationship between Puerto Rico and the United States have dominated elections for many years.

|  | <u>1976</u> | <u>1980</u> | <u>1984</u> | <u>1988</u> | <u>1992</u> |
|--|-------------|-------------|-------------|-------------|-------------|
| New Progressive Party . . . . .          | 48.3 %      | 47.3 %      | 45.5 %      | 45.8 %      | 49.9 %      |
| Popular Democratic Party . . . . .       | 45.3        | 47.0        | 48.5        | 48.7        | 45.9        |
| Puerto Rico Independence Party . . . . . | 6.4         | 5.4         | 3.9         | 5.4         | 4.2         |
| Others . . . . .                         | --          | 0.3         | 2.1         | 0.1         | --          |

The 1992 election saw control of the executive and legislative branches pass to the New Progressive Party. The composition of the Senate and House by the several political parties is as follows:

|  | <u>Senate</u> | <u>House</u> |
|--|---------------|--------------|
| New Progressive Party . . . . .          | 21            | 36           |
| Popular Democratic Party . . . . .       | 7             | 16           |
| Puerto Rico Independence Party . . . . . | <u>1</u>      | <u>1</u>     |
|  | 29            | 53           |

The next general election (gubernatorial, municipal and legislative) in Puerto Rico will be held in November 1996. Voter participation in the Commonwealth has been substantially higher than in the rest of the United States, averaging 85 % since 1972.

## THE ECONOMY

### General

The Commonwealth has established policies and programs directed at the development of manufacturing and the expansion and modernization of the island's infrastructure. The investment of mainland United States, foreign and local funds in new factories has been stimulated by selective tax exemption, 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 island's population.

The economy of Puerto Rico is fully integrated with that of the mainland United States. During fiscal 1995 approximately 89 % of Puerto Rico's exports went to the United States mainland, which was also the source of approximately 65 % of Puerto Rico's imports. In fiscal 1995, Puerto Rico experienced a \$4.6 billion positive adjusted merchandise trade balance.

The economy of Puerto Rico is dominated by the manufacturing and service sectors. The manufacturing sector has experienced a basic change over the years as a result of increased emphasis on higher wage, high technology industries such as pharmaceuticals, electronics, computers, microprocessors, professional and scientific instruments, and certain high technology machinery and equipment. The service sector, including finance, insurance and real estate, wholesale and retail trade, and hotel and related services, also plays a major role in the economy. It ranks second only to manufacturing in contribution to the gross domestic product and leads all sectors in providing employment. In recent years, the service sector has experienced significant growth in response to the expansion of the manufacturing sector.

### *Fiscal 1991 to 1995*

Puerto Rico's more than decade-long economic expansion continued throughout the five-year period from fiscal 1991 through fiscal 1995. Almost every sector of the economy participated, and record levels of employment

were achieved. While trends in the Puerto Rico economy usually follow those in the United States, Puerto Rico did not experience a recession as did the United States in fiscal 1991, primarily because of low oil prices, low interest rates, and Puerto Rico's strong manufacturing base which has a large component of non-cyclical industries. Other factors behind this expansion included Commonwealth-sponsored economic development programs, periodic declines in the exchange value of the United States dollar, the level of federal transfers and the relatively low cost of borrowing.

Gross product in fiscal 1991 was \$22.8 billion (\$19.3 billion in 1987 prices), and gross product in fiscal 1995 was \$28.4 billion (\$21.2 billion in 1987 prices). This represents an increase in gross product of 24.4% from fiscal 1991 to 1995 (10.3% in 1987 prices).

Since fiscal 1985, personal income, both aggregate and per capita, has increased consistently each fiscal year. In fiscal 1995, aggregate personal income was \$27.0 billion (\$22.5 billion in 1987 prices) and personal income per capita was \$7,296 (\$6,074 in 1987 prices).

Personal income includes transfer payments to individuals in Puerto Rico under various social programs. Total federal payments to Puerto Rico, which include transfers to Commonwealth 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. Transfer payments to individuals in fiscal 1995 were \$5.9 billion, of which \$4.0 billion, or 67.6%, represent entitlements to individuals who had previously performed services or made contributions under programs such as Social Security, Veterans' Benefits and Medicare.

Average employment increased from 977,000 in fiscal 1991 to 1,051,300 in fiscal 1995. Average unemployment decreased from 15.2% in fiscal 1991 to 13.8% in fiscal 1995.

The following table shows the gross product for the five fiscal years ended June 30, 1995.

|   |  | <b>Commonwealth of Puerto Rico</b> |             |             |             |                |
|---|--|------------------------------------|-------------|-------------|-------------|----------------|
|   |  | <b>Gross Product</b>               |             |             |             |                |
|   |  | <u>Fiscal Year Ended June 30</u>   |             |             |             |                |
|   |  | <u>1991</u>                        | <u>1992</u> | <u>1993</u> | <u>1994</u> | <u>1995(p)</u> |
| Gross product -- \$ millions . . . . .  |  | \$22,809                           | \$23,696    | \$25,133    | \$26,592    | \$28,371       |
| Real gross product -- \$ millions<br>(1987 prices) . . . . .                        |  | 19,260                             | 19,409      | 20,054      | 20,553      | 21,248         |
| Annual percentage increase in real<br>gross product (1987 prices) . . . . .         |  | 0.9%                               | 0.8%        | 3.3%        | 2.5%        | 3.4%           |
| U.S. annual percentage increase in real<br>gross product (1987 prices)(1) . . . . . |  | (0.1%)                             | 0.5%        | 3.0%        | 3.4%        | 3.7%           |

(p) Preliminary.

(1) Restated to correspond to the Commonwealth's fiscal year ending June 30.

Sources: Planning Board and Data Resources Inc.

## Fiscal 1995 and Fiscal 1996

The Planning Board's Economic Activity Index, a composite index of thirteen economic indicators, increased 2.7% for fiscal 1995 compared to fiscal 1994, and 1.7% for fiscal 1994 compared to fiscal 1993. During the first four months of fiscal 1996 the Index increased 1.8% compared to the same period of fiscal 1995, which period showed an increase of 2.7% over the same period of fiscal 1994. The thirteen economic indicators are: total employment, manufacturing employment, manufacturing payroll, electric energy consumption, external trade, tourist hotel registrations, retail sales, excise taxes, electric energy production, new housing unit permits, hours worked, cement production, and new motor vehicle registrations. The Index may not necessarily change at the same percentage rate as the gross product of Puerto Rico.

According to the Labor Department's Household Employment Survey, during fiscal 1995, total employment increased 4.0% over fiscal 1994. Total employment averaged 1,051,000 in fiscal 1995 compared to 1,010,900 in fiscal 1994. This increase caused the unemployment rate for fiscal 1995 to decrease from 16.0% to 13.8%. During the first five months of fiscal 1996, total employment (seasonally adjusted) averaged 1,079,000 compared to 1,038,600 in the same period in fiscal 1995, an increase of 3.9%. For the first five months of fiscal 1996 the unemployment rate was 13.8%, a decrease of 1.7% in comparison with the same period of fiscal 1995.

The Planning Board's most recent gross product forecast for fiscal 1996, made in February 1995, showed an increase of 2.7%. Further growth in the Puerto Rico economy in fiscal 1996 will depend on several factors, including the state of the United States economy and the relative stability in the price of oil imports, increases in visitors to the island and in exports, the exchange value of the U.S. dollar, the level of federal transfers and the cost of borrowing.

### Economic Development Program

The present administration envisions major economic reforms and has developed a new economic development model to be implemented during the next few years. This program is structured on the premise that the private sector will be the primary vehicle for economic development and growth. It promotes changing the role of the government from one of being a provider of most basic services to serving as a facilitator for private sector initiatives and will encourage private sector investment by reducing regulatory restraints imposed by government.

The program contemplates the development of initiatives that will foster private investment in sectors that are served more efficiently and effectively by private enterprise. The program also contemplates a general revision of the tax system to expand the tax base, reduce top personal and corporate tax rates and simplify a highly complex system. On October 31, 1994 legislation was enacted which provides for comprehensive revisions to Puerto Rico's income tax system. See "Major Sources of General Fund Revenues" under *Commonwealth Taxes, Other Revenues and Expenditures*.

Another important goal for the new program is to reduce the size of the government's direct contribution to gross domestic product. This would be realized through a reduction in government consumption and an increase in government investment in order to improve and expand Puerto Rico's infrastructure to facilitate private sector development and growth.

The new economic plan is designed to identify and promote those economic areas in which Puerto Rico can compete more effectively in the global markets. Tourism has been targeted as a top priority because of its potential for job creation and for an increased contribution to the gross product stemming from Puerto Rico's natural competitive advantages.

In February 1994, as part of the government's health reform program to facilitate the provision of private services, a pilot health insurance program was started in the Fajardo region of the island to provide residents with comprehensive health insurance coverage. The program has since expanded to include the Guayama and Arecibo regions as well. In conjunction with this program, the operations of certain public health facilities are being privatized. The administration's goal is to provide universal health insurance for qualifying Puerto Rico residents. The total cost of this program will be dependent on the areas included within the program, the number of participants receiving coverage and the date coverage commences. As of June 30, 1995, over 300,000 persons were participating in the program. For fiscal 1996, it is anticipated that over 750,000 persons will be participating in the program at a cost to the General Fund of the Commonwealth of approximately \$370 million.

In addition, the government is negotiating the sale of certain governmental assets and the transferring to private parties of certain governmental operations. On March 3, 1995, the government completed the sale of the assets of the Maritime Shipping Authority to a private purchaser. On May 26, 1995, the Aqueduct and Sewer Authority executed a five-year agreement pursuant to which the management, operation, repair and maintenance of the Authority's water and waste water treatment systems will be provided by a private company. The Aqueduct and Sewer Authority is also negotiating a construction and operating agreement with a private consortium for the design, construction and operation of an approximately 75 million gallon per day pipeline to deliver water to the San Juan metropolitan area from Dos Bocas reservoir in Utuado. The Electric Power Authority has entered into certain power purchase agreements with private power producers under which two cogenerating plants (with a total capacity of approximately 800 megawatts) using fuels other than oil will be constructed in Puerto Rico, and the Electric Power Authority will purchase the electricity produced by such plants. In addition, other privatization transactions are being undertaken and pursued, including the private operations of certain correctional facilities. See "Other Public Corporations" under *Public Corporations* for a discussion of certain of these actions.

#### **Employment and Unemployment**

The number of persons employed in Puerto Rico during fiscal 1995 averaged 1,051,300. Unemployment, although at relatively low historical levels, remains above the average for the United States. The following table presents annual statistics of employment and unemployment from fiscal 1991 through fiscal 1995 and monthly statistics for July 1995 to November 1995.

**Commonwealth of Puerto Rico**

**Employment and Unemployment**

| <u>Fiscal Year Ended June 30</u> | <u>Labor Force(1)</u> | <u>Employed(1)</u>           | <u>Unemployed(1)</u> | <u>Unemployment Rate (2)</u> |
|----------------------------------|-----------------------|------------------------------|----------------------|------------------------------|
|                                  |                       | <u>(Annual Average)</u>      |                      |                              |
| 1991 .....                       | 1,152                 | 977                          | 175                  | 15.2%                        |
| 1992 .....                       | 1,170                 | 977                          | 193                  | 16.5                         |
| 1993 .....                       | 1,201                 | 999                          | 202                  | 16.8                         |
| 1994 .....                       | 1,204                 | 1,012                        | 192                  | 16.0                         |
| 1995 .....                       | 1,220                 | 1,051                        | 169                  | 13.8                         |
| <u>Fiscal 1996</u>               |                       | <u>(Seasonally Adjusted)</u> |                      |                              |
| July .....                       | 1,245                 | 1,065                        | 179                  | 14.4                         |
| August .....                     | 1,251                 | 1,086                        | 162                  | 12.9                         |
| September .....                  | 1,236                 | 1,062                        | 174                  | 14.0                         |
| October .....                    | 1,278                 | 1,087                        | 191                  | 15.0                         |
| November .....                   | 1,265                 | 1,095                        | 170                  | 13.4                         |

(1) Thousands of persons age 16 years and over.

(2) Unemployed as percentage of labor force.

*Source:* Department of Labor and Human Resources -- Household Survey.

## Economic Performance by Sector

Puerto Rico has a diversified economy. During the fiscal years 1991-1995, the manufacturing and service sectors generated the largest portion of gross domestic product. Three sectors of the economy provide the most employment: manufacturing, services and government.

The following table presents annual statistics of gross domestic product by sector and gross product for the five fiscal years ended June 30, 1995.

### Commonwealth of Puerto Rico

#### Gross Domestic Product by Sector and Gross Product

(in millions at current prices)

|   | <u>Fiscal Year Ended June 30</u> |                 |                 |                 |                |
|---|----------------------------------|-----------------|-----------------|-----------------|----------------|
|   | <u>1991</u>                      | <u>1992</u>     | <u>1993</u>     | <u>1994</u>     | <u>1995(p)</u> |
| Manufacturing . . . . .   | \$12,661                         | \$14,183        | \$15,428        | \$16,580        | 17,719         |
| Services(1) . . . . .   | 12,142                           | 12,817          | 14,109          | 15,086          | 15,892         |
| Government(2) . . . . .   | 3,522                            | 3,672           | 3,881           | 4,071           | 4,471          |
| Transportation, communication and public<br>utilities . . . . . | 2,671                            | 2,828           | 3,009           | 3,115           | 3,264          |
| Agriculture, forestry and fisheries . . . . .                   | 449                              | 420             | 411             | 377             | 366            |
| Construction(3) . . . . .                                       | 770                              | 798             | 874             | 907             | 959            |
| Hotels and related services . . . . .                           | 320                              | 351             | N.A.            | N.A.            | N.A.           |
| Statistical discrepancy . . . . .                               | <u>(248)</u>                     | <u>(439)</u>    | <u>(789)</u>    | <u>(605)</u>    | <u>(306)</u>   |
| Total gross domestic product(4) . . . . .                       | 32,287                           | 34,630          | 36,922          | 39,531          | 42,364         |
| Less: net payments abroad . . . . .                             | <u>9,478</u>                     | <u>10,934</u>   | <u>11,790</u>   | <u>12,945</u>   | <u>13,992</u>  |
| Total gross product(4) . . . . .                                | <u>\$22,809</u>                  | <u>\$23,696</u> | <u>\$25,133</u> | <u>\$26,586</u> | <u>28,371</u>  |

(p) Preliminary.

N.A. Data is included in Services for fiscal years 1993 through 1995.

(1) Includes wholesale and retail trade; finance, insurance and real estate; and other services; excludes services in hotels in fiscal years 1991 and 1992.

(2) Includes the Commonwealth, its municipalities and the federal government; excludes the public corporations.

(3) Includes mining.

(4) Totals may not add due to rounding.

Source: Planning Board.

The following table presents annual statistics of average employment by sector for the five fiscal years ended June 30, 1995.

**Commonwealth of Puerto Rico**

**Average Employment by Sector**

(thousands of persons age 16 and over)

|   | <u>Fiscal Year Ended June 30</u> |             |             |              |              |
|---|----------------------------------|-------------|-------------|--------------|--------------|
|   | <u>1991</u>                      | <u>1992</u> | <u>1993</u> | <u>1994</u>  | <u>1995</u>  |
| Manufacturing . . . . .   | 164                              | 164         | 168         | 166          | 172          |
| Services(1) . . . . .   | 448                              | 449         | 467         | 478          | 496          |
| Government(2) . . . . .   | 217                              | 219         | 217         | 224          | 232          |
| Transportation, communication and<br>public utilities . . . . . | 58                               | 55          | 54          | 55           | 60           |
| Construction(3) . . . . .                                       | 55                               | 56          | 59          | 54           | 57           |
| Agriculture, forestry and fisheries . . . . .                   | <u>35</u>                        | <u>34</u>   | <u>34</u>   | <u>34</u>    | <u>34</u>    |
| Total(4) . . . . .  | <u>977</u>                       | <u>977</u>  | <u>999</u>  | <u>1,012</u> | <u>1,051</u> |

- (1) Includes wholesale and retail trade; finance, insurance and real estate; services in hotels; and other services.
- (2) Includes the Commonwealth, its municipalities and federal government; excludes the public corporations.
- (3) Includes mining.
- (4) Totals may not add due to rounding.

Source: Department of Labor and Human Resources -- Household Survey.

*Manufacturing*

Manufacturing is the largest sector in the economy of Puerto Rico in terms of gross domestic product. In fiscal 1995, the Planning Board estimates that manufacturing generated \$17.7 billion, or 41.8% of gross domestic product. The manufacturing sector employed 153,450 workers as of March 1995 (as reported in the Department of Labor and Human Resources -- Monthly Survey on Employment Hours and Earnings). Most of the island's manufacturing output is shipped to the mainland United States, which is also the principal source of semifinished manufactured articles on which further manufacturing operations are performed in Puerto Rico. The United States minimum wage laws are generally applicable in Puerto Rico. As of November 1995, the average hourly manufacturing wage rate in Puerto Rico was approximately 61% of the average mainland United States rate.

Manufacturing in Puerto Rico is now more diversified than during the earlier phases of the industrial development program. In the last two 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 the heavy investment in the pharmaceuticals, scientific instruments, computers, microprocessors, medical products, and electrical products industries over the last decade. The following table sets forth gross domestic product by manufacturing industry for the five fiscal years ended June 30, 1995.

**Commonwealth of Puerto Rico**

**Gross Domestic Product by Manufacturing Industry**

(in millions at current prices)

|  | Fiscal Year Ended June 30 |                 |                 |                 |                 |
|--|---------------------------|-----------------|-----------------|-----------------|-----------------|
|  | <u>1991</u>               | <u>1992</u>     | <u>1993</u>     | <u>1994</u>     | <u>1995(p)</u>  |
| Pharmaceuticals . . . . .  | \$5,763                   | \$6,460         | \$7,249         | \$8,158         | \$8,781         |
| Machinery and metal products . . . . .                               | 2,804                     | 2,935           | 3,226           | 3,255           | 3,618           |
| Food products . . . . .  | 2,032                     | 2,413           | 2,456           | 2,555           | 2,550           |
| Apparel . . . . .  | 491                       | 536             | 548             | 522             | 559             |
| Other(1) . . . . .   | <u>1,572</u>              | <u>1,840</u>    | <u>1,949</u>    | <u>2,095</u>    | <u>2,210</u>    |
| Total gross domestic product of<br>manufacturing sector(2) . . . . . | <u>\$12,661</u>           | <u>\$14,183</u> | <u>\$15,428</u> | <u>\$16,584</u> | <u>\$17,719</u> |

(p) Preliminary.

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

(2) Totals may not add due to rounding.

Source: Planning Board.

The following table sets forth manufacturing employment by industry group as of March for the last five years.

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

| <u>Industry Group</u>  | <u>As of March</u> |                |                |                |                |
|--|--------------------|----------------|----------------|----------------|----------------|
|  | <u>1991</u>        | <u>1992</u>    | <u>1993</u>    | <u>1994</u>    | <u>1995</u>    |
| Apparel and related products . . . . .   | 29,841             | 30,875         | 29,018         | 25,213         | 25,676         |
| Food and related products . . . . .  | 20,059             | 20,928         | 20,608         | 20,471         | 20,528         |
| Electrical machinery, equipment and<br>supplies . . . . .  | 19,361             | 17,923         | 17,721         | 19,676         | 22,387         |
| Chemicals and related products . . . . .   | 23,130             | 24,015         | 26,141         | 27,174         | 27,505         |
| Professional and scientific instruments . . . . .  | 16,341             | 15,838         | 16,437         | 15,495         | 15,091         |
| Machinery, except electrical and<br>transportation equipment . . . . .                               | 4,562              | 4,452          | 4,241          | 4,262          | 4,012          |
| Petroleum refining and related industries;<br>rubber and miscellaneous plastic<br>products . . . . . | 6,296              | 5,763          | 5,294          | 5,593          | 5,558          |
| Leather and leather products . . . . .   | 5,904              | 6,057          | 7,196          | 7,260          | 7,041          |
| Paper and related products; printing,<br>publishing and related industries . . . . .                 | 6,056              | 5,991          | 5,944          | 6,118          | 6,645          |
| Metal products . . . . .   | 5,078              | 4,768          | 4,632          | 4,648          | 4,733          |
| Stone, clay and glass products . . . . .   | 4,808              | 4,755          | 4,410          | 4,716          | 4,570          |
| Lumber and wood products; furniture<br>and fixtures . . . . .  | 2,787              | 2,953          | 2,937          | 2,927          | 2,918          |
| Textile mill products . . . . .  | 3,596              | 3,860          | 3,876          | 3,503          | 3,490          |
| Tobacco products . . . . .   | 917                | 935            | 850            | 763            | 800            |
| Miscellaneous manufacturing industries . . . . .   | <u>2,698</u>       | <u>2,347</u>   | <u>2,221</u>   | <u>2,443</u>   | <u>2,496</u>   |
| Total . . . . .  | <u>151,434</u>     | <u>151,460</u> | <u>151,526</u> | <u>150,262</u> | <u>153,450</u> |

*Sources:* Department of Labor and Human Resources -- Census of Manufacturing, except for March 1995 statistics which were derived from the "Monthly Survey on Employment, Hours and Earnings."



## Services

Puerto Rico has experienced significant growth in the services sector 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 1991 and 1995, the gross domestic product in the services sector increased at an annual average rate of 6.3%. Employment in this sector (including finance, insurance, real estate, wholesale and retail trade and other services) increased at an annual average rate of 2.1% during the same period. The development of the services sector in the local economy has shown a strong interaction among the following important sectors: manufacturing, tourism, construction and agriculture. The services sector in Puerto Rico has a diversified base.

The high degree of knowledge, skills, and expertise in professional and technical services available in Puerto Rico places Puerto Rico in a favorable competitive position with respect to Latin America and other trading countries throughout the world. A major element in the economic program of the present administration is the further development of the local services sector which has the capacity to increase its export potential and to generate more income and jobs during the coming years.

The service sector ranks second to manufacturing in its contribution to gross domestic product, and it is the sector with the greatest employment. In fiscal 1995, services generated \$15.9 billion of gross domestic product, or 37.5% of the total. Service employment grew from 448,000 in fiscal 1991 to 496,000 in fiscal 1995, a cumulative increase of 10.7%, which increase was greater than the 7.5% cumulative growth in total employment over the same period. Wholesale and retail trade and finance, insurance and real estate have experienced significant growth in the fiscal 1991 to 1995 period, as measured by gross domestic product. Gross domestic product in the wholesale and retail trade increased from \$4.8 billion in fiscal 1991 to \$5.9 billion in fiscal 1995. In finance, insurance and real estate, gross domestic product increased from \$4.3 billion in fiscal 1991 to \$5.5 billion in fiscal 1995. There are 22 commercial banks and trust companies currently operating in Puerto Rico of which two are U.S. major money center banks, three are foreign banks and seventeen are local banks and trust companies. Total assets of these institutions as of June 30, 1995 were \$32.1 billion. In addition, two federal thrift institutions operate on the island and nine major investment banks maintain operations in Puerto Rico. The following tables set forth gross domestic product and service sector employment for the five fiscal years ended June 30, 1995.

### Commonwealth of Puerto Rico

#### Gross Domestic Product by Service Industry

(in millions at current prices)

|  | <u>1991</u>     | <u>1992</u>     | <u>1993</u>     | <u>1994</u>     | <u>1995(p)</u>  |
|--|-----------------|-----------------|-----------------|-----------------|-----------------|
| Wholesale and retail trade . . . . .     | \$ 4,832        | \$ 4,990        | \$ 5,303        | \$ 5,642        | \$ 5,895        |
| Finance, insurance and real estate . . . | 4,308           | 4,596           | 4,897           | 5,160           | 5,451           |
| Hotels . . . . .                         | 320             | 351             | N.A.            | N.A.            | N.A.            |
| Other services . . . . .                 | <u>3,002</u>    | <u>3,231</u>    | <u>3,909</u>    | <u>4,284</u>    | <u>4,546</u>    |
| Total(1) . . . . .                       | <u>\$12,461</u> | <u>\$13,168</u> | <u>\$14,109</u> | <u>\$15,086</u> | <u>\$15,892</u> |

N.A. Data is included in Other services in fiscal years 1993 through 1995.

(p) Preliminary

(1) Totals may not add due to rounding.

Source: Planning Board.

**Commonwealth of Puerto Rico**

**Average Employment by Service Sector**

(thousands of persons age 16 and over)

|                                    | <u>Fiscal Year Ended June 30</u> |             |             |             |                |
|------------------------------------|----------------------------------|-------------|-------------|-------------|----------------|
|                                    | <u>1991</u>                      | <u>1992</u> | <u>1993</u> | <u>1994</u> | <u>1995(p)</u> |
| Wholesale and retail trade         | 195                              | 193         | 201         | 201         | 211            |
| Finance, insurance and real estate | 32                               | 32          | 32          | 33          | 36             |
| Other services(1)                  | <u>221</u>                       | <u>224</u>  | <u>234</u>  | <u>244</u>  | <u>249</u>     |
| Total                              | <u>448</u>                       | <u>449</u>  | <u>467</u>  | <u>478</u>  | <u>496</u>     |

(p) Preliminary

(1) Including hotels and related services.

*Source:* Department of Labor and Human Resources -- Household Survey.

*Government*

The government sector of the Commonwealth plays an important role in the economy of the island. In fiscal 1995 government accounted for \$4.5 billion of Puerto Rico's gross domestic product, or 10.6% of the total. Government is also a significant employer, providing jobs for 232,000 workers, or 22.1% of total employment in fiscal 1995. The government sector employment does not include data relating to certain public corporations which are included in other sectors. These public corporations include such significant employers as the Electric Power Authority, the Telephone Authority and the Aqueduct and Sewer Authority.

*Tourism*

Total visitors' expenditures accounted for 6.4% of the island's gross product in fiscal 1995. Visitors' expenditures and the number of visitors have grown consistently since 1985, reaching \$1.8 billion and more than 4.1 million, respectively, in fiscal 1995. Since fiscal 1987 a number of major hotels have undergone substantial renovation and more than 2,350 new rooms have been added with the opening of several major hotels. Several international hotel corporations have recently made or are expected to make substantial capital investments to develop additional tourist facilities. The government has developed an economic package that encourages private development in tourism projects. The average number of total rooms available in September 1995 was 8,351.

San Juan has become the largest home port for cruise ships in the Caribbean and the second largest home port 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, 1995.

Commonwealth of Puerto Rico

Tourism Data

| <u>Fiscal Year Ended June 30</u> | <u>Number of Visitors</u>   |                        |                 | <u>Total</u> | <u>Total<br/>Visitors'<br/>Expenditures<br/>(in millions)</u> |
|----------------------------------|-----------------------------|------------------------|-----------------|--------------|---|
|                                  | <u>Tourist<br/>Hotel(1)</u> | <u>Cruise<br/>Ship</u> | <u>Other(2)</u> |              |   |
| 1991 .....                       | 650,115                     | 891,348                | 1,962,876       | 3,504,339    | \$1,436   |
| 1992 .....                       | 653,545                     | 1,063,370              | 2,003,083       | 3,719,998    | 1,520   |
| 1993 .....                       | 688,509                     | 1,014,490              | 2,165,959       | 3,868,958    | 1,628   |
| 1994 .....                       | 721,427                     | 980,220                | 2,320,948       | 4,022,595    | 1,728   |
| 1995(p) .....                    | 766,019                     | 954,132                | 2,388,274       | 4,108,425    | 1,826   |

(p) Preliminary.

(1) Includes tourists in guest houses.

(2) Including visitors in homes of relatives, friends and in hotel apartments.

Sources: Puerto Rico Tourism Company and the Planning Board.

During the first three months of fiscal 1996, the number of persons registered in tourist hotels totaled 319,100, a 22.3% increase compared with the same period in fiscal 1995. The average of the occupancy rate in tourist hotels was 66.6% in the first three months of fiscal 1996. The average number of rooms rented in tourist hotels increased 8.1% in the first three months of fiscal 1996 compared with the same period in fiscal 1995. These increases are due in part to increased marketing of Puerto Rico by the Government and increased hotel usage by Puerto Rico residents.

Hotel operations are eligible for certain tax incentives under Commonwealth law. See "Tax Incentives" below.

*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 on the island including Arecibo, Culebra, Fajardo, Guayama, Guayanilla, Mayaguez, Ponce, Vieques and Yabucoa.

The San Juan Luis Muñoz Marín International Airport is currently served by 28 United States and international airlines. At present, there is daily direct service between San Juan and New York, Chicago, Dallas, Los Angeles, Miami, Atlanta, Boston and numerous other United States cities. There is also regularly scheduled service between Puerto Rico and other Caribbean islands and major Latin American and European cities. A major United States airline uses San Juan as a hub for its intra-Caribbean 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, 1995, totaled approximately 4,600 miles.

## *Agriculture*

The Commonwealth has traditionally supported the agricultural sector. The efforts of the Department of Agriculture and related agencies are directed to increase and improve local agricultural production, increase efficiency and quality of produce and stimulate import substitution where economically feasible. In the last few years, non-traditional crops and livestock products have contributed a higher percentage of the sector's income.

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. 106, approved July 10, 1986, extended the exemption period from 10 to 15 years. The exemption from taxation during the entire 15-year period is set at 90%.

## *Construction*

The construction industry has experienced substantial real growth since fiscal 1987. In fiscal 1995, the investment in construction rose to a record \$3.3 billion, an increase of 10.5%, as compared to \$2.9 billion for fiscal 1994. The construction sector experienced a 33.1% increase in total value of construction permits and an increase of 3.5% in local cement consumption for fiscal 1995 when compared to fiscal 1994. During the first five months of fiscal 1996, the total value of construction permits decreased 25.5% and local cement consumption increased 0.2% in comparison with the same period in fiscal 1995. A decline of 18.9% in cement sales in September was due to weather-related construction delays caused by an unusually active hurricane season which resulted in several major storms passing close to the island. However, in October and November, cement sales grew at an annual average rate of 13.8%. Construction employment increased to 56,600 in fiscal 1995 from 53,700 in fiscal 1994 an increase of 5.4%. In the first five months of fiscal 1996 the average employment in the construction sector was 58,700.

## **Higher Education**

During the past four decades, Puerto Rico has made significant advances in the field of education, particularly at the college and graduate school level. The transformation of Puerto Rico during the 1950's and 1960's from an agricultural economy to an industrial economy brought about an increased demand for education at all levels. During the 1970's and 1980's, certain higher wage, higher technology industries became more prominent in Puerto Rico. More recently service sector employment has increased significantly. This has resulted in an increased demand for workers having a higher level of education in general and, in particular, 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 the college-age population.

The University of Puerto Rico, the only public university in the Commonwealth, includes eleven campuses located throughout the island. Total enrollment of the University was approximately 55,800 as of August 1994. The Commonwealth is legally obligated to annually appropriate to the University an amount equal to 9.33% of the average of the annual revenues from internal sources in each of the two fiscal years immediately preceding the current fiscal year.

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

### Trend in College Enrollment

| <u>Academic Year</u> | <u>Puerto Rico</u>                           |  |                   | <u>Mainland United States</u>                |  |                   |
|----------------------|--|--|-------------------|--|--|-------------------|
|                      | <u>Population<br/>18-24 Years<br/>of Age</u> | <u>Higher<br/>Education<br/>Enrollment</u> | <u>Percent(1)</u> | <u>Population<br/>18-24 Years<br/>of Age</u> | <u>Higher<br/>Education<br/>Enrollment</u> | <u>Percent(1)</u> |
| 1970 .....           | 341,448                                      | 57,340                                     | 16.8%             | 23,989,000                                   | 8,580,887                                  | 35.8%             |
| 1980 .....           | 397,839                                      | 130,105                                    | 32.7              | 29,252,000                                   | 12,096,895                                 | 41.4              |
| 1990 .....           | 417,636                                      | 156,147                                    | 37.4              | 27,038,000                                   | 13,820,000                                 | 51.1              |
| 1993 .....           | 438,390                                      | 161,187                                    | 36.8              | 26,063,000                                   | 14,994,000                                 | 57.5              |

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

Sources: Planning Board, U.S. Bureau of the Census, U.S. National Center for Education Statistics and Council on Higher Education of Puerto Rico.

The table demonstrates that higher education enrollment in Puerto Rico has continued to increase despite slower growth in the college-age population and despite a slight drop in the proportion of attendance by the college-age population.

In addition to the University of Puerto Rico, there are 37 private institutions of higher education located in Puerto Rico. Such institutions have current enrollment of approximately 100,000 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.

### Tax Incentives

Much of the development of the manufacturing sector in Puerto Rico can be attributed to various federal and Commonwealth tax incentives, particularly Section 936 of the Internal Revenue Code, as amended (the "Code"), and the Commonwealth's Industrial Incentives Program.

#### Section 936

Under Section 936 of the Code, United States corporations that meet certain requirements and elect its application ("Section 936 Corporations") are entitled to credit against their United States corporate income tax the portion of such tax attributable to (i) income derived from the active conduct of a trade or business within Puerto Rico ("active business income") or from the sale or exchange of substantially all assets used in the active conduct of such trade or business and (ii) qualified possession source investment income ("passive income").

To qualify under Section 936 in any given taxable year a corporation must derive (i) for the three-year period immediately preceding the end of such taxable year 80% or more of its gross income from sources within Puerto Rico and (ii) for taxable years beginning after December 31, 1986, 75% or more of its gross income from the active conduct of a trade or business in Puerto Rico.

A Section 936 Corporation may elect to compute its active business income eligible for the Section 936 credit under one of three formulas: (A) a cost sharing formula, whereby it is allowed to claim all profits attributable to manufacturing intangibles and other functions carried out in Puerto Rico, provided it contributes to the research and development expenses of its affiliated group or pays certain royalties; (B) a profit split formula, whereby it is allowed to claim 50% of the net income of its affiliated group from the sale of products manufactured in Puerto Rico; or (C) a cost plus formula, whereby it is allowed to claim a reasonable profit on the manufacturing costs incurred in Puerto Rico. To be eligible for the first two formulas, the Section 936 Corporation must have a significant business presence for purposes of the Section 936 rules.

Pursuant to amendments to the Code adopted in August of 1993, and effective for taxable years commencing after 1993, two alternative limitations apply to the Section 936 credit against active business income and sale of assets income previously described. The first option limits (the "percentage limitation") the credit against such income to 40% of the credit allowable previous to the amendments of 1993, with a five year phase-in period starting at 60% of the current allowable credit. The second option limits (the "economic limitation") the allowable credit against such income to the sum of (i) 60% of qualified compensation paid to employees as defined in the Code, which includes wages up to 85% of the maximum earnings subject to the OASDI portion of Social Security taxes (\$61,200 for 1995) plus an allowance for fringe benefits of 15% of qualified wages, (ii) a specified percentage of depreciation deductions ranging between 15% and 65%, based on the class life of the property claimed by Section 936 Corporation for tangible property located in Puerto Rico and used in its trade or business and (iii) a portion of Puerto Rico income taxes paid by the Section 936 Corporation, up to a 9% effective tax rate (but only if the Section 936 Corporation does not elect the profit-split method for allocating income from intangible property).

At present, while it is difficult to forecast what the long term effects of the 1993 limitations to the Section 936 credit will be on the economy of Puerto Rico, econometric studies by the Planning Board and private sector economists on the economic effects of such limitations, assuming no enhancements to the existing Industrial Incentives Program (described below), projected only a slight reduction in average annual growth rates. Despite no changes in the Industrial Incentives Program, no adverse economic impact has been observed. Data on the performance of the Puerto Rico economy since the 1993 limitations became effective bear out these studies by showing no reductions in the economic growth rate or employment in the industries expected to be adversely affected by the 1993 amendments to Section 936 (generally pharmaceuticals and beverages due to their higher profit margins). The data suggest that the effect of the performance of the United States economy on the performance of the Puerto Rico economy as described under the "Economy -- General" is and will be greater than the effect thereon of the 1993 changes in the Section 936 credit. In addition, the above limitations do not reduce the tax credit currently enjoyed by certain labor-intensive, lower profit-margin industries, which represent approximately 40% of the total employment by Section 936 corporations in Puerto Rico.

On November 17, 1995 the United States Congress adopted, as part of its larger federal income tax legislative package a ten-year phase out of the current 936 credit for companies that are existing credit claimants and the elimination of the credit for companies establishing new operations in Puerto Rico and for existing companies that add a substantial new line of business. The credit based on the economic limitation will continue as under current law without change until tax years beginning in 2002, during which years the possession business income will be subject to a cap based on the corporation's possession income for an average adjusted base period. The credit based on the percentage limitation will continue as under current law until tax years beginning in 1998. In that year and thereafter, the credit based on the percentage limitation will be 40%, but the possession business income will be subject to a cap based on the corporation's possession income for an average adjusted base period. The 936 credit is eliminated for taxable years beginning in 2006. However, the credit granted to passive income (QPSII) is eliminated for taxable years beginning after December 31, 1995.

The Governor of Puerto Rico has proposed to the Congress a modification of the total elimination of the Section 936 credit by offering qualifying companies the option of the existing 936 credit plan, as amended by the House proposal, or a new incentive program, to be available in Puerto Rico, that would provide to such companies a credit based on qualifying wages paid, other wage related expenses, such as fringe benefits, depreciation expenses for certain tangible assets, research and development expenses and the credit granted to passive income under current law. The credit granted to qualifying companies would continue in effect until Puerto Rico shows, among other things, substantial economic improvements in terms of the certain economic parameters. These provisions are not currently in the legislation adopted by the United States Congress on November 17, 1995.

The President vetoed the legislation submitted by the United States Congress on December 7, 1995. The Administration has proposed a modification to the 936 credit that would phase out the credit based upon the percentage limitation over a five year period beginning in 1997, retain the credit based upon the economic limitation under current law, allow a five year carry forward of excess credit based upon the economic limitation and retain the credit granted to passive income under current law.

It is not possible at this time to determine the final legislative changes that may be made to Section 936, or the effect on the long-term outlook on the economy of Puerto Rico. The Government of Puerto Rico does not believe there will be short-term or medium-term material adverse effects on Puerto Rico's economy as a result of the changes to Section 936 currently proposed by Congress or by the Administration. The Government of Puerto Rico further believes that even if the Congressional proposal became law, sufficient time exists to put additional incentive programs in place to safeguard Puerto Rico's competitive position.

#### *Industrial Incentives Program*

Since 1948 Puerto Rico has had various industrial incentives laws designed to stimulate industrial investment in the island. Under these laws, companies engaged in manufacturing and certain other designated activities (such as hotel operations) were eligible to receive full or partial exemption from income, property and certain local taxes.

On January 24, 1987, the Governor of Puerto Rico signed into law the most recent industrial incentives law, Act No. 8 of January 24, 1987, known as the Puerto Rico Tax Incentives Act (the "1987 Act"). The tax exemption benefits provided by the 1987 Act are generally more favorable than those provided by its predecessor, the Industrial Incentives Act of 1978 (the "1978 Act"). The activities eligible for exemption under the 1987 Act include manufacturing, certain designated services for markets outside Puerto Rico, the production of energy from local renewable sources for consumption in Puerto Rico, and laboratories for scientific and industrial research.

The 1987 Act provides a fixed 90% exemption from income and property taxes and a 60% exemption from municipal license taxes during a 10, 15, 20 or 25 year period, depending on the zone where the operations are located. This initial exemption period may be extended for an additional 10 years at lower exemption rates. The 1987 Act also provides a special deduction equal to 15% of the production payroll for companies whose net income from operations is less than \$20,000 per production job. This special benefit is designed to attract and maintain labor intensive operations in Puerto Rico. The passive income from certain qualified investments in Puerto Rico and the instruments evidencing such investments are fully exempt from income tax. In addition, companies making such investments for fixed periods of not less than five years are eligible to reduce the tollgate tax imposed on dividend and liquidating distributions from a maximum rate of 10% to 5%, depending on the amount and term of the investment.

This bottom limit of 5% was approved in a recent amendment (December 1993) of the 1987 Act (the "1993 amendments"). The 1993 amendments also impose a new 5% estimated tax on annual industrial development income, subject to reduction in the event certain long-term qualified investments with such income are made.

The Department of Treasury is collecting an additional amount annually as a result of the implementation of the bottom limit. As a result of the 1993 amendments, the Department of the Treasury has increased its ability to predict tax revenues from corporations with greater accuracy. The 1993 amendments also contain an option to pay a flat 14% tax on annual industrial development income, which would allow eligible companies to repatriate profits free of tollgate taxes. Under this option, if a company invests 25% or 50% of its profits in qualified industrial development investments, the 14% rate drops to 11% or 9%, respectively.

The 1987 Act imposes a special surtax on sales volume designed to raise revenues to fund a special government program of scientific and technical research for the development of new products and industrial processes and the creation of special training programs for the chronically unemployed.

The 1987 Act applies to newly established operations as well as to existing operations that elect to convert their tax exemption grants to the provisions of the 1987 Act. Companies with existing operations that elect not to convert remain subject to the provisions of the 1978 Act or any of the predecessor industrial incentives laws.

Since 1983 hotel operations have been covered by a special incentives law, the Tourism Incentives Act of 1983, which provides exemptions from income, property and municipal license taxes for a period of 10 years. The income tax exemption rates vary depending on the zone where the business is located. In 1993, legislation was enacted providing for an additional set of tax incentives for new hotel development projects. This legislation also provides exemptions from income, property and municipal license taxes for a period of up to 10 years. In addition, it provides certain tax credits for qualifying investments in such projects. Upon meeting certain prescribed conditions, businesses exempted under the 1983 special incentives law may elect instead to be covered by the 1993 law.

### **Caribbean Basin Initiative**

In August, 1983, the President of the United States signed into law the Caribbean Basin Economic Recovery Act. The Tax Reform Act of 1986 amended Section 936 to allow Puerto Rico financial institutions, including Government Development Bank and Puerto Rico Economic Development Bank, to invest funds representing earnings accumulated under Section 936, in active business assets or development projects in a qualified Caribbean Basin country. Such investments must be in accordance with a specific authorization from the Commissioner of Financial Institutions pursuant to regulations issued by the Secretary of the Treasury. As of December 1994, 167 projects under the Puerto Rico Caribbean Development Program have been promoted in fourteen Caribbean Basin countries, representing 36,115 jobs and over \$1,989 million in loan commitments, of which \$1,217 million of Section 936 funds have been disbursed.

### **North American Free Trade Agreement**

The United States, Canada and Mexico have entered into the North American Free Trade Agreement ("NAFTA"), which agreement is designed to eliminate restrictions on trade and investment flows among the three countries. KPMG Peat Marwick conducted a study in 1992 of the potential economic impact of NAFTA on the economy of Puerto Rico for Government Development Bank and concluded that, once NAFTA is fully implemented, certain of the Commonwealth's industries, including those that are lower salaried and labor intensive, may face increased competition from Mexico, while Puerto Rico's favorable investment environment, highly skilled work force, infrastructure development and tax structure (mainly Section 936) would tend to create expanded trade opportunities for Puerto Rico in such areas as pharmaceuticals and high technology manufacturing. KPMG Peat Marwick updated the analysis of the original study to incorporate the changes to Section 936 enacted in 1993 and concluded that the reductions in after-tax rates of return resulting from such changes do not eliminate Puerto Rico's competitive advantage in certain key industries over Mexico. The after-tax rate of return advantages are maintained

in pharmaceuticals, electronics and scientific instruments. In addition, said changes have no significant effect on the other major industries analyzed in the original study (tuna canning, textiles, apparel and footwear).

## DEBT

### Public Sector Debt

Public sector debt comprises bonds and notes of the Commonwealth and its municipalities and public corporations ("notes" as used in this Section is intended to refer to certain types of non-bond debt regardless of maturity), subject to the exclusions described in the following paragraph. Direct debt of the Commonwealth is supported by Commonwealth taxes. 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 charges 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.

The following table presents a summary of public sector debt as of November 30, 1995. Excluded from this table is debt not primarily payable from either Commonwealth or local taxes, or Commonwealth appropriations or public corporation charges for services or products. Also excluded from the following table is debt the inclusion of which would reflect double counting, including, but not limited to, \$449,909,219 of bonds issued by Municipal Finance Agency to finance its purchase of bonds of Commonwealth municipalities; and \$1,648,482,000 of obligations of Government Development Bank issued to purchase certain Commonwealth public sector debt and for other purposes, of which \$267,000,000 are guaranteed by the Commonwealth.

### Commonwealth of Puerto Rico

#### Public Sector Debt

(in thousands)

|   | <u>November 30,</u><br><u>1995</u> |
|---|------------------------------------|
| Commonwealth direct debt(1) . . . . .                         | \$ 4,028,186                       |
| Municipal debt . . . . .                                      | 737,211                            |
| Public corporations debt: . . . . .                           |                                    |
| Commonwealth guaranteed debt(2) . . . . .                     | 444,901                            |
| Debt supported by Commonwealth appropriations or taxes(3) . . | 4,709,353                          |
| Other non-guaranteed debt(4) . . . . .                        | <u>6,191,096</u>                   |
| Total public corporations debt . . . . .                      | <u>11,345,350</u>                  |
| Total public sector debt . . . . .                            | <u>\$16,110,747</u>                |

(1) Includes \$186,370,000 loan from Government Development Bank to the Department of Treasury to settle certain property tax claims of the municipalities (the "GDB tax claims loan") and \$146,527,000 of certain indebtedness originally issued by Urban Renewal and Housing Corporation that was transferred to the

- Commonwealth by virtue of Act No. 134 of the Legislature of Puerto Rico, approved December 13, 1994 ("Act No. 134 of 1994") (such indebtedness being called the "transferred CRUV debt").
- (2) Excludes \$1,335,611,000 of Public Buildings Authority bonds and notes which are primarily payable from Commonwealth appropriations and \$267,000,000 of Government Development Bank bonds payable from available moneys of Government Development Bank. Includes bonds issued by Housing Bank and Finance Agency and Aqueduct and Sewer Authority. Does not include \$400,340,000 Aqueduct and Sewer Authority Refunding Bonds, Series 1995, Guaranteed by the Commonwealth of Puerto Rico (the "1995 PRASA Guaranteed Bonds") issued on December 21, 1995 to refund all of the outstanding Aqueduct and Sewer Authority revenue and revenue refunding bonds previously guaranteed by the Commonwealth (collectively, the "Prior PRASA Bonds").
  - (3) Represents, among others, bonds and notes issued by Aqueduct and Sewer Authority, Highway and Transportation Authority, Public Buildings Authority, Maritime Shipping Authority, Infrastructure Financing Authority, Economic Development Bank (and its affiliate, the Agriculture and Commercial Development Corporation), Health Facilities and Services Administration and Housing Bank and Finance Agency, including certain of the bonds issued by the former Urban Renewal and Housing Corporation.
  - (4) Does not include \$50,850,000 Affordable Housing Bonds issued on December 21, 1995 by Housing Bank and Finance Agency (the "1995 Housing Bank Bonds").

*Source:* Government Development Bank.

No deductions have been made in the above table 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 debt service requirements for outstanding general obligation bonds and for the Bonds (excluding the Refunded Bonds). Debt service requirements for each fiscal year, as shown in the following table, include principal and interest due on July 1 of the next fiscal year.

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

| Fiscal Year<br>Ending June 30 | Outstanding Bonds  |                           | Bonds            |                  | Total              |
|-------------------------------|--------------------|---------------------------|------------------|------------------|--------------------|
|                               | Principal          | Interest                  | Principal        | Interest         |                    |
| 1996 . . . . .                | \$ 198,580         | \$ 101,022 <sup>(1)</sup> | \$ 5,065         | \$ 11,070        | \$ 315,738         |
| 1997 . . . . .                | 202,295            | 196,443                   | 5,685            | 21,938           | 426,361            |
| 1998 . . . . .                | 202,971            | 188,062                   | 5,905            | 21,718           | 418,656            |
| 1999 . . . . .                | 192,386            | 181,257                   | 6,150            | 21,476           | 401,269            |
| 2000 . . . . .                | 183,755            | 165,465                   | 6,395            | 21,230           | 376,845            |
| 2001 . . . . .                | 177,776            | 154,381                   | 14,390           | 20,926           | 367,473            |
| 2002 . . . . .                | 176,214            | 146,364                   | 15,115           | 20,206           | 357,900            |
| 2003 . . . . .                | 104,804            | 215,485                   | 15,790           | 19,541           | 355,621            |
| 2004 . . . . .                | 106,755            | 212,324                   | 16,500           | 18,831           | 354,409            |
| 2005 . . . . .                | 180,382            | 135,129                   | 17,265           | 18,072           | 350,847            |
| 2006 . . . . .                | 140,168            | 150,416                   | 18,225           | 17,122           | 325,932            |
| 2007 . . . . .                | 123,214            | 158,062                   | 8,275            | 16,120           | 305,670            |
| 2008 . . . . .                | 99,033             | 120,487                   | 8,815            | 15,582           | 243,917            |
| 2009 . . . . .                | 103,370            | 97,885                    | 9,400            | 15,009           | 225,663            |
| 2010 . . . . .                | 111,190            | 89,564                    | 10,000           | 14,445           | 225,199            |
| 2011 . . . . .                | 116,727            | 83,538                    | 10,600           | 13,845           | 224,710            |
| 2012 . . . . .                | 123,290            | 69,976                    | 11,185           | 13,209           | 217,660            |
| 2013 . . . . .                | 111,825            | 63,772                    | 11,915           | 12,482           | 199,994            |
| 2014 . . . . .                | 98,855             | 56,074                    | 12,690           | 11,707           | 179,327            |
| 2015 . . . . .                | 104,575            | 50,540                    | 13,510           | 10,883           | 179,507            |
| 2016 . . . . .                | 109,685            | 45,360                    | 14,390           | 10,004           | 179,440            |
| 2017 . . . . .                | 116,785            | 38,438                    | 15,180           | 9,213            | 179,616            |
| 2018 . . . . .                | 122,990            | 32,134                    | 16,015           | 8,378            | 179,517            |
| 2019 . . . . .                | 109,285            | 24,913                    | 16,880           | 7,513            | 158,592            |
| 2020 . . . . .                | 116,455            | 18,876                    | 17,795           | 6,602            | 159,728            |
| 2021 . . . . .                | 79,895             | 12,184                    | 18,755           | 5,641            | 116,474            |
| 2022 . . . . .                | 62,420             | 7,620                     | 19,765           | 4,628            | 94,433             |
| 2023 . . . . .                | 42,860             | 3,894                     | 20,835           | 3,561            | 71,150             |
| 2024 . . . . .                | 21,990             | 1,264                     | 21,960           | 2,436            | 47,650             |
| 2025 . . . . .                |                    |                           | 23,145           | 1,250            | 24,395             |
| <b>Total</b>                  | <b>\$3,640,529</b> | <b>\$2,820,931</b>        | <b>\$407,595</b> | <b>\$394,637</b> | <b>\$7,263,692</b> |

<sup>(1)</sup> Represents six months' interest through June 30, 1996.

\* Totals may not add due to rounding.

Sources: Government Development Bank and Department of the Treasury.

## **Commonwealth Guaranteed Debt**

Annual debt service on outstanding Commonwealth guaranteed bonds issued by Urban Renewal and Housing Corporation and assumed in fiscal year 1992 by Housing Bank and Finance Agency is \$13,254,048 in the fiscal year ending September 30, 1996, which constitutes the maximum annual debt service on such bonds. The final maturity of such bonds is October 1, 2001. As of November 30, 1995, \$65,665,000 of Commonwealth guaranteed bonds of Housing Bank and Finance Agency were outstanding. Annual debt service on Commonwealth guaranteed bonds of Public Buildings Authority is \$114,777,000 in fiscal year ending June 30, 1996 with the final maturity on July 1, 2025. As of November 30, 1995, \$1,335,611,000 of Commonwealth guaranteed bonds of Public Buildings Authority were outstanding.

No payments under the Commonwealth guaranty have been required to date for bonds of Housing Bank and Finance Agency or Public Buildings Authority.

As of November 30, 1995, \$267,000,000 of Commonwealth guaranteed obligations of Government Development Bank were outstanding. No payments under the Commonwealth guaranty have been required for any obligations of Government Development Bank to date.

The Farm Credit Corporation ("Farm Credit"), created pursuant to Act No. 68, approved June 8, 1960, as amended, assumed responsibility in 1971 for the administration of the Farm Credit Security Fund (the "Security Fund") from the Department of Agriculture. The Security Fund has guaranteed, under the good faith and credit of the Commonwealth, certain loans made by financial institutions and Farm Credit to farmers. The Security Fund is authorized to guarantee loans of which approximately \$14,431,681 has been committed as of December 31, 1995. As of December 31, 1995, \$1,408,019 was available in the Security Fund to cover loan payment defaults by farmers. The Commercial and Agricultural Credit and Development Corporation has been created to provide, among other things, loans to the commercial and agricultural sectors. The functions of Farm Credit and the administration of the Security Fund have been transferred to the new public corporation, which is an affiliate of Economic Development Bank. Simultaneously with the creation of the new corporation, the amount of guarantees was limited to the outstanding loans which carry such guaranty. A joint resolution adopted by the Legislature on August 19, 1990 appropriates \$8,000,000 per year beginning fiscal 1993 for five years to provide funds for the Security Fund. The proceeds of these appropriations will be used to pay a \$40,000,000 loan made to the Security Fund by Government Development Bank which is being used to cover payment on loans guaranteed by the Security Fund.

As of November 30, 1995, the Commonwealth had guaranteed certain outstanding revenue bonds of the Aqueduct and Sewer Authority in the aggregate principal amount of \$379,236,249. No payments under the Commonwealth guaranty have been required for such revenue bonds to date. These revenue bonds were refunded with the net proceeds of the 1995 PRASA Guaranteed Bonds, on December 21, 1995.

## **Trends of Public Sector Debt**

Historically, the Commonwealth has maintained a fiscal policy which provides for a prudent relationship between the growth of public sector debt and the growth of the economic base required to service that debt. The Commonwealth has also sought opportunities to realize debt service savings by refunding outstanding debt with obligations bearing lower interest rates. In certain years, this policy has had the effect of increasing the rate of growth of public sector debt above that of gross product. Over fiscal years 1991 to 1995, public sector debt increased 24.7% while gross product rose 24.4%. This slightly greater increase in the rate of public sector debt relative to the rate of increase in gross product over the subject period was principally the result of refinancings to achieve debt service savings. Short term debt outstanding relative to total debt was 7.5% as of November 30, 1995.

The following table shows the trends in gross product (in current dollars) and public sector debt for the five fiscal years ended June 30, 1995 and at November 30, 1995.

Commonwealth of Puerto Rico

Public Sector Debt and Gross Product  
(dollars in millions)

| June 30             | Public Sector Debt |                           |                       |          |                     | Gross Product <sup>(1)</sup> |                     |
|---------------------|--------------------|---------------------------|-----------------------|----------|---------------------|------------------------------|---------------------|
|                     | Long Term          | Short Term <sup>(2)</sup> | Short Term<br>as % of |          | Rate of<br>Increase | Amount                       | Rate of<br>Increase |
|                     |                    |                           | Total                 | Total    |                     |                              |                     |
| 1991                | \$12,041           | \$ 784 <sup>(3)</sup>     | 6.1%                  | \$12,825 | 2.1%                | \$22,809                     | 5.5%                |
| 1992                | 13,108             | 713                       | 5.2                   | 13,821   | 7.8                 | 23,696                       | 3.9                 |
| 1993                | 13,257             | 985 <sup>(3)</sup>        | 6.9                   | 14,242   | 3.0                 | 25,133                       | 6.1                 |
| 1994                | 14,077             | 1,181 <sup>(3)</sup>      | 7.7                   | 15,258   | 7.1                 | 26,592                       | 5.8                 |
| 1995                | 14,688             | 1,305                     | 8.2                   | 15,993   | 4.8                 | 28,371                       | 6.7                 |
| 1996 <sup>(5)</sup> | 14,895             | 1,215                     | 7.5                   | 16,110   | 0.7                 | N/A                          | N/A                 |

(1) In current dollars.

(2) Obligations issued with a 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 sufficient funds had been set aside for the payment of such notes in full prior to the end of said fiscal years.

(4) Does not include the 1995 PRASA Guaranteed Bonds, the refunding of the Prior PRASA Bonds and the 1995 Housing Bank Bonds.

(5) As of November 30, 1995.

Source: Government Development Bank.

The following table shows the trend of public sector debt by major category for the five fiscal years ended June 30, 1995 and at November 30, 1995.

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

| June 30             | Commonwealth(1) |                  |          | Municipalities |                  |        | Public Corporations(2) |                  |           | Total<br>Long Term | Total<br>Short Term(3) | Grand<br>Total* |
|---------------------|-----------------|------------------|----------|----------------|------------------|--------|------------------------|------------------|-----------|--------------------|------------------------|-----------------|
|                     | Long<br>Term    | Short<br>Term(3) | Total*   | Long<br>Term   | Short<br>Term(3) | Total* | Long<br>Term           | Short<br>Term(3) | Total*    |                    |                        |                 |
| 1991                | \$3,260         | \$ 54(4)         | \$3,314  | \$386          | \$ 30            | \$416  | \$ 8,395               | \$ 700           | \$ 9,095  | \$12,041           | \$ 784                 | \$12,825        |
| 1992                | 3,402           | --               | 3,402    | 460            | 39               | 499    | 9,246                  | 675              | 9,921     | 13,108             | 713                    | 13,821          |
| 1993                | 3,483           | 120(4)           | 3,603    | 497            | 39               | 536    | 9,276                  | 826              | 10,102    | 13,257             | 985                    | 14,242          |
| 1994                | 3,713           | 120(4)           | 3,833    | 571            | 47               | 618    | 9,792                  | 1,014            | 10,807    | 14,076             | 1,181                  | 15,258          |
| 1995                | 4,236           | 30               | 4,266(5) | 679            | 53               | 732    | 9,773                  | 1,222            | 10,995    | 14,688             | 1,305                  | 15,993          |
| 1996 <sup>(7)</sup> | 4,028           | 0                | 4,028(5) | 690            | 47               | 737    | 10,177                 | 1,169            | 11,346(6) | 14,895             | 1,215                  | 16,110          |

(1) General obligation and other direct debt; Special Promissory Notes are included in Long Term portion for fiscal years 1990 through 1992.

(2) Includes Commonwealth guaranteed debt.

(3) Obligations with a maturity of three years or less are considered short-term debt.

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

(5) Includes the Treasury Department tax claims loan and the transferred CRUV debt.

(6) Does not include the 1995 PRASA Guaranteed Bonds, the refunding of the Prior PRASA Bonds and the 1995 Housing Bank Bonds.

(7) As of November 30, 1995.

\* Totals may not add due to rounding.

Source: Government Development Bank.



## **Government Development Bank for Puerto Rico**

The principal functions of Government Development Bank 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 November 30, 1995, \$1,648,482,000 of bonds and notes of Government Development Bank were outstanding. Government Development Bank has loaned \$2,322,400,000 to Commonwealth public corporations and municipalities. Act No. 12, approved May 9, 1975, as amended, provides that the payment of principal of and interest on specified notes and other obligations of Government Development Bank, not exceeding \$550,000,000, may be guaranteed by the Commonwealth, of which \$267,000,000 were outstanding as of November 30, 1995.

Government Development Bank has the following principal subsidiaries:

*Higher Education Assistance Corporation* was established in May 1981 for the purpose of guaranteeing loans made to post-secondary school students under Federal insurance programs. The operations of this Corporation were transferred to the Great Lakes Higher Education Corporation, a guarantee agency based in Wisconsin, and the Corporation is in the process of liquidation.

*Housing Finance Corporation* was created in November 1977 for the purposes of providing needed rental housing units and stimulating the construction industry under federally subsidized programs. The Corporation has issued tax-exempt revenue bonds and notes to finance the construction of housing units approved for federal rental subsidies, which bonds and notes are limited obligations of the Corporation payable solely from revenues collected in respect of such housing units. The Federal Housing Administration has insured mortgages on certain of the housing units. As of November 30, 1995, \$1,427,533,820 of bonds were outstanding.

*Tourism Development Fund* was created in November 1993 to promote the hotel and tourism industry of the Commonwealth, primarily through letters of credit or guarantees. The Tourism Development Fund is also authorized to make capital investments and provide direct financing to tourism related projects.

*Development Fund* was created in 1977 to provide an alternate source of financing to private enterprises in Puerto Rico that have difficulties in obtaining financing from traditional sources. The Development Fund may also guarantee obligations of these enterprises and invest in their equity securities.

*Capital Fund* was created in November 1993 for trading in debt obligations and publicly traded shares of domestic and foreign corporations.

*Public Finance Corporation* was established in December 1984 for the purpose of providing the agencies and instrumentalities of the Commonwealth with alternate means of meeting their financing requirements. The Corporation issued on June 30, 1995, \$298,524,000 of bonds to purchase certain debt issued by Maritime Shipping Authority to Government Development Bank.

A description of certain other subsidiaries and affiliates of Government Development Bank is provided in "Other Public Corporations."

### **Other Public Corporations**

*Aqueduct and Sewer Authority* owns and operates a system of public water supply and sanitary sewer facilities. Capital expenditures are financed by revenues of the system, debt issuances, and federal and Commonwealth grants. Debt service on revenue bonds is payable from net revenues of the system after payment

of current expenses. As of November 30, 1995, the Authority had bonds outstanding in the amount of \$448,807,000 (not including accretion of interest from the respective issuance dates on capital appreciation bonds) and notes outstanding in the amount of \$433,229,000.

Facilities and operations of the Authority's system are subject to regulation under numerous federal and Commonwealth environmental laws, including the federal Clean Water Act administered by the United States Environmental Protection Agency ("EPA"). The Authority has embarked on an extensive capital improvement program for the five-year period ending June 30, 2000 that is estimated to cost approximately \$1.6 billion. A portion of the capital improvement program is designed to enable the Authority to comply with federal and Commonwealth laws and regulations.

A report prepared for the Governor of the Commonwealth calls for substantially greater investments in infrastructure and a major overhaul of the Authority's operations to maintain the viability of the existing system and to finance its expansion to new users. It is contemplated that funds for these capital improvements will be provided through a combination of bond issues, legislative appropriations and federal grants.

The Authority reported net losses of approximately \$64 million in fiscal 1994 and \$60.5 million in fiscal 1995. The net losses are the result of continuing financial and operating difficulties that the Authority has experienced in recent years.

In response to these difficulties and to the report mentioned above, in July 1994, the Governor signed legislation designed to enhance the Authority's credit position in the capital markets by providing a Commonwealth guaranty of the Authority's outstanding indebtedness of approximately \$388 million (which previously had been sold in public markets) and a guaranty of any indebtedness that may be issued to refinance this debt, and further providing for annual Commonwealth appropriations to the Authority to pay a portion of the principal and interest on the Authority's indebtedness and/or to defray a portion of the Authority's operating and maintenance expenses as follows: \$20 million for fiscal year 1995, \$25 million for fiscal year 1996, \$30 million for fiscal year 1997 and \$35 million for fiscal year 1998. In the event the Authority continues to require financial assistance after 1998, the legislation contemplates future direct contributions by the Commonwealth to the Authority of up to \$35 million annually.

Notwithstanding the issuance of the Series 1995 Bonds and the execution of the agreement discussed below and the legislative appropriations previously discussed, it is likely that additional substantial legislative appropriations may need to be made to the Authority over the next few years in order to support the financial and operational viability of the Authority and allow the Authority to finance its capital improvement program.

On May 26, 1995, the Authority and Professional Services Group, Inc., a subsidiary of Compagnie Generale Des Eaux of France ("PSG"), entered into a five-year agreement under which PSG will provide management, operation, repair and maintenance services for the water and waste water treatment systems of the Authority (collectively, the "Authority System"). The Authority retains control over strategic planning, environmental compliance and long-term financing of its facilities, among other things. The agreement includes terms and conditions that are expected to result in improved efficiency of the Authority System. The Authority will pay PSG a fixed annual fee of \$93,750,000 for the above services based on the Authority's current operating budget. Of this amount \$83,750,000 will be used for the payment of energy costs, chemical products and other operating items (but not labor costs and repairs in excess of \$2,000 per repair), and the remaining \$10,000,000 will be for the payment of administrative and management expenses of PSG. This fixed annual fee may be adjusted up or down under certain events and circumstances. Penalties will be assessed against PSG if certain efficiency standards (including total employment at the Authority) are not met, and bonuses may be earned by PSG for improvement in certain criteria, including increased revenue collections from existing customers, reductions in total employment and other productivity measures. The agreement gives the Authority the right without penalty to terminate it after three years.

The Authority is also negotiating with a private consortium for the construction and operation of a major water pipeline to serve the San Juan metropolitan area. See "Economic Development Program" under *The Economy* above.

On December 21, 1995, the Authority issued \$400,340,000 Puerto Rico Aqueduct and Sewer Authority Refunding Bonds, Series 1995, Guaranteed by the Commonwealth of Puerto Rico to refund all of the Authority's outstanding revenue and revenue refunding bonds previously guaranteed by the Commonwealth.

*Economic Development Bank* was created in July 1985 to engage primarily in granting small direct loans, providing loan guarantees to private enterprises and making equity investments in such enterprises. Its initial capital was provided by a transfer of loans in the principal amount of \$15,000,000 previously administered by a now inactive subsidiary of Government Development Bank. As of November 30, 1995, the Economic Development Bank had \$24,000,000 principal amount of Capital Notes payable from Commonwealth appropriations and \$72,000,000 collateralized Promissory Notes.

*Electric Power Authority* owns and operates the island's electric system. Capital improvements are financed primarily by borrowed funds, supplemented by internally generated funds. The Authority's bonded debt consists of Power Revenue Bonds. The Bonds are secured by a lien on net revenues of the electric system. As of November 30, 1995, the Authority had \$3,261,854,000 in bonds outstanding (not including accretion of interest from the respective issuance dates on capital appreciation bonds). The Authority has entered into power purchase contracts relating to the construction of certain cogenerating plants that will use fuels other than oil. See "Economic Development Program" under *The Economy* above.

*Health Facilities and Services Administration* ("AFASS") was created by Act No. 26, approved on November 13, 1975, as amended, with the objectives of planning, evaluation and development of health services, alleviation of environmental contamination, operation of public hospitals and other health facilities, prevention and treatment of mental illness, administration of family planning programs and maternal and child care activities. The operations of AFASS are funded substantially by appropriations from the Commonwealth. AFASS' outstanding indebtedness to Government Development Bank as of November 30, 1995 was \$287,810,000. In addition, AFASS has a line of credit with Government Development Bank for \$200 million to be used by AFASS to pay operational expenses related to health care reform programs in the Commonwealth. As of November 30, 1995, AFASS has no outstanding amount drawn on such line of credit.

*Highway and Transportation 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 of all the proceeds of the gasoline tax, one-half of the proceeds of the tax on gas oil or diesel oil, highway toll revenues 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 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 November 30, 1995, the Highway and Transportation Authority had \$1,616,890,000 in bonds outstanding.

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 payable by the private company 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 as described in the agreement, including where toll revenues are insufficient to generate certain rates of return to the private operator, the private company may require the Authority, among other things, to assume the private company's obligations with respect to the special facility

revenue bonds. Certain of those circumstances, including low toll revenues, exist at this time but the Authority does not currently anticipate that the private company will exercise its remedy against the Authority.

The Authority is exploring the possibility of undertaking other transactions to privatize the construction and operation of additional traffic facilities.

The Authority has issued a request for proposals seeking responses from qualified firms for the planning, design, construction and operation of a light-rail mass transit system to serve a portion of the San Juan metropolitan area.

*Housing Bank and Finance Agency* is engaged in insuring mortgages and servicing mortgages originated by Urban Renewal and Housing Corporation and issues bonds and notes to provide interim and permanent financing for low-income housing projects and single-family home ownership programs. The Agency obtains funds from legislative appropriations, sales of mortgages, mortgage repayments and other sources.

As of November 30, 1995, the Agency had outstanding \$646,450,000 of bonds (of which \$65,665,000, originally issued by the Urban Renewal and Housing Corporation, are guaranteed by the Commonwealth) issued to pay obligations of the Commonwealth under law, otherwise payable from Commonwealth appropriations, to fund certain payments of the Commonwealth under its mortgage subsidy program for low and moderate income families, to guaranty certain insurance obligations of the Agency under certain programs and to refund bonds originally issued by Urban Renewal and Housing Corporation to carry out activities related to the provision of low-cost housing for moderate income families, federally aided public housing for low income families, and urban renewal, housing and related activities. These bonds are payable principally from appropriations in substantially the amount that the Commonwealth would otherwise have been obligated to appropriate for such purposes. On December 21, 1995, the Agency issued \$50,850,000 Affordable Housing Bonds.

*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 has issued interim notes and revenue bonds to finance factories and other facilities. Rentals derived from the leasing of specified facilities of the Company are pledged to the payment of the Company's revenue bonds. As of November 30, 1995, the Company had \$155,034,000 in bonds outstanding (not including accretion of interest from the respective issuance dates on capital appreciation bonds). On March 23, 1994, the hotel properties were sold to the Tourism Company in order to facilitate the further sale to the private sector.

*Industrial, Tourist, Educational, Medical and Environmental Control Facilities Financing Authority* was created in June 1977. The Authority has issued revenue bonds to finance industrial, pollution control, medical and educational 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 the Authority 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 September 30, 1995, \$3,588,065,060 of the Authority's bonds had been issued, of which \$2,184,732,792 were outstanding.

*Infrastructure Financing Authority* was created in June 1988 for the purpose of providing financial, administrative, consulting, technical, advisory and other types of assistance to other public corporations and governmental instrumentalities of the Commonwealth authorized to develop infrastructure facilities and to establish alternate means for financing infrastructure facilities. The legislation establishes a Puerto Rico Infrastructure Fund funded in the amount of \$30 million during fiscal 1989 and \$40 million for the following 29 fiscal years with 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 the Commonwealth pursuant to the Internal Revenue Code of 1986, as amended. In November 1988 the Authority issued \$327,740,000 of Special Tax Revenue Bonds, Series 1988A to refund in advance certain outstanding revenue bonds and other debt of the Aqueduct and Sewer Authority. As of

November 30, 1995, \$247,045,000 of such bonds were outstanding. The Authority's Special Tax Revenue Bonds, Series 1988A are secured by a pledge of a portion of such federal excise taxes, subject to the rights of the owners of the Commonwealth's general obligation bonds and notes and certain other obligations guaranteed by the Commonwealth.

*Maritime Shipping Authority* commenced operations in 1974 upon the acquisition of three shipping lines serving Puerto Rico and the United States mainland. The Authority acquired vessels and other equipment financed by the issuance of notes on a secured basis to the previous owners. As of the date of the sale of the Authority's assets referred to below, the Authority carried approximately 30% of the total cargo shipped between Puerto Rico and the United States mainland.

On March 3, 1995, the assets and operations of Maritime Shipping Authority were acquired by an investor group headed by BTIP, a subsidiary of Bankers Trust New York Corporation, under the terms and conditions approved by the Legislature of Puerto Rico and signed by the Governor on September 27, 1994.

Act No. 112 of September 27, 1994 restructured the operations and administration of the Authority by creating the Maritime Shipping Authority as a public corporation affiliated with the Government Development Bank for Puerto Rico, subject to the control of the President of the Bank, but as a separate legal entity, apart from the Bank and any of its other affiliates and subsidiaries. The remaining debt of the Authority was refinanced, as allowed under Act No. 113 of September 27, 1994, by the issuance of \$296,393,673.64 in bonds by the Public Finance Corporation, a subsidiary of the Bank. The Bonds are payable from funds to be appropriated annually by the Legislature of Puerto Rico. The Public Finance Corporation purchased the note of the Authority from the Bank with the proceeds of the bonds issued.

*Municipal Finance Agency* was created in 1972 as a 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 held by the Agency and from the reserve, including investment income thereon. The Commonwealth has agreed to pay such amounts to the reserve as may be necessary to maintain it at its required level, subject to appropriation by the Legislature, which appropriation is not legally required to be made. To date no such payments have been required.

*Ports Authority* owns and operates the major airport and seaport facilities in the Commonwealth. 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 seaport equipment and property. The Authority has a \$73.3 million line of credit from Government Development Bank for capital improvements, of which approximately \$72.4 million was outstanding as of November 30, 1995. In addition, Government Development Bank has approved a \$33 million line of credit for the Authority to finance the construction of a new multi-level parking facility at the Luis Muñoz Marin International Airport. The Authority has had total net losses of approximately \$72 million during the past three years and as a result, has not been in compliance with its rate covenant with bondholders. The Authority is implementing a plan to restructure its operations which, among other things, encompasses revisions to its capital improvement program and to the rate charges for the use of its facilities, measures to increase collections from certain users of its facilities and proposals to improve the efficiency of its operations. As of November 30, 1995, the Authority had \$133,805,000 in bonds outstanding.

*Public Buildings Authority* is authorized to construct, purchase or lease office, school, health and social welfare facilities for lease to Commonwealth departments, public corporations and instrumentalities. 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 Commonwealth appropriations, and are further secured by the Commonwealth's guaranty. The Authority is authorized by Act No. 17 of 1968, as amended, to have outstanding at any one time up to \$1,500,000,000 of bonds guaranteed by the Commonwealth. As of

November 30, 1995, \$1,335,611,000 of such bonds of the Authority were outstanding (not including accretion of interest from the respective issuance dates on capital appreciation bonds).

The Authority is undertaking a program to construct additional correctional facilities (the operations of certain of which are expected to be operated by private companies) to be completed by the end of fiscal 1996 at an estimated cost of \$126,972,552.

The Commonwealth is a defendant in a lawsuit in United States federal court charging, among other things, that the constitutional rights of correctional system inmates have been violated because of severe overcrowding in the Commonwealth's correctional system. Fines to assure compliance with minimum space standards have in the past been assessed against the Commonwealth. Most of these fines have been earmarked for improving the conditions of inmates but not for construction of additional correctional facilities to alleviate prison overcrowding. In April 1995, the district court judge overseeing the above lawsuit imposed an additional series of fines against the Commonwealth for noncompliance with the minimum space standards which fines may exceed \$30 million. These fines are required to be paid to the United States Treasury and also may not be used to construct additional facilities. The fines are payable during the current fiscal year. The Commonwealth can give no assurance that additional fines will not be levied in connection with the above lawsuit.

*Sugar Corporation* was created in 1973 to consolidate ownership and management of the Commonwealth's interests in Puerto Rico's sugar industry. Sugar Corporation owns or leases and operates virtually all the sugar production facilities on the island. Sugar Corporation buys all cane grown by private growers, processes the cane, and sells the crude and refined sugar and molasses.

Puerto Rico's sugar industry has for many years been a deficit operation. From July 1974 to June 30, 1995, the Corporation's cash deficit totaled approximately \$1,000,335,000. The Corporation's objective is to maintain sugar production at 40,000 tons of sugar per year for local consumption only.

Appropriations of approximately \$14,000,000 for the current fiscal year have been made to cover the operating deficit. In order to insure that the annual cash deficit will not exceed \$30,000,000, Sugar Corporation is required to present quarterly reports to the Legislature and implement cutbacks if necessary. As of November 30, 1995, the total debt of the Corporation was \$22,175,000.

The Commonwealth continues with the process of evaluating the sale of the operations of the Corporation to a private buyer.

*Telephone Authority*, in July 1974, purchased Puerto Rico Telephone Company from International Telephone and Telegraph Corporation. The Company operates the principal telephone system in Puerto Rico. The Telephone Authority acquired the assets of the Puerto Rico Communications Authority on May 30, 1990. Capital improvements at present are financed by internally generated funds, although in the past they were also financed with revenue bonds. The Authority's revenue bonds are payable from net revenues, which consist primarily of moneys received after payment of the Company's operating expenses. As of November 30, 1995, the Authority had \$982,055,000 of bonds and other obligations outstanding, none of which was supported by the guaranty of the Commonwealth.

*University of Puerto Rico*, with approximately 55,800 students, is by far the largest institution of higher education on the island. Commonwealth 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 of which \$354,051,000 were outstanding as of November 30, 1995.

*Public corporations* in addition to those mentioned above have issued debt in the aggregate amount of \$580,615,000 as of November 30, 1995. Debt service on \$68,797,000 of such outstanding debt is being paid from Commonwealth appropriations. However, the Commonwealth is not obligated to make any such appropriations. Additional appropriations are made by the Commonwealth to enable certain of such corporations to pay their operating expenses.

## INSURANCE MATTERS

Commonwealth-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, the Aqueduct and Sewer Authority and the Telephone Authority, which 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

Public employees of the Commonwealth and its instrumentalities are covered by five retirement systems: the Employees Retirement System of the Government of Puerto Rico and its Instrumentalities (the "Employees Retirement System"), the Annuity and Pension System for the Teachers of Puerto Rico (the "Teachers Retirement System"), the Commonwealth of Puerto Rico 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, respectively, to employees of the University of Puerto Rico and Puerto Rico Electric Power Authority. The Commonwealth is not required to contribute directly to those two systems, but a large proportion of University revenues are derived from central government appropriations.

The Teachers Retirement System covers public school teachers, the Judiciary Retirement System covers judges, and the Employees Retirement System covers all other employees of the Commonwealth and its municipalities and instrumentalities. As of June 30, 1995, the total number of active members of the three systems was as follows: Employees Retirement System, 153,978; Teachers Retirement System, 46,998 and Judiciary Retirement System, 283. These three systems are financed by contributions by the employers (the Commonwealth, public corporations or municipalities), employees, and investment income. The Commonwealth is responsible for approximately 66 % of total employer contributions to the Employees Retirement System and 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 employees are determined by statute. Required contributions to the systems by employers are determined by statute with respect to the Teachers Retirement System and, with respect to the Employees and Judiciary Retirement Systems, by the Administrator of the Systems. In fiscal 1996, the Commonwealth has budgeted approximately \$225,100,000 as its contribution to the Employees Retirement System, \$3,357,000 as the contribution to the Judiciary Retirement System and \$78,402,000 as its contribution to the Teachers Retirement System.

The most recent actuarial valuation of the Employees Retirement System and Judiciary Retirement System was submitted by a firm of independent consulting actuaries as of June 1994. As of June 30, 1994, the total pension benefit obligation for the Employees Retirement System and Judiciary Retirement System was \$5,542,000,000 and \$58,900,000, respectively. The unfunded pension benefit obligation of the Employees Retirement System and Judiciary Retirement System for the same period was \$4,588,374,000 and \$23,293,000, respectively. The actuarial valuation was done in accordance with the "Projected Unit Credit" method. An investment return of 8.5 % per year,

a salary increase of 5% per year and a post-retirement benefit increase for the Employees Retirement System of 3% every third year were assumed. This benefit increase was provided by the Legislature of Puerto Rico, on May 10, 1992, by Act No. 10. The first 3% increase was granted to retirees who have been receiving their annuities for three or more years as of that date. The second 3% increase was granted to retirees who have 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. Subsequent increases will depend upon the explicit approval of the System's Board of Trustees and the Legislature, based on a favorable recommendation from the System's independent consulting actuary and given a minimum of 24 months of benefit payment reserves.

The Legislature of Puerto Rico, on February 1, 1990, enacted Act No. 1 which is directed at ensuring the solvency of the Employees Retirement System for the next fifty years. Among other provisions, the legislation increases the level of contribution to the System and limits benefits for new employees by increasing the length of time for the vesting of certain benefits and reducing the level of benefits in the case of early retirement. The legislation also reduces the level of occupational injury and death benefits received by new employees.

The most recent actuarial valuation of the Teachers Retirement System was submitted by a firm of independent consulting actuaries in March 1994. As of June 30, 1992 the total pension benefit obligation of the system was \$2,407,007,700, assets amounted to \$1,104,050,500 and the resulting unfunded pension benefit obligation was \$1,302,957,200. The Teachers Retirement System is undertaking a comprehensive review of its data base for current and retired covered employees. Initial indications are that the System's information concerning system participants has historically overstated the number of beneficiaries. In addition, certain assumptions used in predicting future benefit growth have been shown to be too conservative, particularly assumptions about future price level changes. As a result, the System expects to show a sizeable reduction in its unfunded pension benefit obligation in its actuarial valuation expected to be released in February 1996.

Nonetheless, it is recognized that it will be necessary further to strengthen the finances of the Teachers Retirement System in order to assure that combined contributions and investment income continue to exceed benefit payments, avoiding the possible future drawdown of assets.

The following table presents in summary form income and expenses of the retirement systems for the fiscal years ended June 30, 1994 and 1995 and estimates for the fiscal year ending June 30, 1996.

**Retirement Systems  
Income and Expenses  
(in thousands)**

|   | <u>Employees<br/>Retirement<br/>System</u> | <u>Judiciary<br/>Retirement<br/>System</u> | <u>Teachers<br/>Retirement<br/>System</u> |
|---|--|--|---|
| <u>Fiscal Year Ended June 30, 1994</u>  |  |  |   |
|   | <u>Actual</u>                              | <u>Actual</u>                              | <u>Actual</u>                             |
| <b>Income:</b>                          |  |  |   |
| Employers contributions                 | \$203,747                                  | \$2,996                                    | \$ 62,777                                 |
| Employee contributions                  | 150,121                                    | 1,280                                      | 51,718                                    |
| Investment income                       | 24,533                                     | 175  | 90,902                                    |
| Total                                   | <u>378,401</u>                             | <u>4,451</u>                               | <u>205,397</u>                            |
| <b>Expenses:</b>                        |  |  |   |
| Benefit payments                        | 350,259                                    | 4,946                                      | 134,968                                   |
| Administrative and other expenses       | 17,585                                     | 534  | 9,845                                     |
| Total                                   | <u>367,844</u>                             | <u>5,480</u>                               | <u>144,813</u>                            |
| Net Income                              | <u>\$ 10,557</u>                           | <u>\$(1,029)</u>                           | <u>\$ 60,584</u>                          |
| <u>Fiscal Year Ended June 30, 1995</u>  |  |  |   |
|   | <u>Actual</u>                              | <u>Actual</u>                              | <u>Actual</u>                             |
| <b>Income:</b>                          |  |  |   |
| Employers contributions                 | \$218,520                                  | \$3,228                                    | \$ 74,668                                 |
| Employee contributions                  | 162,225                                    | 1,346                                      | 60,068                                    |
| Investment income                       | 138,035                                    | 7,332                                      | 152,040                                   |
| Total                                   | <u>518,780</u>                             | <u>11,906</u>                              | <u>286,776</u>                            |
| <b>Expenses:</b>                        |  |  |   |
| Benefit payments                        | 372,923                                    | 5,194                                      | 143,634                                   |
| Administrative and other expenses       | 22,007                                     | 262  | 11,654                                    |
| Total                                   | <u>394,930</u>                             | <u>5,456</u>                               | <u>155,288</u>                            |
| Net Income                              | <u>\$123,850</u>                           | <u>\$6,450</u>                             | <u>\$131,488</u>                          |
| <u>Fiscal Year Ending June 30, 1996</u> |  |  |   |
|   | <u>Estimated</u>                           | <u>Estimated</u>                           | <u>Estimated</u>                          |
| <b>Income:</b>                          |  |  |   |
| Employers contributions                 | \$225,100                                  | \$3,357                                    | \$ 78,402                                 |
| Employee contributions                  | 168,725                                    | 1,399                                      | 63,071                                    |
| Investment income                       | 140,715                                    | 7,655                                      | 101,991                                   |
| Total                                   | <u>534,540</u>                             | <u>12,411</u>                              | <u>243,464</u>                            |
| <b>Expenses:</b>                        |  |  |   |
| Benefit payments                        | 395,298                                    | 5,435                                      | 150,816                                   |
| Administrative and other expenses       | 23,105                                     | 270  | 12,237                                    |
| Total                                   | <u>418,403</u>                             | <u>5,705</u>                               | <u>163,053</u>                            |
| Net Income                              | <u>\$116,137</u>                           | <u>\$6,706</u>                             | <u>\$ 80,411</u>                          |

Sources: Employees Retirement System, Judiciary Retirement System and Teachers Retirement System.

## SUMMARY OF COMMONWEALTH FINANCIAL STATEMENTS

Since fiscal 1990 the complete financial statements of the Commonwealth have been audited. For fiscal 1994, such financial statements were audited by Deloitte & Touche LLP, whose report thereon is dated February 3, 1995 (March 3, 1995 as to note 18 of such report). Preparation of the audited financial statements of the Commonwealth involves the collection and consolidation of audited financial statements from 44 separate reporting entities.

### COMMONWEALTH TAXES, OTHER REVENUES AND EXPENDITURES

The Secretary of the Treasury has custody of the funds of the Central Government of the Commonwealth and is responsible for the disbursement and investment of and accounting for 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 was incorporated into the General Fund commencing in fiscal 1993.

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-Commonwealth sources. Internal revenues consist principally of income taxes and excise taxes. Revenues from non-Commonwealth 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 Discussion of General Fund Results

The following table presents the Commonwealth revenues and expenditures of the General Fund on a cash basis for fiscal 1991 through fiscal 1996. Insofar as the information relates to fiscal 1996, it is based on estimates provided by the Secretary of the Treasury as of October 9, 1995. The information for fiscal 1991 through fiscal 1995 is based on actual year end results (the fiscal 1995 information is, however, still subject to year-end audit adjustments; see footnote 1 to the following table). 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, 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)

|  | Fiscal Year       |                    |                     |                   |                   |                   |
|--|-------------------|--------------------|---------------------|-------------------|-------------------|-------------------|
|  | 1991              | 1992               | 1993                | 1994              | 1995(1)           | 1996(2)           |
| Beginning cash balance                       | \$ 112,251        | \$ 105,475         | \$ (62,359)         | \$ (116,501)      | \$ 309,055        | \$ 484,585        |
| Revenues from internal sources:              |                   |                    |                     |                   |                   |                   |
| Income taxes:                                |                   |                    |                     |                   |                   |                   |
| Individuals                                  | 1,123,733         | 1,122,335          | 1,241,924           | 1,409,824         | 1,578,269         | 1,447,000         |
| Corporations                                 | 931,912           | 1,019,468          | 975,134             | 1,107,265         | 1,304,612         | 1,197,000         |
| Partnerships                                 | 4,001             | 1,167              | 1,165               | 1,802             | 3,391             | 3,000             |
| Withheld from non-residents                  | 48,312            | 62,066             | 50,531              | 73,626            | 79,072            | 40,000            |
| Tollgate taxes                               | 176,851           | 98,502             | 98,771              | 224,356           | 220,873           | 202,000           |
| Interest                                     | 15,060            | 8,505              | 6,076               | 5,293             | 6,070             | 6,000             |
| Dividends                                    | 25,644            | 23,588             | 27,678              | 33,968            | 28,650            | 15,000            |
| Total income taxes                           | <u>2,325,513</u>  | <u>2,335,631</u>   | <u>2,401,279</u>    | <u>2,856,134</u>  | <u>3,220,937</u>  | <u>2,910,000</u>  |
| Commonwealth excise taxes:                   |                   |                    |                     |                   |                   |                   |
| Alcoholic beverages                          | 219,055           | 216,890            | 215,035             | 220,882           | 222,187           | 259,000           |
| Cigarettes                                   | 104,454           | 102,400            | 106,740             | 115,453           | 107,943           | 128,000           |
| Motor vehicles                               | 172,272           | 178,329            | 217,012             | 275,654           | 319,676           | 345,000           |
| Other excise taxes                           | <u>432,941</u>    | <u>460,702</u>     | <u>528,748</u>      | <u>588,411</u>    | <u>602,521</u>    | <u>653,000</u>    |
| Total Commonwealth excise taxes              | <u>928,722</u>    | <u>958,321</u>     | <u>1,067,535</u>    | <u>1,200,400</u>  | <u>1,252,327</u>  | <u>1,385,000</u>  |
| Property taxes                               | 132,360           | 15,003             | 12,877              | 4,568             | 7,889             | 0                 |
| Inheritance and gift taxes                   | 1,421             | 1,148              | 1,072               | 934               | 1,535             | 1,000             |
| Licenses                                     | 39,483            | 46,842             | 48,251              | 49,084            | 49,087            | 53,000            |
| Other:                                       |                   |                    |                     |                   |                   |                   |
| Lottery                                      | 68,327            | 60,597             | 70,821              | 62,348            | 63,317            | 61,000            |
| Electronic Lottery                           | 0                 | 59,091             | 56,284              | 52,193            | 59,414            | 54,000            |
| Miscellaneous non-tax revenues               | <u>92,984</u>     | <u>96,437</u>      | <u>109,713</u>      | <u>131,909</u>    | <u>125,966</u>    | <u>136,000</u>    |
| Total other                                  | <u>161,311</u>    | <u>216,125</u>     | <u>236,818</u>      | <u>246,450</u>    | <u>248,697</u>    | <u>251,000</u>    |
| Total revenues from internal sources         | <u>3,588,810</u>  | <u>3,573,070</u>   | <u>3,767,832</u>    | <u>4,357,570</u>  | <u>4,780,472</u>  | <u>4,600,000</u>  |
| Revenues from non-Commonwealth sources:      |                   |                    |                     |                   |                   |                   |
| Federal excise taxes                         | 198,787           | 195,028            | 167,732             | 185,285           | 187,494           | 191,000           |
| Customs                                      | <u>94,384</u>     | <u>93,038</u>      | <u>89,741</u>       | <u>122,477</u>    | <u>112,153</u>    | <u>115,000</u>    |
| Total revenues from non-Commonwealth sources | <u>293,171</u>    | <u>288,066</u>     | <u>257,473</u>      | <u>307,762</u>    | <u>299,647</u>    | <u>306,000</u>    |
| Sub-total revenues                           | 3,881,981         | 3,861,136          | 4,025,305           | 4,665,332         | 5,080,119         | 4,906,000         |
| Proceeds from special funds                  | <u>72,956</u>     | <u>53,983</u>      | <u>37,286</u>       | <u>56,527</u>     | <u>14,155</u>     | <u>0</u>          |
| Total revenues                               | 3,954,937         | 3,915,119          | 4,062,591           | 4,721,859         | 5,094,274         | 4,906,000         |
| Other income                                 | 391,872           | 440,667            | 553,954             | 562,354           | 244,931           | 67,500            |
| Less tax refunds -- previous years           | <u>0</u>          | <u>(7,503)</u>     | <u>(12,784)</u>     | <u>(4,285)</u>    | <u>(8,337)</u>    | <u>(8,304)</u>    |
| Total revenues -- net                        | <u>4,346,809</u>  | <u>4,348,283</u>   | <u>4,603,761</u>    | <u>5,279,928</u>  | <u>5,330,868</u>  | <u>4,965,196</u>  |
| Transfers to debt service fund(3)            | (273,859)         | (283,236)          | (298,358)           | (284,346)         | (331,195)         | (364,638)         |
| Revenues from 1992 tax amnesty               | 0                 | 189,877            | 0                   | 0                 | 0                 | 0                 |
| Other non-revenue sources                    | 30,000(4)         | 0                  | 0                   | 0                 | 0                 | 0                 |
| Note proceeds(5)                             | 400,236           | 0                  | 401,917             | 700,000           | 0                 | 0                 |
| Repayment of notes(6)                        | <u>(408,120)</u>  | <u>0</u>           | <u>(413,788)</u>    | <u>(717,850)</u>  | <u>0</u>          | <u>0</u>          |
| Adjusted revenues                            | <u>4,095,066</u>  | <u>4,254,924</u>   | <u>4,293,532</u>    | <u>4,977,732</u>  | <u>4,999,673</u>  | <u>4,600,558</u>  |
| Expenditures:                                |                   |                    |                     |                   |                   |                   |
| Grants and subsidies                         | 1,197,664         | 1,217,157          | 1,156,498           | 1,251,879         | 1,328,511         | 1,138,916         |
| Personal services                            | 1,332,459         | 1,405,472          | 1,418,697           | 1,559,152         | 1,805,996         | 2,248,849         |
| Other services                               | 348,237           | 448,239            | 453,658             | 492,653           | 579,568           | 549,226           |
| Materials and supplies                       | 60,118            | 67,474             | 59,741              | 64,945            | 82,701            | 71,049            |
| Equipment purchased                          | 26,834            | 31,152             | 43,939              | 41,885            | 54,288            | 189,096           |
| Capital outlays                              | 50,490            | 41,235             | 13,850              | 40,646            | 34,691            | 0                 |
| Other debt service                           | 194,275           | 146,304            | 86,183              | 87,750            | 0                 | 163,717           |
| Transfers to agencies                        | 501,205           | 543,444            | 523,826             | 565,696           | 537,649           | 468,113           |
| Other expenditures                           | <u>390,560</u>    | <u>522,281</u>     | <u>591,282</u>      | <u>447,570</u>    | <u>400,739</u>    | <u>85,700</u>     |
| Total expenditures                           | <u>4,101,842</u>  | <u>4,422,758</u>   | <u>4,347,674</u>    | <u>4,552,176</u>  | <u>4,824,143</u>  | <u>4,914,666</u>  |
| Adjusted revenues less expenditures          | (6,776)           | (167,834)          | (54,142)            | 425,556           | 175,530           | (314,108)         |
| Ending cash balance                          | <u>\$ 105,475</u> | <u>\$ (62,359)</u> | <u>\$ (116,501)</u> | <u>\$ 309,055</u> | <u>\$ 484,585</u> | <u>\$ 170,477</u> |

(footnotes appear on following page)

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- (1) Preliminary, subject to audit adjustments.
  - (2) Budget, as adopted.
  - (3) Consists of amounts to pay principal and interest on general obligation bonds and notes of the Commonwealth. Does not include amounts deposited directly to the debt service fund from non-General Fund revenues.
  - (4) Consists of moneys received by the Commonwealth from the reoffering of certain notes of the Sugar Corporation.
  - (5) Consists of proceeds from Commonwealth tax and revenue anticipation notes issued in each such fiscal year.
  - (6) Consists of repayment of Commonwealth tax and revenue anticipation notes in each such fiscal year.

Source: Department of Treasury.

#### *Estimated Fiscal 1996 Compared to Fiscal 1995*

General Fund estimated total revenues for fiscal 1996 are forecast at \$4,906 million, a decrease of \$174 million (3.4%) over fiscal 1995. Major projected changes are: a decrease in income taxes of \$310.9 as a result of the certain income tax reductions enacted in late 1994 and fully effective in fiscal 1996; and an increase in excise taxes of \$132.6 million.

Total projected expenditures for fiscal 1996 are estimated to increase by \$90.8 million. The ending cash balance for the General Fund for fiscal year 1996 is estimated to be reduced by \$314.1 million.

#### *Preliminary Fiscal 1995 Compared to Fiscal 1994*

General Fund total revenues for fiscal 1995 were \$5,080 million, an increase of \$414.7 million (8.17%) over fiscal 1994. Major changes were the following: total income taxes and excise taxes increased by \$364.8 million and \$51.9 million, respectively.

Total expenditures for fiscal 1995 increased by \$271.9 million (5.56%), when compared to fiscal 1994. The ending cash balance for the General Fund for fiscal 1995 increased by \$175.5 million.

#### *Fiscal 1994 Compared to Fiscal 1993*

General Fund total revenues for fiscal 1994 were \$4,665 million, an increase of \$640 million (15.9%) over fiscal 1993. Major changes were the following: total income taxes, excise taxes, federal excise taxes and customs increased by \$454.9 million, \$132.9 million, \$17.5 million and \$32.7 million, respectively.

Total expenditures for fiscal 1994 increased by \$204.5 million (4.7%) when compared to fiscal 1993. The ending cash balance for the General Fund for fiscal 1994 increased by \$425.6 million as compared to fiscal 1993.

#### *Fiscal 1993 Compared to Fiscal 1992*

General Fund total revenues for fiscal 1993 were \$4,025 million, an increase of \$164.2 million (4.25%) over fiscal 1992. Major changes were the following: total income taxes and excise taxes increased by \$65.6 million and \$109.2 million, respectively, and federal excise taxes decreased by \$27.3 million.

Beginning in fiscal 1992, municipal property taxes were no longer included as revenue of the General Fund. This revenue source was transferred to the municipalities pursuant to Act No. 80.

In general terms, the revenue increase for fiscal 1993 was tied to the economic expansion projected for fiscal 1993. The economy of the Commonwealth of Puerto Rico grew at a real rate of 3.1% for fiscal 1993.

Total expenditures for fiscal 1993 decreased to \$4,347.7 million, a 1.7% decrease, when compared to fiscal 1992. The ending cash balance for the General Fund for fiscal 1993 decreased by \$54.1 million as compared with fiscal 1992.

#### *Fiscal 1992 Compared to Fiscal 1991*

Total revenues for fiscal 1992 were 0.5% below fiscal 1991. This was due to the transfer of municipal property taxes to the municipalities under Act No. 80. Although this was partly offset by minor increases in income taxes, excise taxes and licenses, there were slight decreases in revenues from customs duties and federal excise taxes. The ending cash balance for the General Fund for fiscal 1992 decreased by \$167.8 million as compared with fiscal 1991.

Total expenditures for fiscal 1992 were \$4,422.8 million, compared with \$4,101.8 million for fiscal 1991, a 7.8% increase. This increase resulted from a \$73 million increase in personal services due to salary increases granted to government employees and increases in public pension contributions and a \$131.7 million increase in other expenditures primarily due to certain accounting adjustments.

### **Major Sources of General Fund Revenues**

#### *Income Taxes*

The Commonwealth's Internal Revenue Code of 1994 (the "1994 Internal Revenue Code"), adopted on October 31, 1994, 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. The 1994 Internal Revenue Code represented a major revision to the existing income tax structure. The purpose of the 1994 Internal Revenue Code is to establish a more equitable tax structure that lowers tax rates and simplifies and enhances compliance.

*Individuals.* Resident individuals are subject to tax on their taxable income from all sources. Prior to the 1994 Internal Revenue Code, the five tax bracket rates for individuals ranged from 9% to 36%. The 1994 Internal Revenue Code maintains five tax brackets but reduces tax rates to 8%, 12%, 18%, 31% and 33%. However, blended rates are applicable for 1995 to give effect to these rate reductions after June 30, 1995. Dividend income from Puerto Rico sources, previously taxed at the rate of 20%, is now taxed at a rate of 10%. Gains realized from the sale or exchange of a capital asset, if held for more than 6 months, are taxed at a rate of 20%.

Interest income in excess of \$2,000 on deposits with Puerto Rico financial institutions is taxed at a rate of 17%; the first \$2,000 of interest income is exempt from taxation. In addition, certain deductions and exclusions were expanded. These changes are effective for taxable years commencing after June 30, 1995.

*Corporations and Partnerships.* Puerto Rico corporations and partnerships are subject to tax on income from whatever source; 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 a 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*), it is subject to tax at graduated rates.

The 1994 Internal Revenue Code maintains the six income tax brackets for corporations and partnerships, with a reduction in tax rates being effective July 1, 1995. The 1994 Internal Revenue Code provides for the highest rate applicable to taxable income in excess of \$275,000 to be 39%, a 3% reduction from prior law. Certain corporations and partnerships covered by the tax incentives act will 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 Acts

will be subject to a maximum tax rate of 42 % on their taxable income. The 1994 Internal Revenue Code maintains the alternative minimum tax at 22 %.

The 1994 Internal Revenue Code maintains the branch profits tax applicable to resident foreign corporations. The tax is, however, reduced to 10 % (from 25 %) 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 corporate recipients generally are no longer subject to any withholding tax. The basic tax on dividends paid to foreign corporate shareholders of Section 936 Corporations is 10 % but is subject to reduction with respect to dividends paid from profits invested in certain eligible instruments for specified periods of time. Gains realized from the sale or exchange of a capital asset, if held for more than six months, is taxed at a maximum rate of 25 %. Payments in excess of \$1,000 made by the Government of Puerto Rico and persons engaged in a trade or business in consideration of the receipt of services are now subject to a 7 % withholding tax.

#### *Excise Taxes*

Puerto Rico imposes a tax on articles and commodities that are imported into or manufactured in Puerto Rico for consumption in Puerto Rico and a tax on certain transactions, such as hotel occupancy, public shows, and horse racing. The excise tax on certain articles and commodities, such as cigarettes and petroleum products, is based upon the quantity of goods imported. The excise tax on motor vehicles is based on the suggested retail prices. The Excise Tax Act imposes a tax at an effective rate of 6.6 % of the F.O.B. factory price for imported goods and 3.6 % of the sales price of goods manufactured in Puerto Rico, except sugar, cement, cigarettes, motor vehicles and certain petroleum products which are taxed at different rates. The Excise Tax Act contains no exemption applicable to goods to be used by the government, except for motor vehicles and construction equipment. Exemptions apply to certain articles, such as food and medicines, and to articles designated for certain users.

#### *Other Taxes and Revenues*

Motor vehicle license plate and registration fees comprise the major portion of license tax receipts.

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

Revenues from non-Commonwealth sources include customs duties collected in Puerto Rico and excise taxes on shipments of alcoholic beverages from the island to the mainland United States. The customs duties and excise taxes on shipments are imposed and collected by the United States and returned to the Commonwealth.

#### *Property Taxes*

Personal property, which accounts for approximately 37 % of total assessed valuation of taxable property, is self-assessed. Real property taxes are currently assessed at 1958 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.

On August 30, 1991, legislation was adopted in the Commonwealth providing a municipal reform program which involves the creation of the Municipal Revenues Collection Center to collect property taxes. The program transfers the previous functions of the Department of the Treasury with respect to real and personal property tax assessment, notification, determination and collection to the Municipal Revenues Collection Center, as of July 1,

1993. Special provisions have been made so that \$1.03 per \$100 of property tax collections continues to be deposited in the Redemption Fund.

**Commonwealth of Puerto Rico**

**Assessed Valuations and Real and Personal Property Taxes  
(Commonwealth and Municipalities Combined)  
(in thousands)**

| <u>Fiscal Year Ended June 30</u> | <u>Assessed<br/>Valuations(1)</u> | <u>Taxes<br/>Levied</u> | <u>Collections<br/>of Current<br/>Year</u> | <u>Collections<br/>of Previous<br/>Years</u> | <u>Total</u> |
|----------------------------------|-----------------------------------|-------------------------|--|--|--------------|
| 1991 . . . . .                   | \$11,359,276                      | \$374,834               | \$275,603                                  | \$76,015                                     | \$351,618    |
| 1992 . . . . .                   | 11,209,804                        | 368,209                 | 276,185                                    | 22,234                                       | 298,419      |
| 1993 . . . . .                   | 11,337,421                        | 378,750                 | 267,220                                    | 21,579                                       | 288,799      |
| 1994 . . . . .                   | 11,735,626                        | 443,448                 | 329,058                                    | 32,654                                       | 361,712      |
| 1995 . . . . .                   | 12,508,656                        | 508,275                 | 376,567                                    | 36,299                                       | 412,866      |

(1) Valuation set as of January 1 of preceding fiscal year.

*Source:* Municipal Revenues Collection Center.

**Collections of Income and Excise Taxes**

The Department of the Treasury has continued its program for improving tax collections which began in fiscal 1986. The program has consisted, 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 (a) improving the methods by which delinquent taxpayers are identified, primarily through the use of computer analyses, (b) computerizing the processing of tax returns, and (c) identifying and eliminating taxpayer abuses of the existing tax laws.

**Transfers to General Obligation Debt Service Fund**

These consist of transfers from the General Fund to the Debt Service 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 contributions to charitable institutions. It also includes items for or included in court awards, damage awards for personal injury or property damage as well as payment of taxes and payment 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 the payment of services other than the services referred to above, including advertising, printing, communication services, legal expenses, utility services, building and equipment rental and maintenance expenses, insurance premiums and miscellaneous services.

### *Materials and Supplies*

This category includes all articles which ordinarily have 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*

The category includes items which have three special characteristics which distinguish 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*

This category includes the acquisition of land and interests in land, the construction of buildings, roads and bridges, and other structures, as well as permanent improvements and additions.

### *Other Debt Service*

Includes payments for the amortization of the principal of and interest on non-general obligation special promissory notes to be paid from collections of past due taxes and, if necessary, from Commonwealth appropriations received in and after fiscal 1990 and payments on notes to Government Development Bank to be paid from the balance in the General Fund.

### *Transfers to Agencies*

Includes 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 consists of transfers to the Health Facilities and Services Administration and advances to the municipalities.

## **Federal Grants**

The Commonwealth receives federal grants under numerous programs. The following table presents revenues from federal grants by broad program areas which are accounted in the central accounting system of the Treasury Department.

## Commonwealth of Puerto Rico

### Federal Grants

(in thousands)

|  | Fiscal Year Ending June 30 |                    |                    |
|--|----------------------------|--------------------|--------------------|
|  | 1994                       | 1995(p)            | 1996(1)            |
| Education . . . . .                          | \$ 427,407                 | \$ 501,403         | \$ 516,472         |
| Social Services . . . . .                    | 1,329,671                  | 1,459,268          | 1,467,881          |
| Health . . . . .                             | 380,714                    | 394,115            | 394,416            |
| Labor and Human Resources . . . . .          | 36,955                     | 36,791             | 35,546             |
| Public Works and Transportation(2) . . . . . | 75,945                     | 75,330             | 74,000             |
| Crime . . . . .                              | 12,208                     | 17,087             | 27,517             |
| Housing(3) . . . . .                         | 201,695                    | 221,736            | 220,079            |
| Drug and Justice . . . . .                   | 24,758                     | 28,317             | 38,356             |
| Agriculture and Natural Resources . . . . .  | 6,764                      | 7,939              | 8,731              |
| Contributions to Municipalities . . . . .    | 61,801                     | 65,893             | 65,873             |
| Other . . . . .                              | 99,590                     | 79,817             | 79,432             |
| <b>TOTAL</b>                                 | <b>\$2,657,508</b>         | <b>\$2,887,696</b> | <b>\$2,928,303</b> |

(p) Preliminary.

(1) Estimated.

(2) Amounts of federal grants to the Highway and Transportation Authority are included in the Public Works and Transportation area. For fiscal 1994, 1995 and 1996, the federal grants to this agency are \$75.9 million, \$74.8 million and \$74.0 million, respectively.

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

## COMMONWEALTH BUDGET

### Office of Management and Budget

The fundamental objective of the Office of Management and Budget ("OMB") is to improve and strengthen the relationship between policy formulation and budgetary and fiscal management. The law creating OMB also strengthened budgetary controls and created an Operational Audit Division with the primary function of evaluating government operations and programs.

The annual budget includes the public corporations as well as the Commonwealth government, however, the following describes only the Commonwealth budget.

### Budgetary Process

The fiscal year of the Commonwealth begins on July 1. The Governor is constitutionally required to submit to the Legislature an annual balanced budget of capital improvements and operating expenses of the Commonwealth for the ensuing fiscal year. The annual budget is prepared by OMB, working with the Planning Board, the Department of 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 and zero-base 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 Legislature 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 Legislature, 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 Legislature with his objections. The Legislature, by a two-thirds majority in each house, may override the Governor's veto. If a budget is not adopted prior to the end of the fiscal year, the annual budget for the preceding fiscal year as originally approved by the Legislature and the Governor is automatically renewed for the ensuing fiscal year until a new budget is approved by the Legislature and the Governor. This permits the Commonwealth to continue to make payments of its operating and other expenses until a new budget is approved.

### **Financial Control and Adjustment Procedures**

Revenue estimates for budgetary purposes are prepared by the Department of the Treasury, except for estimates of federal grants, which are prepared by OMB and 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 severally by the Governor, through the Director of OMB, and the Secretary of the Treasury. Quarterly reviews and expenditure cut-off procedures are designed 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 Legislature a detailed report of any adjustment necessary to balance the budget, or make recommendations to the Legislature for new taxes, or take any other necessary action to meet the estimated deficiency, or authorize borrowings under provisions of existing legislation. 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 certain commitments to protect the name, credit and good faith of the Commonwealth government; 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, as amended, approved by the Legislature of Puerto Rico on June 18, 1980 (the "Budgetary Fund Act"). The Budgetary Fund is used to cover the appropriations approved in any fiscal year in which the revenues available for such fiscal year are insufficient, to honor the public debt and to provide for unforeseen circumstances in the provision of public services. The Budgetary Fund Act was amended in 1994 to provide for annual legislative appropriations from the General Fund to be deposited in the Budgetary Fund in an amount not less than one third of one percent (.33%) of the total budgeted appropriations in the budget joint resolution. The maximum balance of the Budgetary Fund shall not exceed six percent (6%) of the total appropriations in the budget joint resolution for any fiscal year.

## Appropriations

Appropriations in the Central Government Budget of the Commonwealth consist of the following:

(i) General Fund appropriations for recurring ordinary operating expenses of the Central Government and for contributions to public corporations, municipalities, and private organizations. Such appropriations are made by a single annual law known as the Joint Resolution of the General Budget.

(ii) General Fund appropriations for special operating expenses and for capital expenditures. Such appropriations are authorized by separate laws 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 may occur in one or more years.

In Puerto Rico, the Central Government has many functions which in the 50 states are the responsibility of local government, such as providing public education and police and fire protection. The Central Government also makes large annual grants to the University of Puerto Rico and to the municipalities. See "Property Taxes" under *Commonwealth Taxes, Other Revenues and Expenditures*. In the summaries of the budgets of the Central Government presented below, grants to the University of Puerto Rico are included in current expenses for education and debt service on general obligation bonds is included in current expenses for debt service. Debt service on Sugar Corporation notes paid by the Commonwealth is included in current expenses for economic development, and debt service on Urban Renewal and Housing Corporation bonds and notes and on Housing Bank and Finance Agency mortgage subsidy bonds paid by the Commonwealth is included in current expenses for housing.

Approximately 23.5% of the General Fund is committed, including debt service on direct debt of the Commonwealth and on the debt of the Sugar Corporation, municipal subsidies, grants to the University of Puerto Rico, contributions to Aqueduct and Sewer Authority and rental payments to Public Buildings Authority, among others.

**Fiscal 1995 Budget**

The following table presents a summary of the budget for the Commonwealth for the fiscal year ended June 30, 1995.

**COMMONWEALTH OF PUERTO RICO**  
**Summary of Central Government Annual Budget**  
**Fiscal Year Ended June 30, 1995**  
(in thousands)

|  | <u>General</u>     | <u>Bond</u>      | <u>Special</u>     | <u>Total</u>       |
|--|--------------------|------------------|--------------------|--------------------|
|  | <u>Fund</u>        | <u>Fund</u>      | <u>Funds</u>       |                    |
| <b>Resources:</b>  |                    |                  |                    |                    |
| <b>Revenues from internal sources:</b>                               |                    |                  |                    |                    |
| Property taxes . . . . .   | \$ 7,889           | \$ 0             | \$ 65,000          | \$ 72,889          |
| Personal income taxes . . . . .                                      | 1,578,269          | 0                | 0                  | 1,578,269          |
| Retained non-resident income taxes . . . . .                         | 79,072             | 0                | 0                  | 79,072             |
| Corporation income taxes . . . . .                                   | 1,304,612          | 0                | 0                  | 1,304,612          |
| Partnership income taxes . . . . .                                   | 3,391              | 0                | 0                  | 3,391              |
| Tollgate taxes . . . . .   | 220,872            | 0                | 0                  | 220,872            |
| Interest subject to 17% withholding tax . . . . .                    | 6,070              | 0                | 0                  | 6,070              |
| Dividends subject to 20% withholding tax . . . . .                   | 28,650             | 0                | 0                  | 28,650             |
| Inheritance and gift taxes . . . . .                                 | 1,535              | 0                | 0                  | 1,535              |
| <b>Excise taxes:</b>   |                    |                  |                    |                    |
| Alcoholic beverages . . . . .  | 222,187            | 0                | 0                  | 222,187            |
| Motor vehicles and accessories . . . . .                             | 319,676            | 0                | 200                | 319,876            |
| Cigarettes . . . . .   | 107,943            | 0                | 0                  | 107,943            |
| Special excise tax on certain petroleum products . . . . .           | 139,593            | 0                | 0                  | 139,593            |
| General Excise of 5% . . . . .                                       | 367,545            | 0                | 0                  | 367,545            |
| Other . . . . .  | 95,381             | 0                | 57,300             | 152,681            |
| Licenses . . . . .   | 49,087             | 0                | 0                  | 49,087             |
| <b>Miscellaneous non-tax revenues:</b>                               |                    |                  |                    |                    |
| Contributions from lottery fund . . . . .                            | 63,317             | 0                | 0                  | 63,317             |
| Electronic lottery . . . . .   | 59,414             | 0                | 0                  | 59,414             |
| Registration and document certification fees . . . . .               | 88,639             | 0                | 0                  | 88,639             |
| Other . . . . .  | <u>37,330</u>      | <u>0</u>         | <u>129,504</u>     | <u>166,834</u>     |
| Total revenues from internal sources . . . . .                       | 4,780,472          | 0                | 252,004            | 5,032,476          |
| <b>Revenues from non-Commonwealth sources:</b>                       |                    |                  |                    |                    |
| Federal excise taxes on off-shore shipments . . . . .                | 187,494            | 0                | 13,000             | 200,494            |
| Federal grants . . . . .   | 0                  | 0                | 2,887,696(a)       | 2,887,696          |
| Customs . . . . .  | <u>112,153</u>     | <u>0</u>         | <u>0</u>           | <u>112,153</u>     |
| Total revenues from non-Commonwealth sources . . . . .               | <u>299,647</u>     | <u>0</u>         | <u>2,900,696</u>   | <u>3,200,343</u>   |
| Total revenues . . . . .   | <u>5,080,119</u>   | <u>0</u>         | <u>3,152,700</u>   | <u>8,232,819</u>   |
| <b>Other:</b>  |                    |                  |                    |                    |
| Surplus from prior year appropriations<br>and encumbrances . . . . . | 3,906              | 0                | 0                  | 3,906              |
| Miscellaneous Income . . . . .                                       | 80,664             | 0                | 0                  | 80,664             |
| Payment in lieu of taxes PRTA . . . . .                              | 35,055             | 0                | 0                  | 35,055             |
| Reimbursement of Capital Fund (FEPEG) . . . . .                      | 15,000             | 0                | 0                  | 15,000             |
| Debt service savings . . . . .                                       | 14,000             | 0                | 0                  | 14,000             |
| Balance from previous year . . . . .                                 | 255,218            | 0                | 555,474            | 810,692            |
| Bonds authorized . . . . .   | <u>0</u>           | <u>325,000</u>   | <u>0</u>           | <u>325,000</u>     |
| Total other sources . . . . .  | <u>403,843</u>     | <u>325,000</u>   | <u>555,474</u>     | <u>1,284,317</u>   |
| Total resources . . . . .  | <u>\$5,483,962</u> | <u>\$325,000</u> | <u>\$3,708,174</u> | <u>\$9,517,136</u> |

*(table continued on next page)*

|   | <u>General</u><br><u>Fund</u> | <u>Bond</u><br><u>Fund</u> | <u>Special</u><br><u>Funds</u> | <u>Total</u>       |
|---|-------------------------------|----------------------------|--------------------------------|--------------------|
| <b>Appropriations:</b>                              |                               |                            |                                |                    |
| <b>Current expenses:</b>                            |                               |                            |                                |                    |
| Reserve to reimburse the General Fund . . . . .     | \$ 30,000                     | \$0                        | \$0                            | \$ 30,000          |
| General government . . . . .                        | 651,181                       | 0                          | 21,942                         | 673,123            |
| Education . . . . .                                 | 1,578,582                     | 0                          | 619,316                        | 2,197,898          |
| Health . . . . .                                    | 769,110                       | 0                          | 458,424                        | 1,227,534          |
| Welfare . . . . .                                   | 310,907                       | 0                          | 1,752,724                      | 2,063,631          |
| Economic development . . . . .                      | 383,897                       | 0                          | 49,604                         | 433,501            |
| Public safety and protection . . . . .              | 822,543                       | 0                          | 44,595                         | 867,138            |
| Transportation and communications . . . . .         | 90,283                        | 0                          | 6,852                          | 97,135             |
| Housing . . . . .                                   | 116,397                       | 0                          | 128,605                        | 245,002            |
| Contributions to municipalities . . . . .           | 251,155                       | 0                          | 1,916                          | 253,071            |
| Special pension contributions . . . . .             | 19,320                        | 0                          | 0                              | 19,320             |
| Debt service . . . . .                              | <u>331,195</u>                | <u>0</u>                   | <u>65,000</u>                  | <u>396,195</u>     |
| Total appropriations -- current expenses . . . . .  | <u>5,354,570</u>              | <u>0</u>                   | <u>3,148,978</u>               | <u>8,503,548</u>   |
| Capital improvements . . . . .                      | 0                             | 325,000                    | 170,298                        | 495,298            |
| Total appropriations . . . . .                      | <u>5,354,570</u>              | <u>325,000</u>             | <u>3,319,276</u>               | <u>8,998,846</u>   |
| Year-end balance . . . . .                          | <u>129,392</u>                | <u>0</u>                   | <u>388,898</u>                 | <u>518,290</u>     |
| Total appropriations and year-end balance . . . . . | <u>\$5,483,962</u>            | <u>\$325,000</u>           | <u>\$3,708,174</u>             | <u>\$9,517,136</u> |

(a) Do not include grants received by agencies whose accounting systems are not centralized in the Department of the Treasury.

Sources: Department of the Treasury as to resources and Office of Management and Budget as to appropriations, as reported on October 19, 1995.

In the fiscal 1995 budget revenues and other resources of all budgetary funds total \$8,381,444,000 excluding balances from the previous fiscal year and general obligation bonds authorized. The estimated net increase in General Fund revenues in fiscal 1995 are accounted for primarily by personal income taxes (up \$168,445,000), motor vehicles and accessories (up \$44,022,000), general excise of 5% (up \$21,530,000), alcoholic beverages (up \$1,305,000), electronic lottery (up \$7,221,000), retained non-resident income tax (up \$5,446,000), corporation income taxes (up \$197,347,000), customs (down \$10,324,000), special excise taxes on certain petroleum products (down \$13,318,000), tollgate taxes (down \$3,484,000) and other revenues decreases (down \$3,401,000).

Current expenses and capital improvements, other than those financed by bonds, of all budgetary funds total \$8,673,845,000, an increase of \$1,160,550,000 from fiscal 1994. The major changes in General Fund expenditures by program in fiscal 1995 are: education (up \$145,966,000), general government (up \$171,861,000), public safety and protection (up \$106,300,000), debt service (up \$63,512,000), welfare (up \$56,837,000), health (up \$120,556,000), economic development (up \$31,081,000), housing (up \$26,102,000) contributions to municipalities (up \$16,852,000), transportation and communications (up \$4,980,000) and special pension contributions (up \$1,483,000).

The general obligation bond authorization for the fiscal 1995 budget is \$325,000,000.

**Fiscal 1996 Budget**

The following table presents a summary of the budget for the Commonwealth for the fiscal year ending June 30, 1996.

**COMMONWEALTH OF PUERTO RICO**  
**Summary of Central Government Annual Budget**  
**Fiscal Year Ending June 30, 1996**  
(in thousands)

|  | <u>General Fund</u>       | <u>Bond Fund</u>        | <u>Special Funds</u>      | <u>Total</u>              |
|--|---------------------------|-------------------------|---------------------------|---------------------------|
| <b>Resources:</b>  |                           |                         |                           |                           |
| <b>Revenues from internal sources:</b>                               |                           |                         |                           |                           |
| Property taxes . . . . .   | \$ 0                      | \$ 0                    | \$ 65,000                 | \$ 65,000                 |
| Personal income taxes . . . . .                                      | 1,447,000                 | 0                       | 0                         | 1,447,000                 |
| Retained non-resident income taxes . . . . .                         | 40,000                    | 0                       | 0                         | 40,000                    |
| Corporation income taxes . . . . .                                   | 1,197,000                 | 0                       | 0                         | 1,197,000                 |
| Partnership income taxes . . . . .                                   | 3,000                     | 0                       | 0                         | 3,000                     |
| Tollgate taxes . . . . .   | 202,000                   | 0                       | 0                         | 202,000                   |
| Interest subject to 17% withholding tax . . . . .                    | 6,000                     | 0                       | 0                         | 6,000                     |
| Dividends subject to 20% withholding tax . . . . .                   | 15,000                    | 0                       | 0                         | 15,000                    |
| Inheritance and gift taxes . . . . .                                 | 1,000                     | 0                       | 0                         | 1,000                     |
| <b>Excise taxes:</b>   |                           |                         |                           |                           |
| Alcoholic beverages . . . . .  | 259,000                   | 0                       | 0                         | 259,000                   |
| Motor vehicles and accessories . . . . .                             | 345,000                   | 0                       | 200                       | 345,200                   |
| Cigarettes . . . . .   | 128,000                   | 0                       | 0                         | 128,000                   |
| Special excise tax on certain petroleum products . . . . .           | 162,000                   | 0                       | 0                         | 162,000                   |
| General Excise of 5% . . . . .                                       | 393,000                   | 0                       | 0                         | 393,000                   |
| Other . . . . .  | 98,000                    | 0                       | 59,200                    | 157,200                   |
| Licenses . . . . .   | 53,000                    | 0                       | 0                         | 53,000                    |
| <b>Miscellaneous non-tax revenues:</b>                               |                           |                         |                           |                           |
| Contributions from lottery fund . . . . .                            | 61,000                    | 0                       | 0                         | 61,000                    |
| Electronic lottery . . . . .   | 54,000                    | 0                       | 0                         | 54,000                    |
| Registration and document certification fees . . . . .               | 96,000                    | 0                       | 0                         | 96,000                    |
| Other . . . . .  | <u>40,000</u>             | <u>0</u>                | <u>139,631</u>            | <u>179,631</u>            |
| <b>Total revenues from internal sources . . . . .</b>                | <b><u>4,600,000</u></b>   | <b><u>0</u></b>         | <b><u>264,031</u></b>     | <b><u>4,864,031</u></b>   |
| <b>Revenues from non-Commonwealth sources:</b>                       |                           |                         |                           |                           |
| Federal excise taxes on off-shore shipments . . . . .                | 191,000                   | 0                       | 13,000                    | 204,000                   |
| Federal grants . . . . .   | 0                         | 0                       | 2,928,303(a)              | 2,928,303                 |
| Customs . . . . .  | <u>115,000</u>            | <u>0</u>                | <u>0</u>                  | <u>115,000</u>            |
| <b>Total revenues from non-Commonwealth sources . . . . .</b>        | <b><u>306,000</u></b>     | <b><u>0</u></b>         | <b><u>2,941,303</u></b>   | <b><u>3,247,303</u></b>   |
| <b>Total revenues . . . . .</b>                                      | <b><u>4,906,000</u></b>   | <b><u>0</u></b>         | <b><u>3,205,334</u></b>   | <b><u>8,111,334</u></b>   |
| <b>Other:</b>  |                           |                         |                           |                           |
| Surplus from prior year appropriations<br>and encumbrances . . . . . | 19,540                    | 0                       | 0                         | 19,540                    |
| Miscellaneous income . . . . .                                       | 86,974                    | 0                       | 0                         | 86,974                    |
| Payment in lieu of taxes PRTA . . . . .                              | 40,000                    | 0                       | 0                         | 40,000                    |
| Assets Sale . . . . .  | 12,000                    | 0                       | 0                         | 12,000                    |
| Balance from previous year . . . . .                                 | 129,392                   | 0                       | 388,898                   | 518,290                   |
| Bonds authorized . . . . .   | <u>0</u>                  | <u>355,000</u>          | <u>0</u>                  | <u>355,000</u>            |
| <b>Total other sources . . . . .</b>                                 | <b><u>287,906</u></b>     | <b><u>355,000</u></b>   | <b><u>388,898</u></b>     | <b><u>1,031,804</u></b>   |
| <b>Total resources . . . . .</b>                                     | <b><u>\$5,193,906</u></b> | <b><u>\$355,000</u></b> | <b><u>\$3,594,232</u></b> | <b><u>\$9,143,138</u></b> |

*(table continued on next page)*

|   | <u>General Fund</u> | <u>Bond Fund</u> | <u>Special Funds</u> | <u>Total</u>       |
|---|---------------------|------------------|----------------------|--------------------|
| <b>Appropriations:</b>                              |                     |                  |                      |                    |
| <b>Current expenses:</b>                            |                     |                  |                      |                    |
| Reserve to reimburse the General Fund . . . . .     | \$ 30,000           | \$ 0             | \$ 0                 | \$ 30,000          |
| General government . . . . .                        | 534,229             | 0                | 20,667               | 554,896            |
| Education . . . . .                                 | 1,644,200           | 0                | 666,303              | 2,310,503          |
| Health . . . . .                                    | 766,320             | 0                | 424,610              | 1,190,930          |
| Welfare . . . . .                                   | 309,346             | 0                | 1,756,563            | 2,065,909          |
| Economic development . . . . .                      | 310,211             | 0                | 49,316               | 359,527            |
| Public safety and protection . . . . .              | 831,414             | 0                | 65,352               | 896,766            |
| Transportation and communications . . . . .         | 81,808              | 0                | 4,487                | 86,295             |
| Housing . . . . .                                   | 58,032              | 0                | 125,653              | 183,685            |
| Contributions to municipalities . . . . .           | 240,768             | 0                | 1,896                | 242,664            |
| Special pension contributions . . . . .             | 22,638              | 0                | 0                    | 22,638             |
| Debt service . . . . .                              | <u>364,638</u>      | <u>0</u>         | <u>65,000</u>        | <u>429,638</u>     |
| Total appropriations -- current expenses . . . . .  | <u>5,193,604</u>    | <u>0</u>         | <u>3,179,847</u>     | <u>8,373,451</u>   |
| Capital improvements . . . . .                      | 0                   | 355,000          | 173,092              | 528,092            |
| Total appropriations . . . . .                      | <u>5,193,604</u>    | <u>355,000</u>   | <u>3,352,939</u>     | <u>8,901,543</u>   |
| Year-end balance . . . . .                          | <u>302</u>          | <u>0</u>         | <u>241,293</u>       | <u>241,595</u>     |
| Total appropriations and year-end balance . . . . . | <u>\$5,193,906</u>  | <u>\$355,000</u> | <u>\$3,594,232</u>   | <u>\$9,143,138</u> |

(a) Do not include grants received by agencies whose accounting systems are not centralized in the Department of the Treasury.

Sources: Department of the Treasury as to resources and Office of Management and Budget as to appropriations, as reported on October 19, 1995.

In the fiscal 1996 budget proposal revenues and other resources of all budgetary funds total \$8,269,848,000 excluding balances from the previous fiscal year and general obligation bonds authorized. The estimated net decreases in General Fund revenues in fiscal 1996 are accounted for by general excise of 5% (up \$25,455,000), alcoholic beverages (up \$36,813,000), motor vehicles and accessories (up \$25,324,000), special excise tax on certain petroleum products (up \$22,407,000) and other revenues increases (up \$12,707,000) and by decreases in tollgate taxes (down \$18,872,000), retained non-resident income tax (down \$39,072,000) corporation income taxes (down \$107,612,000), and personal income taxes (down \$131,269,000).

Current expenses and capital improvements other than those financed by bonds, of all budgetary funds total \$8,546,543,000, a decrease of \$127,303,000 from fiscal 1995. The major changes in General Fund expenditures by program in fiscal 1996 are: education (up \$65,618,000), debt service (up \$33,443,000), special pension contributions (up \$3,318,000), public safety and protection (up \$8,871,000), welfare (down \$1,561,000), transportation and communications (down \$8,475,000), health (down \$2,790,000), contributions to municipalities (down \$10,387,000), housing (down \$58,365,000), economic development (down \$73,686,000) and general government (down \$116,952,000).

The general obligation bond authorization for the fiscal 1996 budget is \$355,000,000.

## **Differences between Budget and General Purpose Financial Statements**

Revenues and expenditures, as reported by the Department of the Treasury in its General Purpose 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 the financial statements prepared by the Department of 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 amount of bonds sold in any year does not necessarily equal the amount of bonds authorized in the budget for that year. Expenditures for capital improvements are financed by advances from the General Fund to the Capital Projects Fund, which are later reimbursed from proceeds of bond or note sales.

**Deloitte &  
Touche LLP**



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**COMMONWEALTH OF PUERTO RICO**

**General Purpose Financial Statements  
Year Ended June 30, 1994  
and Independent Auditors' Report**

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**Deloitte Touche  
Tohmatsu  
International**

# COMMONWEALTH OF PUERTO RICO

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**INDEPENDENT AUDITORS' REPORT**

The Honorable Governor of the  
Commonwealth of Puerto Rico  
San Juan, Puerto Rico

- (1) We have audited the accompanying general purpose financial statements of the Commonwealth of Puerto Rico (the Commonwealth) as of June 30, 1994, and for the year then ended, as listed in the foregoing table of contents. These general purpose financial statements present financial information in various fund types and discrete presentations which are considered independent fiscal entities. These general purpose financial statements are the responsibility of the management of the Commonwealth. Our responsibility is to express an opinion on these general purpose financial statements based on our audit. The financial statements of the University of Puerto Rico, included as a public university funds component unit, and of the following other component units were audited by other auditors whose reports have been furnished to us, and our opinion, insofar as it relates to the amounts included for the University of Puerto Rico and the following components units, is based solely on the reports of the other auditors:
- Puerto Rico Highway and Transportation Authority, a blended component unit, which represents the following indicated percentages of total assets and total revenues, respectively, of the debt service funds (38% and 76%), the capital projects funds (43% and 99%), and the enterprise funds (1% and 1%); of total assets of the general fixed assets account group (1%); and of total liabilities of the long-term debt account group (23%).
  - Puerto Rico Land Administration, an internal service fund, which represents 2% and 3% of the total assets and total revenues, respectively, of the internal service funds.
  - Entities identified in Note 2, which are presented as component units - other represent 64% and 54%, respectively, of the total assets and total revenues of the component units - other.
- (2) Except as discussed in paragraphs three and four below, we conducted our audit in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the general purpose financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the general purpose financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit, and the reports of other auditors, provide a reasonable basis for our opinion.

- (3) We were not engaged to audit the following funds included in the general purpose financial statements and reports of other auditors on the separate financial statements of such funds have not been provided to us because the audits have not been completed:
- Health Facilities and Services Administration of Puerto Rico, which represents 66% and 14% of total assets and total revenues of the enterprise funds.
  - Annuity and Pension System of the Teachers of Puerto Rico, which represents 56% and 35% of the assets and revenues in the pension trust funds.
  - State Unemployment Insurance Fund which represents 92% and 96% of the total assets and total revenues of the expendable trust fund.
  - Puerto Rico Aqueduct and Sewer Authority which represent 21% and 8% of total assets and total revenues, of the component units - other.
- (4) We were unable to audit the general fixed assets account group because of the absence of significant accounting records.
- (5) Because of the limitations described in the third and fourth paragraphs, the scope of our audit was not sufficient to enable us to express, and we do not express, an opinion on the financial statements of the following for the year ended June 30, 1994:
- Enterprise Funds
  - Pension Trust Funds
  - Expendable Trust Fund
  - General Fixed Assets Account Group
  - Component Units - Other
- (6) The general purpose financial statements referred to above do not include financial activities of the Office for the Liquidation of the Accounts of the Puerto Rico Urban Renewal and Housing Corporation, because management believes the amounts needed to prepare the appropriate financial statements are not readily determinable. In our opinion, the Office of the Liquidation of the Accounts of the Puerto Rico Urban Renewal and Housing Corporation should be presented discretely in the general purpose financial statements as a component unit on the liquidation basis of accounting in order to conform with generally accepted accounting principles.
- (7) As discussed in Note 15 to the general purpose financial statements, the Commonwealth accounts for certain pension costs on a pay-as-you-go basis. In our opinion, generally accepted accounting principles require that pension costs be accounted for based on actuarially determined computations. The information needed to quantify the effects of this departure from generally accepted accounting principles on the general purpose financial statements is not reasonably determinable as the required actuarial computations for the Employees Retirement System of the Government of Puerto Rico and Its Instrumentalities, the Puerto Rico Judiciary Retirement System and the Annuity and Pension System of the Teachers of Puerto Rico have not been prepared. Also, as discussed in Note 15 to the general purpose financial statements, the Commonwealth did not obtain an actuarial valuation for the Annuity and Pension System of the Teachers of Puerto Rico as of June 30, 1994. In our opinion, generally accepted accounting principles requires disclosure of actuarial information based on recent actuarial valuations.

- (8) In our opinion, based on our audit and on the reports of other auditors, except for the effects of such adjustments, if any, as might have been determined to be necessary, had pension costs been actuarially determined and the required pension disclosure been made as discussed in the seventh paragraph, the financial statements of the General Fund, Debt Service Funds, Capital Projects Funds, Internal Service Funds, Agency Funds, General Long-Term Debt Account Group and Public University Funds present fairly, in all material respects, the financial position of those fund types and account group as of June 30, 1994 and the results of operations of the fund types and the cash flows of the Internal Service Funds for the year then ended in conformity with generally accepted accounting principles.
- (9) As discussed in Note 12 to the general purpose financial statements, the beginning fund balance as of July 1, 1993 of the public university funds and component units - other were restated for the effect of the adoption of Statement on Government Accounting Standards No 16, *Accounting for Compensated Absences*.
- (10) As discussed in Note 12 to the general purpose financial statements, the beginning fund balances/retained earnings (deficit) as of July 1, 1993 of the general fund, the enterprise funds, pension trust funds, public university funds, and component units - other were restated.
- (11) As discussed in Note 14 to the general purpose financial statements, the Commonwealth and various component units are the defendants in a lawsuit alleging violation of civil rights. Preliminary hearings and discovery proceedings are in progress and the ultimate liability cannot be presently determined. Accordingly, no provision for any loss that may result upon resolution of this matter has been made in the accompanying general purpose financial statements.
- (12) As discussed in Notes 14 and 17 to the general purpose financial statements, the Commonwealth approved the liquidation of the Puerto Rico Urban Renewal and Housing Corporation (PRURHC), through the Office for the Liquidation of the Accounts of the Puerto Rico Urban Renewal and Housing Corporation. The Commonwealth may be contingently responsible for the settlement of any liabilities that are not satisfied by the liquidation of PRURHC's assets.
- (13) As discussed in Note 18 to the general purpose financial statements, the Commonwealth sold the operations of the Puerto Rico Maritime Shipping Authority (PRMSA), a discretely presented component unit. As part of the sale agreement, the Commonwealth assumed certain liabilities from PRMSA.

*Deloitte & Touche LLP*

February 3, 1995  
(March 3, 1995 as to Note 18)

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COMMONWEALTH OF PUERTO RICO

COMBINED BALANCE SHEET - ALL FUND TYPES, ACCOUNT GROUPS AND DISCRETELY PRESENTED COMPONENT UNITS  
JUNE 30, 1994 (Expressed in Thousands)

|  | Governmental Fund Types |                   |                   | Proprietary Fund Types |                     | Fiduciary Fund Types | Account Groups      |                                  |                        | Component Units                      |                         |                      | Totals Reporting Entity (Memorandum Only) |
|--|-------------------------|-------------------|-------------------|------------------------|---------------------|----------------------|---------------------|----------------------------------|------------------------|--------------------------------------|-------------------------|----------------------|---|
|  | General                 | Debt Service      | Capital Projects  | Enterprise             | Internal Service    |                      | Trust and Agency    | General Fixed Assets (Unaudited) | General Long-Term Debt | Primary Government (Memorandum Only) | Public University Funds | Other                |   |
| <b>ASSETS AND OTHER DEBITS</b>   |                         |                   |                   |                        |                     |                      |                     |                                  |                        |                                      |                         |                      |   |
| Assets:  |                         |                   |                   |                        |                     |                      |                     |                                  |                        |                                      |                         |                      |   |
| Cash, cash equivalents and investments   | \$ 116,482              | \$ 314,813        | \$ 193,368        | \$ 33,819              | \$ 3,588,828        | \$ 1,860,992         | \$                  | \$                               | \$ 6,108,302           | \$ 294,479                           | \$ 1,174,804            | \$ 7,377,585         |   |
| Cash, cash equivalents and investments in governmental banks   | 498,036                 | 271,862           | 308,737           | 21,708                 | 151,849             | 1,066,717            |                     |                                  | 2,318,939              | 958,596                              |                         | 3,277,535            |   |
| Receivables, net:  |                         |                   |                   |                        |                     |                      |                     |                                  |                        |                                      |                         |                      |   |
| Taxes  | 76,793                  |                   |                   |                        |                     | 54,789               |                     |                                  | 131,582                |                                      |                         | 131,582              |   |
| Intergovernmental  | 3,822                   |                   | 13,677            |                        | 26,945              | 27,296               |                     |                                  | 17,499                 |                                      | 13,460                  | 30,959               |   |
| Accounts   | 14,665                  | 9,686             |                   | 52,919                 | 233,916             | 526,780              |                     |                                  | 131,551                | 3,343                                | 841,738                 | 976,632              |   |
| Loans and advances   | 948                     |                   | 25,543            |                        | 86,035              | 11,748               |                     |                                  | 787,187                | 102,987                              | 134,082                 | 1,024,256            |   |
| Accrued interest   | 5,657                   | 4,350             | 1,770             | 33,205                 | 12,916              | 10,661               |                     |                                  | 109,560                | 2,568                                | 14,074                  | 126,202              |   |
| Other  | 4,455                   |                   |                   | 19,283                 | 36,246              | 14,089               |                     |                                  | 61,237                 | 8,822                                | 21,060                  | 91,119               |   |
| Due from:  |                         |                   |                   |                        |                     |                      |                     |                                  |                        |                                      |                         |                      |   |
| Other funds  | 20,396                  |                   | 1,961             |                        |                     |                      |                     |                                  | 91,975                 |                                      |                         | 91,975               |   |
| Primary government   | 45,601                  |                   |                   |                        | 12,367              |                      |                     |                                  | 57,968                 | 32,000                               | 215,546                 | 247,546              |   |
| Component units  | 17,430                  |                   |                   |                        |                     |                      |                     |                                  | 17,430                 | 32,276                               | 2,414                   | 92,658               |   |
| Other governmental entities  |                         |                   |                   |                        |                     |                      |                     |                                  |                        |                                      |                         | 17,430               |   |
| Advances to:   |                         |                   |                   |                        |                     |                      |                     |                                  |                        |                                      |                         |                      |   |
| Other funds  |                         |                   |                   |                        |                     |                      |                     |                                  |                        |                                      |                         |                      |   |
| Component units  | 54,881                  |                   |                   |                        |                     |                      |                     |                                  |                        |                                      |                         | 539,429              |   |
| Other governmental entities  |                         |                   |                   |                        |                     |                      |                     |                                  |                        |                                      |                         | 1,037,482            |   |
| Inventories  | 837,444                 |                   |                   | 27,640                 | 1,037,482           | 1,037,482            |                     |                                  | 1,037,482              |                                      |                         | 2,666,924            |   |
| Fixed assets, net  |                         |                   |                   | 109,814                | 212,043             | 138,670              |                     |                                  | 166,310                | 4,321                                | 336,761                 | 286,924              |   |
| Other assets   | 17                      |                   | 973               | 157,698                | 1,728,470           | 22,279               | 2,403,581           |                                  | 2,675,768              | 64,937                               | 1,680,647               | 507,392              |   |
|  |                         |                   |                   | 105                    | 1,038,455           | 16,839               |                     |                                  | 3,622,013              | 496,971                              | 8,828,890               | 12,947,874           |   |
|  |                         |                   |                   |                        | 105,441             |                      |                     |                                  | 123,375                | 383                                  | 150,014                 | 273,772              |   |
| <b>Other Debits:</b>   |                         |                   |                   |                        |                     |                      |                     |                                  |                        |                                      |                         |                      |   |
| Amount available in debt service funds   |                         |                   |                   |                        |                     |                      |                     | 186,867                          | 186,867                |                                      | 340,728                 | 527,595              |   |
| Amount to be provided for retirement of bonds and notes payable  |                         |                   |                   |                        |                     |                      |                     | 5,508,740                        | 5,508,740              |                                      | 73,756                  | 5,582,496            |   |
| Amount to be provided for payment of due to other funds, accrued compensated absences, and other long-term liabilities |                         |                   |                   |                        |                     |                      |                     | 1,505,125                        | 1,505,125              |                                      | 10,985                  | 1,515,710            |   |
| <b>TOTAL ASSETS AND OTHER DEBITS</b>   | <b>\$ 1,696,667</b>     | <b>\$ 600,711</b> | <b>\$ 546,049</b> | <b>\$ 456,191</b>      | <b>\$ 8,949,132</b> | <b>\$ 3,612,200</b>  | <b>\$ 2,403,581</b> | <b>\$ 7,200,732</b>              | <b>\$ 25,465,263</b>   | <b>\$ 1,043,107</b>                  | <b>\$ 14,797,155</b>    | <b>\$ 41,305,525</b> |   |

See notes to general purpose financial statements.

(Continued)

COMMONWEALTH OF PUERTO RICO

COMBINED BALANCE SHEET - ALL FUND TYPES, ACCOUNT GROUPS AND DISCRETELY PRESENTED COMPONENT UNITS  
 JUNE 30, 1994 (Expressed in Thousands)

|   | Governmental Fund Types |              |                  | Proprietary Fund Types |                   | Fiduciary Fund Types |                                  | Account Groups         |                                      | Totals                  |              |   |
|---|-------------------------|--------------|------------------|------------------------|-------------------|----------------------|----------------------------------|------------------------|--------------------------------------|-------------------------|--------------|---|
|   | General                 | Debt Service | Capital Projects | Enterprise             | Internal Services | Trust and Agency     | General Fixed Assets (Unaudited) | General Long-Term Debt | Primary Government (Memorandum Only) | Public University Funds | Other        | Totals Reporting Entity (Memorandum Only) |
| <b>LIABILITIES, FUND EQUITY (DEFICIT) AND OTHER CREDITS</b> |                         |              |                  |                        |                   |                      |                                  |                        |                                      |                         |              |   |
| Liabilities:  |                         |              |                  |                        |                   |                      |                                  |                        |                                      |                         |              |   |
| Accounts payable and accrued liabilities                    | \$ 289,216              | \$ 280       | \$ 40,697        | \$207,772              | \$ 98,060         | \$ 326,621           | \$                               | \$                     | \$ 962,646                           | \$ 110,566              | \$ 2,161,240 | \$ 3,234,452                              |
| Tax refunds payable   | 104,948                 |              |                  |                        |                   | 16,227               |                                  |                        | 104,948                              |                         |              | 104,948                                   |
| Deposits  |                         |              |                  |                        | 3,718,236         |                      |                                  |                        | 3,734,463                            |                         | 474,657      | 4,209,120                                 |
| Due to:   |                         |              |                  |                        |                   |                      |                                  |                        |                                      |                         |              |   |
| Other funds   | 32,475                  | 8,980        | 36,246           | 7,168                  |                   | 7,106                |                                  |                        | 91,975                               |                         |              | 91,975                                    |
| Primary government  |                         |              |                  |                        |                   |                      |                                  |                        |                                      |                         |              |   |
| Component units   |                         |              |                  | 73,297                 |                   |                      |                                  |                        |                                      |                         |              | 45,601                                    |
| Other governmental entities                                 |                         |              |                  |                        | 742               |                      |                                  |                        | 216,442                              |                         | 40,700       | 257,142                                   |
| Advances from:  |                         |              |                  |                        |                   |                      |                                  |                        | 190,788                              |                         | 278          | 191,066                                   |
| Primary government  |                         |              |                  |                        |                   |                      |                                  |                        |                                      |                         |              |   |
| Other funds   |                         |              |                  | 326,245                |                   |                      |                                  | 213,184                | 539,429                              | 58,982                  | 875,829      | 934,811                                   |
| Securities sold under agreement to repurchase               |                         |              |                  |                        | 200,276           | 21,202               |                                  |                        | 221,478                              |                         | 449,812      | 539,429                                   |
| Interest payable  | 15,922                  | 137,087      |                  | 26,100                 | 78,221            | 15,963               |                                  |                        | 257,330                              |                         | 132,644      | 671,290                                   |
| Deferred revenues   | 757                     |              |                  | 15,986                 |                   |                      |                                  |                        | 32,306                               |                         | 43,673       | 389,974                                   |
| Lottery prizes payable                                      |                         |              |                  | 110,627                |                   |                      |                                  |                        | 110,627                              |                         |              | 75,979                                    |
| Notes payable   | 704,746                 |              |                  |                        | 1,239,777         |                      |                                  | 120,000                | 2,064,523                            |                         | 360,548      | 110,627                                   |
| Bonds payable   | 4,413                   | 267,005      |                  | 61,709                 | 2,493,160         | 671                  |                                  | 5,575,607              | 8,335,772                            | 542                     | 5,463,385    | 2,425,613                                 |
| Accrued compensated absences                                | 29,586                  | 492          | 19,348           | 92,588                 | 13,224            | 51,705               |                                  | 658,216                | 747,011                              | 174,046                 | 275,117      | 13,973,203                                |
| Other liabilities   |                         |              |                  | 1,725                  |                   |                      |                                  |                        | 193,719                              | 14,033                  | 8,241        | 1,022,128                                 |
| Other long-term liabilities                                 |                         |              |                  |                        |                   |                      |                                  | 300,534                | 302,259                              |                         | 143,048      | 215,993                                   |
| Total liabilities   | 1,182,063               | 413,844      | 105,069          | 922,817                | 7,841,696         | 439,495              |                                  | 7,200,732              | 18,105,716                           | 358,169                 | 10,474,773   | 28,938,658                                |
| Fund Equity (Deficit) and Other Credits:                    |                         |              |                  |                        |                   |                      |                                  |                        |                                      |                         |              |   |
| Investment in general fixed assets                          |                         |              |                  |                        |                   |                      | 2,403,581                        |                        | 2,403,581                            |                         | 218,706      | 2,886,387                                 |
| Contributed capital   |                         |              |                  | 6,322                  | 1,009,235         |                      |                                  |                        | 1,015,557                            | 264,100                 | 3,296,915    | 4,312,472                                 |
| Retained earnings (deficit)                                 |                         |              |                  | (472,946)              | 98,201            |                      |                                  |                        | (374,747)                            |                         | 660,182      | 285,433                                   |
| Fund balances (deficit):                                    |                         |              |                  |                        |                   |                      |                                  |                        |                                      |                         |              |   |
| Reserved for:   |                         |              |                  |                        |                   |                      |                                  |                        |                                      |                         |              |   |
| Encumbrances  | 29,864                  |              |                  |                        |                   | 2,499                |                                  |                        | 33,382                               |                         | 4,629        | 59,990                                    |
| Debt service  | 223,665                 | 186,867      | 1,019            |                        |                   |                      |                                  |                        | 410,532                              |                         | 452          | 435,058                                   |
| Employee retirement   |                         |              |                  |                        |                   | 2,220,637            |                                  |                        | 2,220,637                            |                         | 344,778      | 2,565,415                                 |
| Unemployment benefits                                       |                         |              |                  |                        |                   | 871,459              |                                  |                        | 871,459                              |                         | 39,300       | 871,459                                   |
| Advances and other specified purposes                       | 45,601                  |              | 23,507           |                        |                   | 15,111               |                                  |                        | 86,219                               |                         | 23,750       | 149,269                                   |
| Unreserved  | 215,474                 |              | 414,454          |                        |                   | 62,999               |                                  |                        | 692,927                              |                         | 102,198      | 801,382                                   |
| Total fund equity (deficit) and other credits               | 514,604                 | 186,867      | 440,980          | (466,626)              | 1,107,436         | 3,172,705            | 2,403,581                        |                        | 7,359,547                            | 684,938                 | 4,322,382    | 12,366,867                                |
| TOTAL LIABILITIES, FUND EQUITY (DEFICIT) AND OTHER CREDITS  | \$1,696,667             | \$600,711    | \$546,049        | \$456,191              | \$8,949,132       | \$3,612,200          | \$2,403,581                      | \$7,200,732            | \$25,465,263                         | \$1,043,107             | \$14,797,155 | \$41,305,525                              |

See notes to general purpose financial statements.

(Concluded)

# COMMONWEALTH OF PUERTO RICO

## COMBINED STATEMENT OF REVENUES, EXPENDITURES AND CHANGES IN FUND BALANCES (DEFICIT) - ALL GOVERNMENTAL FUND TYPES AND EXPENDABLE TRUST FUNDS YEAR ENDED JUNE 30, 1984 (Expressed in Thousands)

|   | Governmental Fund Types |                 |                     | Fiduciary<br>Fund Type             | Totals<br>(Memorandum<br>Only) |
|---|-------------------------|-----------------|---------------------|------------------------------------|--------------------------------|
|   | General                 | Debt<br>Service | Capital<br>Projects | Expendable<br>Trust<br>(Unaudited) |                                |
| <b>REVENUES:</b>  |                         |                 |                     |                                    |                                |
| Taxes:  |                         |                 |                     |                                    |                                |
| Income  | \$ 2,876,542            | \$              | \$                  | \$                                 | \$ 2,876,542                   |
| Excise  | 1,426,728               | 163,042         |                     | 55                                 | 1,589,825                      |
| Unemployment  |                         |                 |                     | 199,109                            | 199,109                        |
| Other   | 53,521                  |                 |                     |                                    | 53,521                         |
| Charges for services  | 144,429                 | 92,171          | 9                   | 3,793                              | 240,402                        |
| Intergovernmental   | 2,209,445               | 63,509          | 55,473              | 97,270                             | 2,425,697                      |
| Other   | 123,374                 | 12,894          | 7,959               | 53,914                             | 198,141                        |
| <b>Total revenues</b>   | <b>6,834,039</b>        | <b>331,616</b>  | <b>63,441</b>       | <b>354,141</b>                     | <b>7,583,237</b>               |
| <b>EXPENDITURES:</b>  |                         |                 |                     |                                    |                                |
| Current:  |                         |                 |                     |                                    |                                |
| General government  | 341,066                 |                 |                     | 29                                 | 341,095                        |
| Public safety   | 798,367                 |                 |                     | 41                                 | 798,408                        |
| Health  | 192,118                 |                 |                     | 2,310                              | 194,428                        |
| Public housing and welfare  | 1,524,344               |                 |                     | 360,447                            | 1,884,791                      |
| Education   | 1,511,610               |                 |                     |                                    | 1,511,610                      |
| Economic development  | 235,915                 |                 |                     | 9                                  | 235,924                        |
| Intergovernmental   | 184,261                 |                 |                     |                                    | 184,261                        |
| Capital outlay  | 49,168                  |                 | 500,184             | 7,439                              | 556,791                        |
| Debt service:   |                         |                 |                     |                                    |                                |
| Principal   | 35,055                  | 282,506         |                     | 157                                | 317,718                        |
| Interest and other  | 27,321                  | 320,939         |                     | 980                                | 349,240                        |
| <b>Total expenditures</b>   | <b>4,899,225</b>        | <b>603,445</b>  | <b>500,184</b>      | <b>371,412</b>                     | <b>6,374,266</b>               |
| Excess (deficiency) of revenues over (under) expenditures   | 1,934,814               | (271,829)       | (436,743)           | (17,271)                           | 1,208,971                      |
| <b>OTHER FINANCING SOURCES (USES):</b>  |                         |                 |                     |                                    |                                |
| Proceeds from long-term debt issues   |                         | 734,927         | 713,412             |                                    | 1,448,339                      |
| Proceeds of refunding bonds   |                         | 967,891         |                     |                                    | 967,891                        |
| Operating transfers-in from other funds   | 224,407                 | 407,066         | 130,357             |                                    | 761,830                        |
| Other sources   | 176,907                 | 3,669           | 38,465              | 16,816                             | 235,857                        |
| Operating transfers-out to other funds  | (1,066,021)             | (132,494)       | (77,125)            |                                    | (1,275,640)                    |
| Operating transfers-out to component units  | (721,816)               |                 | (53,700)            |                                    | (775,516)                      |
| Payment of refunded bond escrow agent   |                         | (1,689,579)     |                     |                                    | (1,689,579)                    |
| Other uses  | (14,057)                |                 | (51,733)            | (15,010)                           | (80,800)                       |
| <b>Total other financing sources (uses)</b>   | <b>(1,400,580)</b>      | <b>291,480</b>  | <b>699,676</b>      | <b>1,806</b>                       | <b>(407,618)</b>               |
| Excess (deficiency) of revenues and other financing<br>sources over (under) expenditures and other financing uses | 534,234                 | 19,651          | 262,933             | (15,465)                           | 801,353                        |
| <b>FUND BALANCES (DEFICIT) AT<br/>BEGINNING OF YEAR (as restated)</b>   |                         |                 |                     |                                    |                                |
|   | (19,630)                | 167,216         | 178,047             | 967,533                            | 1,293,166                      |
| <b>FUND BALANCES AT END OF YEAR</b>   |                         |                 |                     |                                    |                                |
|   | \$ 514,604              | \$ 186,867      | \$ 440,980          | \$ 952,068                         | \$ 2,094,519                   |

See notes to general purpose financial statements.

**COMMONWEALTH OF PUERTO RICO**

**COMBINED STATEMENT OF REVENUES AND EXPENDITURES - BUDGET AND ACTUAL - STATUTORY BASIS - GENERAL, DEBT SERVICE, AND CAPITAL PROJECTS FUNDS YEAR ENDED JUNE 30, 1994 (Expressed in Thousands)**

|   | General Fund       |                    |                                  | Debt Service Fund |                   |                                  | Capital Projects Fund |                   |                                  |
|---|--------------------|--------------------|----------------------------------|-------------------|-------------------|----------------------------------|-----------------------|-------------------|----------------------------------|
|   | Budget             | Actual             | Variance Favorable (Unfavorable) | Budget            | Actual            | Variance Favorable (Unfavorable) | Budget                | Actual            | Variance Favorable (Unfavorable) |
| <b>REVENUES:</b>  |                    |                    |                                  |                   |                   |                                  |                       |                   |                                  |
| Income taxes  | \$ 2,900,000       | \$ 2,856,169       | \$ (43,831)                      | \$ -              | \$ -              | \$ -                             | \$ -                  | \$ -              | \$ -                             |
| Intergovernmental taxes   | 622                | 4,573              | 3,951                            | 64,821            | 55,366            | (9,455)                          |                       |                   |                                  |
| Excise taxes  | 1,345,055          | 1,378,212          | 33,157                           |                   | 10,809            | 10,809                           |                       |                   |                                  |
| Other taxes   | 50,835             | 53,182             | 2,347                            |                   |                   |                                  |                       |                   |                                  |
| Charges for services  | 93,563             | 98,052             | 4,489                            |                   |                   |                                  |                       |                   |                                  |
| Intergovernmental   | 114,000            | 122,491            | 8,491                            |                   | 6,975             | 6,975                            |                       |                   |                                  |
| Other   | 196,718            | 197,332            | 614                              |                   |                   |                                  |                       |                   |                                  |
| <b>Total revenues</b>   | <b>4,700,793</b>   | <b>4,710,011</b>   | <b>9,218</b>                     | <b>64,821</b>     | <b>73,150</b>     | <b>8,329</b>                     |                       |                   |                                  |
| <b>EXPENDITURES:</b>  |                    |                    |                                  |                   |                   |                                  |                       |                   |                                  |
| <b>Current:</b>   |                    |                    |                                  |                   |                   |                                  |                       |                   |                                  |
| General government  | 316,080            | 314,211            | 1,869                            |                   |                   |                                  |                       |                   |                                  |
| Public safety   | 760,668            | 760,512            | 156                              |                   |                   |                                  |                       |                   |                                  |
| Health  | 70,375             | 70,252             | 123                              |                   |                   |                                  |                       |                   |                                  |
| Public housing and welfare  | 162,325            | 161,461            | 864                              |                   |                   |                                  |                       |                   |                                  |
| Education   | 1,037,465          | 1,037,152          | 313                              |                   |                   |                                  |                       |                   |                                  |
| Economic development  | 265,228            | 265,178            | 50                               |                   |                   |                                  |                       |                   |                                  |
| Intergovernmental   | 231,968            | 231,760            | 208                              |                   |                   |                                  |                       |                   |                                  |
| Capital outlay  |                    |                    |                                  |                   |                   |                                  |                       |                   |                                  |
| Debt service:   |                    |                    |                                  |                   |                   |                                  |                       |                   |                                  |
| Principal   |                    |                    |                                  |                   |                   |                                  |                       |                   |                                  |
| Interest and other  |                    |                    |                                  |                   |                   |                                  |                       |                   |                                  |
| <b>Total expenditures</b>   | <b>2,844,109</b>   | <b>2,840,526</b>   | <b>3,583</b>                     | <b>224,655</b>    | <b>224,691</b>    | <b>(36)</b>                      | <b>224,213</b>        | <b>83,778</b>     | <b>140,435</b>                   |
| <b>Excess (deficiency) of revenues over (under) expenditures</b>                                  | <b>1,856,684</b>   | <b>1,869,485</b>   | <b>12,801</b>                    | <b>(380,378)</b>  | <b>(364,922)</b>  | <b>15,456</b>                    | <b>(224,213)</b>      | <b>(83,778)</b>   | <b>140,435</b>                   |
| <b>OTHER FINANCING SOURCES (USES):</b>  |                    |                    |                                  |                   |                   |                                  |                       |                   |                                  |
| Proceeds from long-term debt issues   |                    |                    |                                  |                   |                   |                                  | 305,000               | 305,812           | 812                              |
| Proceeds of refunding bonds   |                    |                    |                                  |                   |                   |                                  |                       |                   |                                  |
| Payment of refunded bond escrow agent   |                    |                    |                                  |                   |                   |                                  |                       |                   |                                  |
| Operating transfers-in from other funds   | 110,500            | 105,855            | (4,645)                          | 380,378           | 967,891           | 967,891                          |                       |                   |                                  |
| Other sources   |                    |                    |                                  |                   | (959,296)         | (959,296)                        |                       |                   |                                  |
| Operating transfers-out to other funds  | (921,932)          | (921,932)          |                                  |                   | 359,545           | (20,833)                         |                       |                   |                                  |
| Operating transfers-out to component units  | (721,816)          | (721,816)          |                                  |                   | 3,150             | 3,150                            |                       |                   |                                  |
| <b>Total other financing sources (uses)</b>   | <b>(1,533,248)</b> | <b>(1,537,892)</b> | <b>(4,645)</b>                   | <b>380,378</b>    | <b>360,903</b>    | <b>(19,475)</b>                  | <b>(27,087)</b>       | <b>(27,087)</b>   | <b>812</b>                       |
| <b>Excess (deficiency) of revenues and other sources over (under) expenditures and other uses</b> | <b>\$ 323,436</b>  | <b>\$ 331,592</b>  | <b>\$ 8,156</b>                  | <b>\$ -</b>       | <b>\$ (4,019)</b> | <b>\$ (4,019)</b>                | <b>\$ -</b>           | <b>\$ 141,247</b> | <b>\$ 141,247</b>                |

See notes to general purpose financial statements.

COMMONWEALTH OF PUERTO RICO

COMBINED STATEMENT OF REVENUES, EXPENSES AND CHANGES IN RETAINED EARNINGS (DEFICIT)/FUND BALANCES - ALL PROPRIETARY FUND TYPES, PENSION TRUST FUNDS AND SIMILAR DISCRETELY PRESENTED COMPONENT UNITS  
YEAR ENDED JUNE 30, 1994 (Expressed in Thousands)

|   | Proprietary Fund Types |                  | Fiduciary Fund Types | Totals Primary Government (Memorandum Only) | Other Discretely Presented Component Units | Totals Reporting Entity (Memorandum Only) |
|---|------------------------|------------------|----------------------|---|--|---|
|   | Enterprise             | Internal Service | Pension Trust        |   |  |   |
| <b>OPERATING REVENUES:</b>  |                        |                  |                      |   |  |   |
| Charges for services  | \$ 787,112             | \$ 202,341       | \$                   | \$ 989,453                                  | \$ 3,708,739                               | \$ 4,698,192                              |
| Financing income  |                        | 112,796          |                      | 112,796                                     | 4,388                                      | 117,184                                   |
| Investment earnings   |                        | 263,059          | 112,857              | 375,916                                     | 67,977                                     | 443,893                                   |
| Contributions to retirement systems   |                        |                  | 472,620              | 472,620                                     |  | 472,620                                   |
| Other   | 9,544                  | 598              | 2,748                | 12,890                                      | 38,264                                     | 51,154                                    |
| <b>Total operating revenues</b>   | <b>796,656</b>         | <b>578,794</b>   | <b>588,225</b>       | <b>1,963,675</b>                            | <b>3,819,368</b>                           | <b>5,783,043</b>                          |
| <b>OPERATING EXPENSES:</b>  |                        |                  |                      |   |  |   |
| Cost of services  | 1,445,974              | 126,158          | 28,504               | 1,600,636                                   | 2,907,180                                  | 4,507,816                                 |
| Retirement benefits   |                        |                  | 490,149              | 490,149                                     |  | 490,149                                   |
| Interest  |                        | 337,996          |                      | 337,996                                     | 57,464                                     | 395,460                                   |
| Depreciation and amortization   | 12,532                 | 22,830           |                      | 35,362                                      | 469,979                                    | 505,341                                   |
| Other   |                        | 7,961            |                      | 7,961                                       | 4,317                                      | 12,278                                    |
| <b>Total operating expenses</b>   | <b>1,458,506</b>       | <b>494,945</b>   | <b>518,653</b>       | <b>2,472,104</b>                            | <b>3,438,940</b>                           | <b>5,911,044</b>                          |
| <b>OPERATING INCOME (LOSS)</b>  | <b>(661,850)</b>       | <b>83,849</b>    | <b>69,572</b>        | <b>(508,429)</b>                            | <b>380,428</b>                             | <b>(128,001)</b>                          |
| <b>NON-OPERATING REVENUES (EXPENSES):</b>   |                        |                  |                      |   |  |   |
| Intergovernmental   | 179,108                |                  |                      | 179,108                                     | 8,835                                      | 187,943                                   |
| Interest income   | 2,481                  | 9,064            |                      | 11,545                                      | 107,266                                    | 118,811                                   |
| Interest expense  | (37,050)               | (406)            |                      | (37,456)                                    | (359,963)                                  | (397,419)                                 |
| Other, net  |                        | 45,310           |                      | 45,310                                      | (263,240)                                  | (217,930)                                 |
| <b>Total non-operating revenues (expenses)</b>                                      | <b>144,539</b>         | <b>53,968</b>    |                      | <b>198,507</b>                              | <b>(507,102)</b>                           | <b>(308,595)</b>                          |
| <b>INCOME (LOSS) BEFORE OPERATING TRANSFERS</b>                                     | <b>(517,311)</b>       | <b>137,817</b>   | <b>69,572</b>        | <b>(309,922)</b>                            | <b>(126,674)</b>                           | <b>(436,596)</b>                          |
| <b>OPERATING TRANSFERS:</b>   |                        |                  |                      |   |  |   |
| From:   |                        |                  |                      |   |  |   |
| Other funds   | 425,669                | 479              |                      | 426,148                                     |  | 426,148                                   |
| Primary government  |                        |                  |                      |   | 66,309                                     | 66,309                                    |
| Other component units   |                        |                  |                      |   | 9,500                                      | 9,500                                     |
| <b>OPERATING TRANSFERS, net</b>   | <b>425,669</b>         | <b>479</b>       |                      | <b>426,148</b>                              | <b>75,809</b>                              | <b>501,957</b>                            |
| <b>NET INCOME (LOSS)</b>  | <b>(91,642)</b>        | <b>138,296</b>   | <b>69,572</b>        | <b>116,226</b>                              | <b>(50,865)</b>                            | <b>65,361</b>                             |
| <b>EXCESS OF REVENUES OVER EXPENDITURES FROM GOVERNMENTAL OPERATIONS</b>            |                        |                  |                      |   | 39,798                                     | 39,798                                    |
| <b>RETAINED EARNINGS (DEFICIT)/ FUND BALANCE AT BEGINNING OF YEAR (as restated)</b> |                        |                  |                      |   |  |   |
|   | (381,973)              | 43,840           | 2,151,065            | 1,812,932                                   | 991,749                                    | 2,804,681                                 |
| <b>CONTRIBUTIONS</b>  |                        |                  |                      |   | 1,364                                      | 1,364                                     |
| <b>DEPRECIATION ON FIXED ASSETS ACQUIRED THROUGH CAPITAL CONTRIBUTION</b>           |                        |                  |                      |   |  |   |
|   | 667                    |                  |                      | 667   | 42,120                                     | 42,787                                    |
| <b>TRANSFERS FROM CONTRIBUTED CAPITAL</b>   |                        |                  |                      |   |  |   |
|   |                        | 41,065           |                      | 41,065                                      |  | 41,065                                    |
| <b>TRANSFERS TO CONTRIBUTED CAPITAL</b>   |                        |                  |                      |   |  |   |
|   |                        | (125,000)        |                      | (125,000)                                   |  | (125,000)                                 |
| <b>RETAINED EARNINGS (DEFICIT)/ FUND BALANCE AT END OF YEAR</b>                     |                        |                  |                      |   |  |   |
|   | \$ (472,948)           | \$ 98,201        | \$ 2,220,637         | \$ 1,845,890                                | \$ 1,024,166                               | \$ 2,870,056                              |

See notes to general purpose financial statements.

COMMONWEALTH OF PUERTO RICO

COMBINED STATEMENT OF CASH FLOWS -  
ALL PROPRIETARY FUND TYPES AND SIMILAR DISCRETELY PRESENTED COMPONENT UNITS  
YEAR ENDED JUNE 30, 1994 (Expressed in Thousands)

|   | Proprietary Fund Types |                  | Totals                               | Other                                | Totals                             |
|---|------------------------|------------------|--------------------------------------|--------------------------------------|------------------------------------|
|   | Enterprise             | Internal Service | Primary Government (Memorandum Only) | Discretely Presented Component Units | Reporting Entity (Memorandum Only) |
| <b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>  |                        |                  |                                      |                                      |                                    |
| Operating income (loss)   | \$ (661,850)           | \$ 83,849        | \$ (578,001)                         | \$ 400,656                           | \$ (177,345)                       |
| Adjustments to reconcile operating income (loss) to net cash provided by (used in) operating activities:                        |                        |                  |                                      |                                      |                                    |
| Depreciation and amortization   | 12,532                 | 22,830           | 35,362                               | 473,398                              | 508,760                            |
| Provision for uncollectible accounts  |                        | 18,298           | 18,298                               | 88,182                               | 106,480                            |
| Amortization of debt discount   |                        | 7,857            | 7,857                                | 3,516                                | 11,373                             |
| Net loss (gain) on disposition of fixed assets  | 2                      |                  | 2                                    | (3,931)                              | (3,929)                            |
| Net loss (gain) on sale of investments and fixed assets   |                        | 3,355            | 3,355                                | (5,323)                              | (1,968)                            |
| Contribution of in lieu of taxes  |                        |                  |                                      | (219,769)                            | (219,769)                          |
| Net cash flow effect of noncapital financing, capital and related financing and investing activities included in operating loss |                        | (78,094)         | (78,094)                             | (7,805)                              | (85,899)                           |
| Other   |                        | 7,563            | 7,563                                | (75,553)                             | (67,990)                           |
| Change in assets and liabilities:   |                        |                  |                                      |                                      |                                    |
| Increase in:  |                        |                  |                                      |                                      |                                    |
| Receivables, net  | (23,899)               | (8,528)          | (32,427)                             | (95,200)                             | (127,627)                          |
| Due from other funds  | (34,569)               |                  | (34,569)                             |                                      | (34,569)                           |
| Due from component units  |                        |                  |                                      | (59)                                 | (59)                               |
| Inventories   | (5,697)                |                  | (5,697)                              | (8,338)                              | (14,035)                           |
| Other assets  | (71)                   |                  | (71)                                 | (8,860)                              | (8,931)                            |
| Accounts payable and accrued liabilities  | 110,240                |                  | 110,240                              | 77,550                               | 187,790                            |
| Deposits  |                        | 412              | 412                                  | 4,120                                | 4,532                              |
| Interest payable  |                        | 422              | 422                                  |                                      | 422                                |
| Accrued compensated absences  |                        |                  |                                      | 40,639                               | 40,639                             |
| Deferred revenues   | 5,728                  |                  | 5,728                                | 7,849                                | 13,577                             |
| Other liabilities   | 39,134                 |                  | 39,134                               |                                      | 39,134                             |
| Other long-term liabilities   |                        |                  |                                      | 9,966                                | 9,966                              |
| Decrease in:  |                        |                  |                                      |                                      |                                    |
| Due from other funds  |                        |                  |                                      | 3,762                                | 3,762                              |
| Inventories   |                        | 2,080            | 2,080                                |                                      | 2,080                              |
| Other assets  |                        | 5,306            | 5,306                                |                                      | 5,306                              |
| Accounts payable and accrued liabilities  |                        | (3,689)          | (3,689)                              |                                      | (3,689)                            |
| Due to other funds  | (8,763)                |                  | (8,763)                              | (20,525)                             | (29,288)                           |
| Interest payable  |                        |                  |                                      | (1,834)                              | (1,834)                            |
| Other liabilities   |                        |                  |                                      | (1,160)                              | (1,160)                            |
| Accrued compensated absences  | (3,658)                |                  | (3,658)                              |                                      | (3,658)                            |
| Total adjustments   | 90,979                 | (22,188)         | 68,791                               | 260,625                              | 329,416                            |
| Net cash provided by (used in) operating activities, (carried forward)  | \$ (570,871)           | \$ 61,661        | \$ (509,210)                         | \$ 661,281                           | \$ 152,071                         |

(Continued)

**COMMONWEALTH OF PUERTO RICO**

**COMBINED STATEMENT OF CASH FLOWS -  
ALL PROPRIETARY FUND TYPES AND SIMILAR DISCRETELY PRESENTED COMPONENT UNITS  
YEAR ENDED JUNE 30, 1994 (Expressed in Thousands)**

|  | Proprietary Fund Types |                  | Totals                               | Other                                | Totals                             |
|--|------------------------|------------------|--------------------------------------|--------------------------------------|------------------------------------|
|  | Enterprise             | Internal Service | Primary Government (Memorandum Only) | Discretely Presented Component Units | Reporting Entity (Memorandum Only) |
| Net cash provided by (used in) operating activities, (brought forward) | \$ (570,871)           | \$ 61,661        | \$ (509,210)                         | \$ 661,281                           | \$ 152,071                         |
| <b>CASH FLOWS FROM NONCAPITAL FINANCING ACTIVITIES:</b>                |                        |                  |                                      |                                      |                                    |
| Proceeds from notes and loans  |                        | 601,354          | 601,354                              | 207,892                              | 809,246                            |
| Principal paid on notes and loans                                      |                        | (848,568)        | (848,568)                            | (276,688)                            | (1,125,256)                        |
| Interest paid on notes and loans                                       |                        | (231,753)        | (231,753)                            | (87,071)                             | (318,824)                          |
| Operating grants received  | 190,859                |                  | 190,859                              | 31,536                               | 222,395                            |
| Operating transfers-in from other funds                                | 576,082                | 479              | 576,561                              | 176,974                              | 753,535                            |
| Operating transfers-out to other funds                                 | (150,413)              | (12,988)         | (163,401)                            | (92,652)                             | (256,053)                          |
| Capital contributions  |                        |                  |                                      | 7,978                                | 7,978                              |
| Net cash provided by (used in) noncapital financing activities         | 616,528                | (491,476)        | 125,052                              | (32,031)                             | 93,021                             |
| <b>CASH FLOWS FROM CAPITAL AND RELATED FINANCING ACTIVITIES:</b>       |                        |                  |                                      |                                      |                                    |
| Acquisition and construction of capital assets                         | (14,896)               | (68,856)         | (83,752)                             | (934,006)                            | (1,017,758)                        |
| Proceeds from issuance of bonds and notes                              |                        | 92,299           | 92,299                               | 1,676,060                            | 1,768,359                          |
| Principal paid on bonds and notes                                      | (4,481)                | (38,317)         | (42,798)                             | (1,353,350)                          | (1,396,148)                        |
| Interest paid on bonds and notes                                       | (26,100)               |                  | (26,100)                             | (288,639)                            | (314,739)                          |
| Proceeds from sale of equipment  |                        |                  |                                      | 54,685                               | 54,685                             |
| Capital contributions  |                        | 550              | 550                                  | 122,334                              | 122,884                            |
| Net cash used in capital and related financing activities              | (45,477)               | (14,324)         | (59,801)                             | (722,916)                            | (782,717)                          |
| <b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>                           |                        |                  |                                      |                                      |                                    |
| Purchase of investment securities                                      | (31,544)               | (6,016,035)      | (6,047,579)                          | (3,972,821)                          | (10,020,400)                       |
| Proceeds from sales and maturities of investments and securities       |                        | 6,240,626        | 6,240,626                            | 3,540,720                            | 9,781,346                          |
| Interest and dividends on investments                                  | 2,482                  | 272,456          | 274,938                              | 328,551                              | 603,489                            |
| Net cash provided by (used in) investing activities                    | (29,062)               | 497,047          | 467,985                              | (103,550)                            | 364,435                            |
| NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS                   | (28,882)               | 52,908           | 24,026                               | (197,216)                            | (173,190)                          |
| CASH AND CASH EQUIVALENTS AT BEGINNING OF YEAR                         | 79,027                 | 134,170          | 213,197                              | 570,457                              | 783,654                            |
| CASH AND CASH EQUIVALENTS AT END OF YEAR                               | \$ 50,145              | \$ 187,078       | \$ 237,223                           | \$ 373,241                           | \$ 610,464                         |

See notes to general purpose financial statements.

(Concluded)

**COMMONWEALTH OF PUERTO RICO**

**COMBINED STATEMENT OF CHANGES IN FUND BALANCES (DEFICIT) -  
PUBLIC UNIVERSITY FUNDS  
YEAR ENDED JUNE 30, 1994 (Expressed in Thousands)**

|   | Current Funds    |                  | Plant Funds     |                             |                   |                         |                            |                     |                   |
|---|------------------|------------------|-----------------|-----------------------------|-------------------|-------------------------|----------------------------|---------------------|-------------------|
|   | Unrestricted     | Restricted       | Loan Funds      | Endowment and Similar Funds | Unexpended        | Renewal and Replacement | Retirement of Indebtedness | Investment In Plant | Retirement System |
| <b>REVENUES AND OTHER ADDITIONS:</b>                                    |                  |                  |                 |                             |                   |                         |                            |                     |                   |
| Unrestricted current fund revenues                                      | \$ 417,241       | \$ 69,750        | \$              | \$                          | \$ 57             | \$                      | \$                         | \$                  | \$                |
| Commonwealth of Puerto Rico appropriations, grants and contracts        |                  | 101,690          | 143             | 350                         | 64                |                         | 310                        |                     |                   |
| Federal grants and contracts  |                  | 6,785            |                 |                             | 78                |                         |                            |                     |                   |
| Private gifts, grants and contracts                                     |                  | 126              |                 |                             | 35                |                         | 1,412                      |                     | 2,713             |
| Investment income   |                  |                  | 183             |                             |                   |                         |                            |                     |                   |
| Interest on loans receivable  |                  |                  |                 |                             |                   |                         |                            | 18,278              | 47,284            |
| Contributions to retirement system                                      |                  |                  |                 |                             |                   |                         |                            | 6,459               |                   |
| Expended for plant facilities   |                  |                  |                 |                             |                   |                         |                            | 24,737              | 150               |
| Retirement of indebtedness  |                  |                  |                 |                             |                   |                         |                            |                     | 50,147            |
| Other   |                  |                  |                 |                             |                   |                         |                            |                     |                   |
| <b>Total revenues and other additions</b>                               | <u>417,241</u>   | <u>197,621</u>   | <u>386</u>      | <u>350</u>                  | <u>168</u>        | <u>26</u>               | <u>1,722</u>               | <u>24,737</u>       | <u>150</u>        |
|   |                  |                  |                 |                             | <u>402</u>        |                         |                            |                     | <u>50,147</u>     |
| <b>EXPENDITURES AND OTHER DEDUCTIONS:</b>                               |                  |                  |                 |                             |                   |                         |                            |                     |                   |
| Educational and general expenditures                                    | 373,014          | 208,223          |                 |                             |                   |                         |                            |                     |                   |
| Auxiliary enterprises expenditures                                      | 8,260            |                  |                 |                             |                   |                         |                            |                     |                   |
| Refunded to grantors  |                  | 304              | 1               |                             |                   |                         |                            |                     |                   |
| Loan cancellations and assignments                                      |                  |                  | 38              |                             |                   |                         |                            |                     | 2,431             |
| Administrative and collection costs                                     |                  |                  | 37              |                             |                   |                         |                            |                     | 46,239            |
| Retirement benefits   |                  |                  |                 |                             |                   |                         |                            | 1,380               |                   |
| Expended for plant facilities   |                  |                  |                 |                             |                   |                         |                            | 9,448               |                   |
| Retirement of indebtedness  |                  |                  |                 |                             |                   |                         |                            | 968                 |                   |
| Interest on indebtedness  |                  |                  |                 |                             | 2,227             | 6                       | 6,459                      | 11,796              |                   |
| Disposal of plant facilities  |                  |                  |                 |                             |                   |                         | 7                          |                     |                   |
| Other   |                  |                  |                 |                             |                   |                         | 18,568                     |                     | 48,670            |
| <b>Total expenditures and other deductions</b>                          | <u>381,274</u>   | <u>208,527</u>   | <u>76</u>       |                             | <u>2,227</u>      | <u>6</u>                | <u>18,568</u>              | <u>11,796</u>       | <u>48,670</u>     |
|   |                  |                  |                 |                             |                   |                         |                            |                     |                   |
| <b>TRANSFERS AMONG FUNDS-ADDITIONS (DEDUCTIONS):</b>                    |                  |                  |                 |                             |                   |                         |                            |                     |                   |
| Mandatory:  |                  |                  |                 |                             |                   |                         |                            |                     |                   |
| Principal and interest  | (19,871)         |                  |                 |                             |                   |                         |                            |                     |                   |
| Restricted current fund matching grants                                 | (3,169)          | 3,169            |                 |                             |                   |                         |                            |                     | 19,871            |
| Other transfers:  |                  |                  |                 |                             |                   |                         |                            |                     |                   |
| Unrestricted current funds  | (10,849)         | 9,699            |                 |                             | 1,150             |                         |                            |                     |                   |
| Restricted current fund   |                  | (364)            |                 |                             | 364               |                         |                            |                     |                   |
| Plant funds   |                  |                  |                 |                             |                   |                         |                            |                     |                   |
| <b>Total transfers</b>  | <u>(33,889)</u>  | <u>12,504</u>    |                 |                             | <u>4</u>          | <u>(4)</u>              |                            |                     |                   |
|   |                  |                  |                 |                             |                   |                         |                            |                     |                   |
| <b>NET INCREASE (DECREASE) FOR THE YEAR</b>                             | <u>2,078</u>     | <u>1,598</u>     | <u>310</u>      | <u>350</u>                  | <u>(307)</u>      | <u>16</u>               | <u>3,025</u>               | <u>12,941</u>       | <u>1,477</u>      |
| <b>FUND BALANCES (DEFICIT) AT BEGINNING OF YEAR -<br/>(As Restated)</b> | <u>16,384</u>    | <u>25,205</u>    | <u>6,156</u>    | <u>1,170</u>                | <u>(1,559)</u>    | <u>585</u>              | <u>21,048</u>              | <u>251,159</u>      | <u>343,302</u>    |
| <b>FUND BALANCES (DEFICIT) AT END OF YEAR</b>                           | <u>\$ 18,462</u> | <u>\$ 26,803</u> | <u>\$ 6,466</u> | <u>\$ 1,520</u>             | <u>\$ (1,866)</u> | <u>\$ 601</u>           | <u>\$ 24,073</u>           | <u>\$ 264,100</u>   | <u>\$ 344,779</u> |

See notes to general purpose financial statements.

# COMMONWEALTH OF PUERTO RICO

## COMBINED STATEMENT OF CURRENT FUNDS REVENUES, EXPENDITURES AND OTHER CHANGES - PUBLIC UNIVERSITY FUNDS YEAR ENDED JUNE 30, 1994 (Expressed in Thousands)

|   | Unrestricted    | Restricted      | Total           |
|---|-----------------|-----------------|-----------------|
| <b>REVENUES:</b>  |                 |                 |                 |
| Tuition and fees  | \$ 49,185       | \$ 4,131        | \$ 53,316       |
| Commonwealth of Puerto Rico appropriations, grants<br>and contracts   | 355,880         | 69,750          | 425,630         |
| Federal grants and contracts  |                 | 109,123         | 109,123         |
| Private gifts, grants and contracts                                   |                 | 6,785           | 6,785           |
| Sales and services of educational departments                         | 1,537           | 3,166           | 4,703           |
| Sales and services of auxiliary enterprises                           | 5,500           | 206             | 5,706           |
| Investment income   | 1,739           | 126             | 1,865           |
| Other sources   | 3,400           | 11,767          | 15,167          |
| <b>Total current revenues</b>   | <u>417,241</u>  | <u>205,054</u>  | <u>622,295</u>  |
| <b>EXPENDITURES AND MANDATORY<br/>TRANSFERS:</b>                      |                 |                 |                 |
| <b>Educational and general:</b>                                       |                 |                 |                 |
| Instruction   | 152,181         | 14,108          | 166,289         |
| Research  | 5,167           | 51,416          | 56,583          |
| Public service  | 1,299           | 40,486          | 41,785          |
| Academic support  | 52,166          | 2,934           | 55,100          |
| Student services  | 21,810          | 1,231           | 23,041          |
| Institutional support   | 76,759          | 1,641           | 78,400          |
| Operation and maintenance of plant                                    | 58,527          | 848             | 59,375          |
| Scholarships and fellowships  | 1,068           | 81,989          | 83,057          |
| Hospitals   |                 | 9,061           | 9,061           |
| Independent operations  | 487             | 604             | 1,091           |
| Other   | 3,550           | 3,905           | 7,455           |
| <b>Educational and general expenditures</b>                           | <u>373,014</u>  | <u>208,223</u>  | <u>581,237</u>  |
| <b>Mandatory transfers for:</b>                                       |                 |                 |                 |
| Principal and interest  | 19,871          |                 | 19,871          |
| Restricted current fund matching grants                               | 3,169           | (3,169)         |                 |
| <b>Total educational, general and<br/>mandatory transfers</b>         | <u>396,054</u>  | <u>205,054</u>  | <u>601,108</u>  |
| <b>Auxiliary enterprises - expenditures</b>                           | <u>8,260</u>    |                 | <u>8,260</u>    |
| <b>Total expenditures and mandatory transfers</b>                     | <u>404,314</u>  | <u>205,054</u>  | <u>609,368</u>  |
| <b>OTHER TRANSFERS AND ADDITIONS<br/>(DEDUCTIONS):</b>                |                 |                 |                 |
| Excess (deficit) of restricted receipts over<br>transfers to revenues |                 | (7,433)         | (7,433)         |
| Refunded to grantors  |                 | (304)           | (304)           |
| Nonmandatory transfers  | (10,849)        | 9,335           | (1,514)         |
| <b>Total other transfers and additions<br/>(deductions)</b>           | <u>(10,849)</u> | <u>1,598</u>    | <u>(9,251)</u>  |
| <b>NET INCREASE IN FUND BALANCE</b>                                   | <u>\$ 2,078</u> | <u>\$ 1,598</u> | <u>\$ 3,676</u> |

See notes to general purpose financial statements.

# COMMONWEALTH OF PUERTO RICO

## NOTES TO GENERAL PURPOSE FINANCIAL STATEMENTS YEAR ENDED JUNE 30, 1994

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### 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

The Commonwealth of Puerto Rico (the Commonwealth) was constituted on July 25, 1952, under the provisions of its Constitution as approved by the people of Puerto Rico and the United States Congress. The Commonwealth's Constitution provides for the separation of powers of the executive, legislative and judicial branches of the government. The Commonwealth assumes responsibility for public safety, public health, public housing, welfare, education and economic development.

#### A. The Financial Reporting Entity

Except where noted, the accompanying general purpose financial statements have been prepared in conformity with generally accepted accounting principles (GAAP) as applicable to governmental units. The Governmental Accounting Standards Board (GASB) is the accepted standard-setting body for governmental accounting and financial reporting. In addition, GAAP requires that the Commonwealth's proprietary activities apply GAAP as it is applied by similar business activities in the private sector. As a result, the financial statements of certain component units follow the specialized reporting practices for financial institutions and hospitals, as prescribed by the GASB and other authoritative sources, including pronouncements of the Financial Accounting Standards Board (FASB). The financial statements of the University of Puerto Rico have been prepared following the accounting and financial reporting guidance recognized by the American Institute of Certified Public Accountants, Industry Audit Guide, *Audits of Colleges and Universities*, as amended.

Except as discussed in Note 2, the accompanying general purpose financial statements, as required by GAAP, include all departments, agencies and governmental entities whose funds are under the custody and control of the Secretary of Treasury, and the Commonwealth's component units by Act No. 230 of July 23, 1974, as amended, known as *Commonwealth of Puerto Rico Accounting Law*. The component units discussed below are included as part of the Commonwealth's reporting entity because they are financially accountable to the Commonwealth pursuant with GASB Statement No. 14, *The Financial Reporting Entity*.

#### B. Component Units

GAAP defines component units as those entities which are legally separate organizations for which the Commonwealth's elected officials are financially accountable, or other organizations for which the nature and significance of their relationship with the Commonwealth are such that exclusion would cause the Commonwealth's financial statements to be misleading and incomplete. GAAP details two methods of presentation: blending the financial data of the component units' balances and transactions in a manner similar to the presentation of the Commonwealth's balances and transactions; or discrete presentation of the component units' financial data in columns separate from the Commonwealth's balances and transactions.

The financial statements of the component units discussed below have been included in the financial reporting entity either as blended component units or as discretely presented component units in accordance with GAAP.

1. **Blended Component Units:**

The following entities, while legally separate from the Commonwealth, meet the criteria to be reported as part of the primary government because they provide services entirely or almost entirely to the Commonwealth.

**Government Development Bank for Puerto Rico and Subsidiaries (GDB)**

The Government Development Bank for Puerto Rico and Subsidiaries are governed by a seven-member board appointed by the Governor with the consent of the Senate. The Secretary of Treasury is the Chairman. It is a legally separate entity defined by the Constitution and its activities are blended within the primary government because GDB acts as the financial advisor and fiscal agent for the Commonwealth and its public corporations in connection with the issuance of bonds and notes and it also makes loans and advances funds to public corporations.

**Public Buildings Authority (PBA)**

The Public Buildings Authority is governed by a five-member board appointed by the Governor with the consent of the Senate. It is a legally separate entity, whose activities are blended within the primary government because it exists to construct, purchase or lease office, school, health, jails, and social welfare facilities for lease to the Commonwealth's departments, component units and instrumentalities. Bonds issued by PBA to finance such facilities are payable from lease collections, which are largely derived from Commonwealth appropriations and are generally secured by the Commonwealth's guaranty.

**Puerto Rico Infrastructure Financing Authority (PRIFA)**

The Puerto Rico Infrastructure Financing Authority board is comprised of the same board members as the Government Development Bank for Puerto Rico. Its operations are to provide financial, administrative, consulting, technical, advisory and other types of assistance to other component units and governmental instrumentalities of the Commonwealth which are authorized to develop infrastructure facilities and to establish alternate means of financing them.

**Puerto Rico Land Administration (PRLA)**

The Puerto Rico Land Administration is governed by an eleven-member board comprised by the Governor, who serves as Chairman, the Secretary of Treasury, the Secretary of Agriculture, the Secretary of Transportation and Public Works, the Secretary of Housing, the Economic Development Administrator, the President of the Planning Board, and four other members appointed by the Governor with the consent of the Senate. It is a legally separate entity whose activities are blended within the primary government because PRLA acquires, through negotiation or expropriation, parcels of land, on behalf of government instrumentalities.

## **Puerto Rico Highway and Transportation Authority (PRHTA)**

The Puerto Rico Highway and Transportation Authority is governed by the Secretary of the Department of Transportation and Public Works (DTPW), who is appointed by the Governor with the consent of the Senate. PRHTA has broad powers to carry out its responsibilities in accordance with the DTPW's overall transportation policies. These powers include, among other things, the complete control and supervision of any highway facilities constructed, owned or operated by PRHTA, the ability to set tolls for the use of the highway facilities and the power to issue bonds, notes or other obligations. PRHTA plans and manages the construction of all major projects relating to the Commonwealth toll highway system, undertakes major repairs and maintains the tollways.

Complete financial statements of the blended component units can be obtained directly by contacting their respective administrative office or the Secretary of the Treasury of the Commonwealth.

### **Administrative offices:**

Government Development Bank for  
Puerto Rico and Subsidiaries  
PO Box 42001  
San Juan, PR 00940-2001

Public Buildings Authority  
PO Box 41029 Minillas Station  
San Juan, PR 00940

PR Infrastructure Financing Authority  
PO Box 42001  
San Juan, PR 00940-2001

Puerto Rico Land Administration  
PO Box 363767  
San Juan, PR 00936-3767

PR Highway and Transportation Authority  
PO Box 42007  
San Juan, PR 00940-2007

## **2. Discretely Presented Component Units:**

The following component units, consistent with GASB Statement No. 14, are discretely presented in the general purpose financial statements because of the nature of the services they provide and the Commonwealth's ability to impose its will. The public university funds financial information is presented in a separate column due to its basis of accounting being different from that followed by the other component units.

## **Public University Funds**

### **University of Puerto Rico (UPR)**

The University of Puerto Rico is governed by a thirteen-member Board of Trustees of which ten are appointed by the Governor and confirmed by the Senate, one full-time student and two term professors. The original members appointed by the Governor are for terms from four to eight years. Upon expiration of their terms, the new members will be appointed for a period of six years. The terms for the student and professors are one year. The UPR is the largest institution of higher education in Puerto Rico.

### **University of Puerto Rico Retirement System (UPRRS)**

The University of Puerto Rico Retirement System is the administrator of the retirement system for the employees of the University of Puerto Rico. It is governed by the Council of Higher Education of the University.

## **Component Units - Other**

### **Puerto Rico Electric Power Authority (PREPA)**

The Puerto Rico Electric Power Authority board is composed of nine members. Seven members are appointed by the Governor with the consent of the Senate, and the remaining two members by the Puerto Rico Consumer Affairs Department. PREPA is responsible for conserving, developing and utilizing the power resources of Puerto Rico and owns and operates the Commonwealth's electric system. PREPA's powers include, among others, the ability to issue bonds for any of its corporate purposes and is required, under the terms of a 1947 Indenture and a 1974 Agreement, to determine and collect reasonable rates for electric service in order to produce revenues sufficient to cover all operating and financing obligations.

### **Puerto Rico Aqueduct and Sewer Authority (PRASA)**

The Puerto Rico Aqueduct and Sewer Authority board is composed of seven members. Five members are appointed by the Governor with the consent of the Senate, and the remaining two members by the Puerto Rico Consumer Affairs Department. PRASA owns and operates the system of public water supply and sanitary sewer facilities. PRASA has broad powers, including, among others, to borrow money and issue revenue bonds for any of its corporate purposes. PRASA is required, under the terms of its Trust Agreements, to determine and collect reasonable rates for water services to produce revenues sufficient to cover all operating and financing obligations. PRASA's capital is generated by non-reimbursable legislative appropriations from the Commonwealth, grants from various agencies of the Federal government, donations in-kind or other operating transfers in cash from various governmental agencies and instrumentalities of the Commonwealth, other customers of PRASA, and internally generated funds. As discussed in Note 17, subsequent to June 30, 1994 the Commonwealth guaranteed the payment of bonds payable of approximately \$388 million.

### **Puerto Rico Telephone Authority, Subsidiaries and Affiliate (PRTA)**

The Puerto Rico Telephone Authority, Subsidiaries and Affiliate are governed by a five-member board appointed by the Governor with the consent of the Senate. PRTA is responsible for acquiring, developing and operating telephone, radio, cable or other communication systems. PRTA is obliged, as defined in certain Trust Agreement, to determine and collect reasonable rates for the use of its communication facilities in order to produce revenues sufficient to cover all operating and financing obligations. During 1993, PRTA announced that the Puerto Rico Telephone Company, its affiliate, will be reorganizing its operations by merging with a subsidiary of PRTA, the Puerto Rico Communications Corporation. At the date of such planned reorganization, May 4, 1994, the subsidiary's operations were merged with the operations of the Puerto Rico Telephone Company (the surviving entity).

### **State Insurance Fund Corporation (SIFC)**

The State Insurance Fund Corporation board is composed of five members appointed by the Governor with the consent of the Senate. SIFC provides worker's compensation and disability insurance to public and private employees who suffer accidents during the course, or as a consequence of functions which are inherent to their work.

### **Puerto Rico Housing Bank and Finance Agency (PRHBFA)**

The Puerto Rico Housing Bank and Finance Agency is governed by the Secretary of Housing who is appointed by the Governor with the consent of the Senate. PRHBFA is engaged in insuring mortgages and servicing mortgages originated by the former Puerto Rico Urban Renewal and Housing Corporation which ceased operations effective August 9, 1991. PRHBFA issues bonds and notes to provide interim and permanent financing for low-income housing projects and single-family home ownership programs. PRHBFA obtains funds from legislative appropriations, sale of mortgages, collection of mortgage repayments, and other sources.

### **Economic Development Bank for Puerto Rico (EDB)**

The Economic Development Bank for Puerto Rico is governed by a nine-member board comprised by the President of the Government Development Bank for Puerto Rico, who is the Chairman, the Secretary of Agriculture, the Secretary of Commerce, the Economic Development Administrator, the Executive Director of the Puerto Rico Tourism Company, and four other members appointed by the Governor with the consent of the Senate. EDB is responsible for the promotion and development of the private sector economy of the Commonwealth. This purpose is to be met by making direct loans, loan guarantees, loan participation, and/or direct investments available to any person or business organization devoted to manufacturing, agriculture, trade, tourism or other service enterprises, whose economic activity may have the effect of substituting imports.

### **Puerto Rico Industrial Development Company (PRIDCO)**

The Puerto Rico Industrial Development Company is governed by the Economic Development Administrator as appointed by the Governor with the consent of the Senate. PRIDCO operates the Commonwealth-sponsored economic development program by providing facilities, general assistance, and special incentive grants to manufacturers. PRIDCO has issued interim notes and revenue bonds to finance factories and other facilities. Rentals derived from the leasing of specified facilities of PRIDCO are pledged to the payment of PRIDCO's revenue bonds.

### **Puerto Rico Ports Authority (PRPA)**

The Puerto Rico Ports Authority is governed by a five-member board consisting of the Secretary of Transportation and Public Works, as the Chairman, the Secretary of Commerce, the Economic Development Administrator, the Director of the Tourism Administration and one private citizen appointed by the Governor with the consent of the Senate. The purpose of PRPA is to administer all ports and aviation transportation facilities of the Commonwealth and to render other related services. As of June 30, 1994, PRPA was not in compliance with certain provisions of its trust indenture. As discussed in Note 14, effective September 1, 1994 and January 1, 1995 PRPA raised its dockage and landing fees, respectively.

### **Puerto Rico Municipal Finance Agency (PRMFA)**

The Puerto Rico Municipal Finance Agency is governed by a five-member board composed of the Secretary of the Treasury, the President of the Government Development Bank for Puerto Rico and three additional members appointed by the Governor, with the consent of the Senate, one of whom shall be either the mayor or chief financial officer of a municipality. PRMFA was organized to create a capital market to assist the municipalities of Puerto Rico in financing their public improvement programs.

### **Puerto Rico Maritime Shipping Authority (PRMSA)**

The Puerto Rico Maritime Shipping Authority board is composed of seven members appointed by the Governor with the consent of the Senate. PRMSA is responsible for establishing and maintaining an economical maritime transportation system between Puerto Rico and abroad. PRMSA acquired vessels and other equipment financed by the issuance of notes on a secured basis to previous owners. As discussed in Note 18, subsequent to June 30, 1994, the Commonwealth sold PRMSA to private investors.

### **Sugar Corporation of Puerto Rico (SCPR)**

The Sugar Corporation of Puerto Rico is administered by the Governing Board of the Puerto Rico Land Authority consisting of the Secretary of Agriculture as Chairman, and four other members appointed by the Governor with the consent of the Senate. SCPR was created to consolidate ownership and management of the Commonwealth's interests in Puerto Rico's sugar industry. SCPR owns or leases and operates the majority of all the sugar production facilities in Puerto Rico. SCPR buys all the cane grown by private growers, processes the cane, and sells the raw and refined sugar and molasses. The Commonwealth is presently evaluating the sale of SCPR to private investors.

**Puerto Rico Industrial, Tourist, Educational, Medical, and Environmental Control Facilities Financing Authority (AFICA)**

The Puerto Rico Industrial, Tourist, Educational, Medical, and Environmental Control Facilities Financing Authority board is composed of five members consisting of the Economic Development Administrator, the President of the Government Development Bank for Puerto Rico, the Executive Director of the Puerto Rico Aqueduct and Sewer Authority and two private citizens appointed by the Governor with the consent of the Senate. AFICA is authorized to issue revenue bonds to finance industrial, pollution control, medical, and educational facilities in Puerto Rico for the use of private companies, non-profit entities or governmental agencies. The bonds are payable solely from collections from such private companies, non-profit entities or governmental agencies, and do not constitute a debt of the Commonwealth or any of its other components units.

**Caribbean Basin Projects Financing Authority (CBPFA)**

The Caribbean Basin Projects Financing Authority board is composed of five members consisting of the Economic Development Administrator, the President of the Government Development Bank for Puerto Rico, the President of the Economic Development Bank for Puerto Rico and two private citizens appointed by the Governor with the consent of the Senate. CBPFA is authorized to issue revenue bonds and to loan the proceeds thereof to finance the projects for the development of the Caribbean Basin countries that are authorized to receive investments of funds under the provisions of Section 936 (d)(4) of the US Internal Revenue Code.

**Automobile Accident Compensation Administration (AACCA)**

The Automobile Accident Compensation Administration board is composed of one member of the Cabinet of the Governor and four members appointed by the Governor with the consent of the Senate. AACCA operates a system of compulsory insurance coverage for all the registered automobiles and compensates for injuries arising from automobile accidents.

**Puerto Rico Metropolitan Bus Authority (PRMBA)**

The Puerto Rico Metropolitan Bus Authority is composed of a nine-member board appointed by the Governor with the consent of the Senate. The PRMBA provides public land transportation to passengers within the San Juan Metropolitan Area. This service is principally financed by Commonwealth and Federal government appropriations, and passenger fares.

**Puerto Rico Public Broadcasting Corporation (PRPBC)**

The Puerto Rico Public Broadcasting Corporation is an unconsolidated subsidiary of the Puerto Rico Telephone Authority. The board is composed of four members of the public sector and five private citizens on behalf of the public interest, appointed by the Governor with the consent of the Senate. PRPBC was created with the purpose of integrating, developing and operating the radio, television and electronic communication facilities that belong to the Commonwealth.

### **Solid Waste Authority of Puerto Rico (SWAPR)**

The Solid Waste Authority of Puerto Rico board is composed of eleven members appointed by the Governor with the consent of the Senate. SWAPR provides alternatives in the processing of solid waste and encourages recycling, reuse and recovery of resources from waste.

### **Tourism Company of Puerto Rico (TCPR)**

The Tourism Company of Puerto Rico board consists of seven members, of whom the Economic Development Administrator is the Chairman, and the remaining members are the Public Recreation and Parks Administrator, the Chairman of the Planning Board, the Secretary of Transportation and Public Works, and three members appointed by the Governor with the consent of the Senate. TCPR is in charge of the development of the tourism industry of the Commonwealth.

### **Agricultural Development Administration (ADA)**

The Agricultural Development Administration is governed by the Secretary of Agriculture who is appointed by the Governor with the consent of the Senate. The purpose of ADA is to provide incentives and subsidies to farmers.

### **Commercial and Agricultural Credit and Development Corporation (CACDC)**

The Commercial and Agricultural Credit and Development Corporation board is composed of the members of the Economic Development Bank for Puerto Rico board of directors. CACDC has as its purpose the promotion of the development of the productivity, competitiveness and profits of commercial, manufacturing, services and agro-industrial enterprises, including, without limitation, agriculture, livestock, fishing industries, aquatic and marine resources, as well as forestry and terrestrial. Such purpose is to be met by providing financing through diverse credit mechanisms and granting loans to commercial entities, and entities related to agriculture in general.

### **Employment and Training Enterprises Corporation (ETEC)**

The Employment and Training Enterprises Corporation is governed by a ten-member board comprised of the Administrator of Correction, the Administrator of Youth Correctional Institutions, the Secretary of Justice, the Secretary of Education, the Executive Director of the Right to Employment Administration, the Administrator of the Administration of Mental Health and Anti-Addiction, the Sub-Administrator for the Promotion of Puerto Rico Industries of the Economic Development Administration, the Director of Volunteer Corps and two private citizens appointed by the Governor with the consent of the Senate. The purpose of ETEC is to provide training, management development and employment for convicts in the correctional institutions of the Commonwealth.

### **Industries for the Blind, Mentally Retarded and Other Disabled Persons of Puerto Rico**

The Industries for the Blind, Mentally Retarded and Other Disabled Persons of Puerto Rico is governed by the Secretary of the Department of Social Services, who is its President. The purpose of the entity is to provide economic and social rehabilitation for the blind, mentally retarded and other disabled persons through job opportunities within the public and private industries.

### **Institutional Trust of the National Guard of Puerto Rico (ITNGPR)**

The Institutional Trust of the National Guard of Puerto Rico is administered by a seven-member board comprised of the General Assistant of Puerto Rico, the President of the Government Development Bank for Puerto Rico, the Secretary of Justice and four members of the Puerto Rico National Guard appointed by the Governor with the consent of the Senate. ITNGPR has as its purpose to provide life insurance benefits to the active members of the Puerto Rico National Guard, provide economic assistance for the members of the Puerto Rico National Guard and their families and to provide retirement benefits.

### **Musical Arts Corporation and Subsidiaries (MAC)**

The Musical Arts Corporation and Subsidiaries are governed by a seven-member board appointed by the Governor with the consent of the Senate. MAC was created to promote the development of the arts and cultural programs of the Commonwealth.

### **Corporation of Stocks and Deposits Insurance for the Savings and Loans Cooperatives (CSDISLC)**

The Corporation of Stocks and Deposits Insurance for the Savings and Loans Cooperatives is governed by an eleven-member board composed of the Commissioner of Financial Institutions of Puerto Rico, the Inspector of Cooperatives of Puerto Rico, the Administrator of Cooperative Development Administration, a representative of the Puerto Rico Treasury Department, a representative of the Government Development Bank for Puerto Rico, five citizens in the name of the cooperative movement, and one private citizen. CSDISLC has the responsibility of providing to all the cooperatives, and the Federation of Cooperatives of Puerto Rico, insurance coverage over the stocks and deposits, for monitoring the financial condition of the insured cooperatives, and of uninsured cooperatives when requested by the Commissioner of Financial Institutions of Puerto Rico.

### **Agricultural Services Administration (ASA)**

The Agricultural Services Administration is governed by the Secretary of Agriculture who is appointed by the Governor with the consent of the Senate. The purpose of ASA is to provide a wide variety of services to the agricultural sector.

### **Puerto Rico Health Insurance Administration (PRHIA)**

The Puerto Rico Health Insurance Administration board is composed of the Secretary of Health, the Secretary of Treasury, the Commissioner of Insurance and four additional members appointed by the Governor, with the consent of Senate. PRHIA was created for the purpose of implementing, administering and negotiating a health insurance system, through contracts with insurance underwriters, to provide quality medical and hospital care to qualified individuals.

### **Fine Arts Center Corporation (FACC)**

The Fine Arts Center Corporation is governed by a seven-member board of which five are appointed by the President of the Board of Directors of the Arts and Culture Development Administration and two are appointed by the President of the Board of Directors of the Puerto Rico Culture Institute. FACC was created with the purpose of administering the Fine Arts Center.

### **Land Authority of Puerto Rico (LAPR)**

The Land Authority of Puerto Rico is governed by a five-member board consisting of the Secretary of Agriculture and four members appointed by the Governor with the consent of the Senate. LAPR was created to carry out the provisions of the Land Law of Puerto Rico.

### **Right to Employment Administration**

The Right to Employment Administration is governed by an Administrator appointed by the Governor with the consent of the Senate. In addition, a Consultive Board composed of the Secretary of Labor, the Secretary of Agriculture, the Secretary of Transportation and Public Works, the Secretary of Education and five additional members appointed by the Governor, with the consent of the Senate, will advise the Administrator in the implementation of the Right to Employment Act.

### **Farm Insurance Corporation of Puerto Rico (FICPR)**

The Farm Insurance Corporation of Puerto Rico is composed of a five-member board consisting of the Secretary of Agriculture, the Director of the Agriculture Sciences Faculty of the Mayagüez Campus of the University of Puerto Rico, a representative of the Government Development Bank for Puerto Rico and two bona fide farmers appointed by the Governor with the consent of the Senate. The purpose of the FICPR is to provide insurance to farmers against losses in their farms caused by natural disasters.

### **Puerto Rico Medical Services Administration**

The Puerto Rico Medical Services Administration is governed by the Secretary of Health who is appointed by the Governor with the consent of the Senate. It was created to plan, organize, operate and administer the centralized health services, provided in support of the hospital and other functions offered by the member institutions and consumers of the medical complex known as *Puerto Rico Medical Center*.

### **Trust for the Development, Operation and Conservation of National Parks of Puerto Rico**

The Trust for the Development, Operation and Conservation of National Parks of Puerto Rico board is composed of the President of the Recreational Development Company of Puerto Rico, and four representatives from the state government, the private sector, the advisory council and the trustees, all of which are appointed by the Governor with the consent of the Senate. The Trust has the obligation to develop, operate and provide maintenance to the national parks of Puerto Rico.

### **Puerto Rico and Caribbean Cardiovascular Center Corporation (PRCCCC)**

The Puerto Rico and Caribbean Cardiovascular Center Corporation is governed by a seven-member board comprised of the Secretary of Health, the Director of the Medical Sciences Department of the University of Puerto Rico, the Executive Director of the Puerto Rico Medical Services Administration and four additional members, one of which should be from the Cardiology Society of Puerto Rico, and another member of a cardiology foundation properly registered in the Department of State, appointed by the Governor with the consent of the Senate. The purpose of the PRCCCC is to provide special treatment in cardiovascular diseases in Puerto Rico and the Caribbean.

### **Recreational Development Company of Puerto Rico**

The Recreational Development Company of Puerto Rico is in charge for developing a program for the construction and operation of recreational facilities which shall contribute to the physical and mental development of the communities, family welfare and improvement of the quality of life.

Complete financial statements of the discretely presented component units can be obtained directly by contacting their administrative offices:

#### Administrative offices:

PR Electric Power Authority  
PO Box 364267  
San Juan, PR 00936-4267

Economic Development Bank for PR  
PO Box 195009  
San Juan, PR 00919-5009

Puerto Rico Ports Authority  
PO Box 2829  
San Juan, PR 00936-2829

Puerto Rico Telephone Authority  
PO Box 360998  
San Juan, PR 00936-0998

PR Aqueduct and Sewer Authority  
PO Box 7066 Barrio Obrero Station  
San Juan, PR 00916

PR Maritime Shipping Authority  
PO Box 71105  
San Juan, PR 00936-8005

Sugar Corporation of PR  
PO Box 9477  
San Juan, PR 00908

PR Industrial Development Co.  
PO Box 362350  
San Juan, PR 00936-2350

State Insurance Fund Corporation  
PO Box 365028  
San Juan, PR 00936-2350

Puerto Rico Industrial, Tourist,  
Educational, Medical and  
Environmental Control Facilities  
Financing Authority  
PO Box 42001 Minillas Station  
San Juan, PR 00940-2001

Automobile Accident  
Compensation Administration  
PO Box 364847  
San Juan, PR 00936-4847

Puerto Rico Public  
Broadcasting Corporation  
PO Box 190909  
San Juan, PR 00919-0909

Tourism Company of Puerto Rico  
PO Box 4435  
Old San Juan Station  
San Juan, PR 00902-4435

Caribbean Basin Projects  
Financing Authority  
PO Box 3271  
San Juan, PR 00904

Commercial and Agricultural  
Credit and Development Corp.  
PO Box 364943  
San Juan, PR 00936-4943

Institutional Trust of the  
National Guard of PR  
PO Box 3786  
San Juan, PR 00904

Industries for the Blind,  
Mentally Retarded and Other  
Disabled Persons of PR  
PO Box 13382  
San Juan, PR 00908

Musical Arts Corporation and Subsidiaries  
PO Box 41227 Minillas Station  
San Juan, PR 00940

Agricultural Services Administration  
603 Hipodromo Avenue  
PO Box 9200

PR Housing Bank and Finance Agency  
PO Box 190345  
San Juan, PR 00919-0345

Corporation of Stocks and Deposits  
Insurance for the Savings and Loans  
Cooperatives  
PO Box 195449  
San Juan, PR 00919-5449

PR Metropolitan Bus Authority  
PO Box 195349  
San Juan, PR 00919-5349

Solid Waste Authority of PR  
PO Box 40285  
San Juan, PR 00940

PR Municipal Finance Agency  
PO Box 42001  
San Juan, PR 00940-2001

Agricultural Development  
Administration  
PO Box 9200  
San Juan, PR 00908-0200

Employment and Training  
Enterprises Corporation  
PO Box 366505  
San Juan, PR 00936-0200

Recreational Development Company  
of Puerto Rico  
PO Box 2089  
San Juan PR 00902-2081

University of Puerto Rico  
Retirement System  
PO Box 21769  
University Station  
San Juan, PR 00931

University of Puerto Rico  
PO Box 364984  
San Juan, PR 00936-4984

Puerto Rico Health Insurance  
Administration  
PO Box 4264

Land Authority of Puerto Rico  
PO Box 9745  
San Juan, PR 00908

Right to Employment Administration  
PO Box 364452  
San Juan, PR 00936

Puerto Rico Medical Services Administration  
PO Box 2129  
San Juan, PR 00922

Puerto Rico and Caribbean  
Cardiovascular Center Corporation  
PO Box 366528  
San Juan, PR 00936

Farm Insurance Corporation of Puerto Rico  
PO Box 9200  
Santurce, PR 00908

Trust for the Development, Operation  
and Conservation of National Parks  
PO Box 363332  
San Juan, PR 00936-3332

Fine Arts Center Corporation  
PO Box 41287 Minillas Station  
Santurce, PR 00940

All the financial statements of the discretely presented component units have a year end of June 30, 1994 except for Puerto Rico Telephone Authority, Puerto Rico Public Broadcasting Corporation and Sugar Corporation of Puerto Rico which have a year end of December 31, 1993.

### **C. Basis of Presentation**

The Commonwealth reports its financial position and results of operations in funds and account groups, each of which is considered an independent fiscal entity, and discrete presentations of component units. The operations of each fund are accounted for within a set of self-balancing accounts that comprise its assets, liabilities, fund equity, revenues and expenditures/expenses. Transactions between funds within a fund type, if any, have been eliminated. Fund accounting segregates funds according to their intended purpose and is used to aid management in demonstrating compliance with finance-related legal and contractual provisions. The minimum number of funds are maintained consistent with legal and managerial requirements. Account groups are a reporting device to account for certain assets and liabilities of the governmental funds not recorded directly in those funds. They are not considered funds because they do not report expendable available financial resources and related liabilities. For financial reporting purposes, the Commonwealth's reporting entity is divided into the primary government and its component units. Individual funds of the primary government are classified into three type categories: governmental funds, proprietary funds and fiduciary funds. Discretely presented component units are classified into public university funds and component units - other.

The Commonwealth has established the following fund categories, fund types, account groups and discrete presentation of component units:

1. **Governmental Fund Types:**

Governmental funds are used to account for the general government functions of the Commonwealth. The following are the Commonwealth's governmental fund types:

**General Fund** - The general fund is the primary operating fund of the Commonwealth. It is used to account for all financial transactions, except those required to be accounted for in another fund.

**Debt Service Funds** - The debt service funds are used to account for the accumulation of resources for, and the payment of, general long-term debt principal, interest, and related costs other than bonds payable from the operations of proprietary fund types, nonexpendable trust funds, public university funds and component units - other. Long-term debt and interest due on July 1 of the following fiscal year are accounted for as a fund liability if resources are available as of June 30 for its payment.

**Capital Projects Funds** - Capital projects funds are used to account for the financial resources used for acquisition or construction of major capital facilities not being financed by proprietary fund types, nonexpendable trust funds, public university funds and component units - other.

2. **Proprietary Fund Types:**

Proprietary funds are used to account for activities that are similar to those found in the private sector where net income and capital maintenance are measured. The following are the Commonwealth's proprietary fund types:

**Enterprise Funds** - Enterprise funds are used to account for operations that are financed and operated in a manner similar to private business enterprises. Costs of providing goods and services to the general public on a continuing basis, including depreciation, are financed or recovered primarily through user charges.

**Internal Service Funds** - Internal service funds are used to account for goods or services provided by blended component units or agencies to other blended or discretely presented component units, departments or agencies on a cost-reimbursement basis.

3. **Fiduciary Fund Types:**

Fiduciary funds are used to account for assets held by the Commonwealth in a trustee capacity, or as an agent for individuals, private organizations, other governmental units, and/or other funds. The following are the Commonwealth's fiduciary fund types:

**Expendable Trust Funds** - are used to account for trusts which principal and income may be expended for their designated purpose.

**Pension Trust Funds** - are used to account for the assets, liabilities and fund equities held in trust for the public employees retirement systems. They account for assets of which the principal may not be spent for general government purposes.

Agency Funds - are custodial in nature (assets equal liabilities) and do not involve measurement of the results of operations.

4. **Account Groups:**

Account groups establish control and accountability over the Commonwealth's general fixed assets and general long-term obligations.

General Fixed Assets Account Group - This account group is used to account for general fixed assets of the Commonwealth, which exclude the fixed assets held by the proprietary funds, nonexpendable trust funds, public university funds, and component units - other.

General Long-Term Debt Account Group - This account group is used to account for long-term obligations of the Commonwealth including bonds, appropriations and revenue bonds and notes payable, obligations under lease/purchase agreements, and other long-term liabilities excluding the liabilities of proprietary funds, nonexpendable trust funds, public university funds, and component units - other.

5. **Public University Funds:**

The public university funds are used to account for the activities of the University of Puerto Rico and the University of Puerto Rico Retirement System. Accordingly, the public university funds are an aggregate of the following funds required by the American Institute of Certified Public Accountants, *Industry Audit Guide-Audits of Colleges and Universities*, as amended: current funds - restricted and unrestricted; loan funds; endowment and similar funds; plant funds; and agency funds; and the activities of the retirement system.

6. **Component Units - Other:**

The financial activities of the Commonwealth's discretely presented component units (excluding public university funds) are reported in this column. The financial statements of other component units are presented in accordance with the appropriate accounting methods as discussed below.

D. **Basis of Accounting**

The basis of accounting determines when the Commonwealth recognizes revenues and expenditures or expenses and related assets and liabilities.

The modified accrual basis of accounting is followed by governmental fund types, expendable trust funds and agency funds. Under the modified accrual basis of accounting, revenues are recorded when they become measurable and available to pay liabilities of the current period. Tax revenues, net of estimated overpayments (refunds), are recorded by the Commonwealth as taxpayers earn income (income and unemployment), as sales are made (consumption and use taxes) and as cash is received (miscellaneous taxes). Significant taxes that are susceptible to accrual recorded as receivables and revenues at June 30 if collected subsequent to June 30 as described on next page.

|  |          |
|--|----------|
| Income taxes   | 120 days |
| Unemployment taxes   | 60 days  |
| Excise taxes, including federal excise taxes<br>reimbursed to the Commonwealth | 30 days  |

In applying the susceptible to accrual concept to intergovernmental revenues, there are essentially two types of revenues. For the majority of grants, monies must be expended by the Commonwealth on the specific purpose or project before any amounts will be reimbursed. Revenues are, therefore, recognized as expenditures are incurred. For the other revenues, monies are virtually unrestricted and are generally revocable only for failure to comply with prescribed compliance requirements. These resources are reflected as revenues at the time of receipt or earlier if the susceptible to accrual criteria is met.

Expenditures and related liabilities are recorded in the accounting period in which the liability is incurred, except for (1) principal payment and interest on long-term obligations, which is recorded when due, except for interest due on July 1 of the following year which is recorded when resources are available in the debt service funds and (2) vacation, sick leave, federal funds cost disallowances, long-term payables to municipalities and amounts subject to judgments under litigation which are recorded in the general long-term debt account group.

The Commonwealth reports deferred revenues on its combined balance sheet. Deferred revenues arises when a potential revenue does not meet both the "measurable" and "available" criteria for recognition in the current period. Deferred revenues also arises when resources are received before the Commonwealth has a legal claim to them, as when grant monies are received prior to incurring the qualifying expenditures. In subsequent periods, when the revenue recognition criteria is met, or when the Commonwealth has a legal claim to the resources, the liability for deferred revenues is removed from the combined balance sheet and the revenue is recognized.

The accrual basis of accounting is used by proprietary fund types and pension trust funds. Under the accrual basis, revenue is recognized when earned and expenses are recorded as liabilities when incurred, without regard to receipt or payment of cash. The accrual basis is also used by the public university funds, except that depreciation of fixed assets is not required to be recorded and that pension contributions are not recorded in accordance with generally accepted accounting principles. The Commonwealth has elected not to follow Financial Accounting Standards Board pronouncements issued subsequent to November 30, 1989 for its proprietary fund types, as allowed by Statement 20 of the Governmental Accounting Standards Board, *Accounting and Financial Reporting for Proprietary Funds and Other Governmental Entities That Use Proprietary Fund Accounting*. Certain discretely presented component units have early adopted Statement 20 and have disclosed their election in their separately issued financial statements.

The component units - other follow generally accepted accounting principles as issued by the Governmental Accounting Standards Board (GASB), and the Financial Accounting Standards Board (FASB) as applicable to each component unit based on the nature of their operations.

**E. Statutory (Budgetary) Accounting**

The Commonwealth's budget is adopted in accordance with a statutory basis of accounting which is not in accordance with GAAP. Revenues are generally recognized when cash is received. However, revenues receivable for federal grants and reimbursements are recognized when related expenditures are incurred. Amounts due from certain political subdivisions of the Commonwealth are recognized when considered measurable and available at year end.

Expenditures generally are recorded when the related cash disbursement occurs. At year end, payroll is accrued and payables are recognized, to the extent of approved encumbrances, provided that the goods or services have been received by June 30. Available appropriations and encumbrances lapse three years after the end of the fiscal year. Amounts required to settle claims and judgments against the Commonwealth, and certain other liabilities are not recognized until they are encumbered or otherwise processed for payment.

Under the statutory basis of accounting, the Commonwealth uses encumbrance accounting to record the full amount of purchase orders, contracts and other commitments of appropriated resources as deductions from the appropriation prior to actual expenditure. In the governmental funds, encumbrance accounting is a significant aspect of budgetary control.

**F. Cash, Cash Equivalents and Short Term-Investments**

The Commonwealth follows the practice of pooling cash and cash equivalents. The balance in the pooled cash accounts is available to meet current operating requirements and any excess is invested in various interest bearing accounts with the Government Development Bank for Puerto Rico, an internal service fund. Because all cash is pooled, an individual fund may have a cash deficit. In these instances, the fund with the cash deficit will borrow from another fund. These interfund borrowings are reported as "Due from other funds" and "Due to other funds" on the combined balance sheet. Interest earned on pooled cash is allocated to the general fund.

Cash and cash equivalents include investments with original maturities of ninety days or less.

Cash and short-term investments, and cash equivalents of the public university funds and the component units - other are maintained in separate bank accounts, from those of the primary government, in their own names. Cash equivalents include investments with original maturities of ninety days or less.

Short-term investments are stated at cost or amortized cost.

The cash and cash equivalents at end of year on the combined statement of cash flows - all proprietary fund types and similar discretely presented component units do not agree with the combined balance sheet amounts because in the latter the amounts also include investments that do not qualify as cash equivalents as established by Governmental Accounting Standards Board Statement No. 9, *Reporting Cash Flows of Proprietary and Nonexpendable Trust Funds and Governmental Entities That Use Proprietary Fund Accounting*.

In addition, the operating income (loss) in the combined statement of cash flows - all proprietary fund types and similar discretely presented component units do not agree with the operating income (loss) in the combined statement of revenues, expenses and changes in retained earnings (deficit)/fund balances - all proprietary fund types, pension trust funds and similar discretely presented component units because the Commonwealth did not include the statement of cash flows of a component unit as disclosed in Note 2A.

**G. Investments**

As described in Note 4, investments include US Government and agency obligations, mortgage-backed securities, repurchase agreements, commercial paper, local government obligations, and corporate debt and equity obligations. Investments are reported at cost or amortized cost, as appropriate, except for investments in the mutual funds, equity obligations, individually allocated annuities and the deferred compensation funds (included in the pension trust funds) that are reported at market value.

**H. Receivables**

Receivables are stated net of estimated allowances for uncollectible accounts, which are determined based upon past collection experience and current economic conditions. Intergovernmental receivables represent amounts owed to the Commonwealth for reimbursement of expenditures incurred pursuant to federally funded programs.

The loan funds of the public university funds are stated net of uncollectible amounts.

The accounts receivable from nongovernmental customers of the component units - other are net of estimated uncollectible amounts. These receivables arise primarily from service charges to users. Accounts receivable from the primary government and other component units that arise for service charges do not have allowances for uncollectible accounts, and are separately reported in the general purpose financial statements as "due from primary government", or "due from component units".

**I. Inventories**

The proprietary fund types recognize an asset when the inventory is purchased and an expense when it is consumed. Inventories in proprietary fund types are primarily valued at the lower of cost or market using the first-in, first-out method.

Inventories in the public university funds and in the component units - other are valued at the lower of cost or market using first-in-first-out method.

**J. Restricted Assets**

Restricted assets in the general fund include amounts set aside for the payment of principal and interest on tax revenue anticipation notes and special promissory notes. Restricted assets in the proprietary fund types include amounts set aside for the payment of bonds, construction funds, lottery prizes and other long-term obligations. Restricted assets in the public university funds and in the component units - other column are set aside primarily for the payment of bonds, notes, construction funds, and other specific purposes. See Note 7.

**K. Fixed Assets**

For governmental fund types, general fixed asset acquisitions are recorded as expenditures in the acquiring fund and capitalized in the general fixed assets account group in the year purchased. General fixed assets are recorded at historical cost, or at estimated historical cost if actual historical cost is not available. Donated fixed assets are recorded at fair market value at the time of donation. The costs of normal maintenance and repairs that do not add value to the asset or materially extend asset lives are not capitalized. Public domain general fixed assets (infrastructure) consisting of roads, bridges, streets, sidewalks, drainage systems and lighting systems are not capitalized as these assets are immovable and of value only to the government.

Fixed assets of the proprietary fund types and similar trust funds are stated at cost or estimated historical cost. Contributed fixed assets are recorded at estimated fair market value at the time received. Interest costs are capitalized on projects during the construction period. Depreciation is provided using the straight-line method over estimated useful lives of the assets. The estimated useful lives of fixed assets are as follows:

|   |               |
|---|---------------|
| Buildings                                   | 25 - 50 years |
| Building improvements                       | 10 - 20 years |
| Equipment, furniture, fixtures and vehicles | 3 - 10 years  |

Fixed assets of the public university funds are stated at cost or fair value on the date of donation in the case of gifts. Interest costs are capitalized during the construction period. Depreciation on physical plant and equipment is not recorded, except for equipment in auxiliary enterprises and on the University Pediatric Hospital.

The fixed assets of the component units - other were recorded in accordance with the applicable Governmental Accounting Standards Board and Financial Accounting Standards Board statements. Depreciation has been recorded when required by these standards based on the types of assets, use, and estimated useful lives of the respective assets and on the nature of each of the component unit's operations.

**L. Tax Refunds Payable**

During the calendar year, the Commonwealth collects individual income taxes through withholdings and payments from taxpayers. At June 30, the Commonwealth estimates the amount owed to taxpayers for overpayments during the first half of the calendar year. These estimated amounts are recorded as tax refunds payable and as a reduction of tax revenues.

**M. Long-Term Debt**

The liabilities reported in the general long-term debt account group include the Commonwealth's general obligation bonds and notes, advances from other funds, due to component units, obligations under lease/purchase agreements and other long-term liabilities including vacation, sick leave, litigation, long-term liabilities to other governmental entities, and federal fund cost disallowances related to expenditures of federal grants. Long-term obligations financed by proprietary fund types, public university funds, and component units - other are recorded as liabilities in those funds and discretely presented component units columns.

**N. Reservations of Fund Balance**

Reservations of fund balance represent portions of fund balances that are legally segregated for a specific future use or are not appropriable for expenditure. The Commonwealth has the following reservations of fund balance:

Encumbrances - Represent future expenditures under purchase orders and other commitments. These committed amounts generally will become liabilities in future periods as the goods are received.

Debt Service - Represents net assets available to finance future debt service payments.

Employees Retirement - Represents the public employees retirement systems net assets available to finance future benefit obligations.

Unemployment Benefits - Represent net assets available to fund future unemployment benefits payments.

Advances and Other Specified Purposes - Represent the reservation of monies set aside for long-term receivables which are not considered current financing resources, the guarantee of notes payable, disability, drivers insurance, long-term assets, construction commitments, endowment and amounts available to fund various fiduciary arrangements.

**O. Bond Premiums, Discounts and Issuance Cost**

For governmental fund types, bond premiums and discounts, as well as issuance costs, are recognized during the current period. Bond proceeds are reported as other financing sources net of the applicable premium or discount. Issuance cost, whether or not withheld from the actual net proceeds received, are reported as debt service expenditures. For proprietary fund types, bond premiums and discounts, as well as issuance costs, are deferred and amortized over the life of the bonds using the effective interest method. Bonds payable are reported net of the applicable bond premium or discount. Issuance costs are reported as deferred charges. Public university funds and component units - other follow appropriate statements issued by the Governmental Accounting Standards Board and the Financial Accounting Standards Board.

**P. Postemployment Benefits**

In addition to the pension benefits described in Note 15, the Commonwealth provides postemployment health care benefits and a Christmas bonus for its retired employees in accordance with local law. Substantially all of the employees may become eligible for these benefits if they reach normal retirement age while working for the Commonwealth. Health care benefits are provided through insurance companies whose premiums are paid by the retiree and by the Commonwealth for a fixed amount of \$40 per month for each retiree. During the year ended June 30, 1994, the cost of providing health care benefits amounted to approximately \$24.9 million. The Christmas bonus paid to the retired employees during the year ended June 30, 1994 was \$150 per retiree and the total amount was approximately \$10.6 million. These benefits are recorded as expenditures when paid. The plan covers approximately 70,000 retirees.

**Q. Compensated Absences**

The vacation policy of the Commonwealth generally provides for the accumulation of 2.5 days per month, except for the teachers who accrue 4 days per month. Vacation time accumulated is fully vested to the employees from the first day of work. Employees accumulate sick leave generally at a rate of 1.5 days per month up to a maximum of 90 days. Upon retirement, an employee receives compensation for all accumulated unpaid sick leave at the current rate, if the employee has at least ten years of service with the Commonwealth.

Compensated absence accumulation policies for the blended component units, the public university funds and component units - other vary from entity to entity depending upon negotiated bargaining agreements and other factors agreed upon between the management of these entities and its employees.

The Commonwealth adopted the provisions of Governmental Accounting Standards Board Statement No. 16, *Accounting for Compensated Absences*. This Statement requires the recognition of liabilities for vacation and sick leave in the governmental funds to the extent the liability has been funded and there are current financial resources for its payment. However, since the Commonwealth's governmental funds pay this liability on a pay-as-you-go basis, there were no significant changes in the provisions for current liabilities within the governmental funds to pay for accrued vacations and vested sick leave.

Certain component units have adopted the provisions of Statement on Government Accounting Standards No. 16, *Accounting for Compensated Absences*, in the current year. The effect of the adoption of this Statement has been properly reflected in their individual financial statements.

**R. Interfund and Intra-Entity Transactions**

The Commonwealth has the following types of transactions among funds:

Operating Transfers - Legally required transfers that are reported when incurred as "Operating transfers-in" by the recipient fund and as "Operating transfers-out" by the disbursing fund.

Interfund Payments (Quasi-external Transactions) - Charges or collections for services rendered by one fund to another that are recorded as revenues of the recipient fund and as expenditures or expenses of the disbursing fund.

Intra-Entity Transactions - These are transactions between the primary government and its component units; and among the component units. Transfers between the primary government and its blended component units are reported as interfund transfers. Similarly, receivables and payables between the primary government and its blended component units are reported as amounts due to and due from other funds, except for long-term balances which are shown as advances to and from other funds. Balances and transfers between the primary government and discretely presented component units (and among those component units) are reported separately.

## S. Lottery Revenues and Prizes

The revenues, expenses and prizes awarded by the Lottery of Puerto Rico, and the Additional Lottery System, are reported within the enterprise funds and are recognized as drawings are held. Monies collected prior to June 30 for tickets related to drawings to be conducted subsequent to June 30 are reported as deferred revenues. Unpaid prizes awarded as of June 30 are reported as a fund liability. For certain prizes payable in installments, the Commonwealth purchases annuities through the Government Development Bank for Puerto Rico, an internal service fund, which are reported as restricted assets and lottery prizes payable in the enterprise funds.

## T. Public University Funds

Financial activities of the University of Puerto Rico (the University) and the University of Puerto Rico Retirement System (the System) are reported in the public university funds.

The University's funds are presented in accordance with the American Institute of Certified Public Accountants, *Industry Audit Guide-Audits of Colleges and Universities*, as amended. Such funds are discretely presented in a separate column in the general purpose financial statements. The public university funds represent the combination of the following funds of the University:

Current Funds - Account for resources that may be used for any purpose in carrying out the primary objectives of the University.

Loan Funds - Account for resources available for loans to students, faculty, or staff of the University.

Endowment and Similar Funds - Account for endowment and quasi-endowment transactions. These funds are similar to trust funds and the University must comply with the terms of any applicable agreement.

Plant Funds - Account for transactions involving physical properties of the University. The investment in plant accounts for funds that the University has expended and thus has invested for property and any related outstanding debt.

Agency Funds - Account for resources held by the University as custodian or agent for others.

The combined statement of current funds revenues, expenditures and other changes - public university funds is a statement of financial activities related to the current reporting period. It does not purport to present the results of operations or the net income or loss for the period as would a statement of income or a statement of revenues and expenses.

The measurement focus in the public university funds of the operations of the University is upon determination of resources received and used. Current funds used to finance plant assets are accounted for as (1) expenditures, for normal replacement of movable equipment and library books; (2) mandatory transfers, for required provisions for debt amortization/interest and equipment renewal and replacement; and (3) transfers of a nonmandatory nature for all other cases.

Public university funds record expenditures when they acquire fixed assets and capitalize those assets within the plant funds. These funds capitalize interest expenditures during construction but do not record depreciation.

Public university funds use the consumption method of recording inventories.

The financial activities of the System include the net assets available for plan benefits to participants. Certain reclassifications have been made to the separately issued financial statements to conform the financial statement presentation of the Commonwealth.

**U. Future Adoption of Accounting Pronouncements**

The Governmental Accounting Standards Board has issued the following statements which the Commonwealth, or its component units, have not yet adopted and which require adoption subsequent to June 30, 1994.

**1. Primary Government:**

| Statement No. |   | Adoption required<br>in fiscal year |
|---------------|---|-------------------------------------|
| 21            | Accounting for Escheat Property   | 1995                                |
| 22            | Accounting for Taxpayer-Assessed Tax Revenues in Governmental Funds                                       | 1995                                |
| 23            | Accounting and Financial Reporting for Refundings of Debt Reported by Proprietary Activities              | 1995                                |
| 24            | Accounting and Financial Reporting for Certain Grants and Other Financial Assistance                      | 1996                                |
| 25            | Financial Reporting for Defined Benefit Pension Plans and Note Disclosures for Defined Contribution Plans | 1997                                |
| 26            | Financial Reporting for Postemployment Healthcare Plans Administered by Defined Benefit Pension Plans     | 1997                                |
| 27            | Accounting for Pensions by State and Local Governmental Employers   | 1998                                |

2. **Component Units:**

| <b>Statement No.</b> |   | <b>Adoption required<br/>in fiscal year</b> |
|----------------------|---|---|
| 19                   | Governmental College and University Omnibus Statement   | 1995  |
| 20                   | Accounting and Financial Reporting for Proprietary Funds and Other Governmental Entities That Use Proprietary Fund Accounting | 1995  |
| 23                   | Accounting and Financial Reporting for Refundings of Debt Reported by Proprietary Activities                                  | 1995  |
| 24                   | Accounting and Financial Reporting for Certain Grants and Other Financial Assistance  | 1996  |
| 25                   | Financial Reporting for Defined Benefit Pension Plans and Note Disclosures for Defined Contribution Plans                     | 1997  |
| 26                   | Financial Reporting for Postemployment Healthcare Plans Administered by Defined Benefit Pension Plans                         | 1997  |
| 27                   | Accounting for Pensions by State and Local Governmental Employers   | 1998  |

The impact of these statements has not yet been determined.

V. **Risk Financing**

The Commonwealth purchases commercial insurance to cover for casualty, theft, tort claims and other losses. The current insurance policies have not been canceled or terminated. For workers' compensation, the Commonwealth has a discretely presented component unit, the State Insurance Fund Corporation, which provides workers' compensation to both, public and private employees.

W. **Reclassifications**

The presentation of the separately issued financial statements of certain component units included within the enterprise funds, internal service funds, expendable trust funds, pension trust funds, public university funds and discretely presented component units column have been reclassified to conform to the accounting classifications used by the Commonwealth.

## **X. Totals Columns (Memorandum Only)**

Total columns on the combined financial statements are captioned "Memorandum Only" to indicate that they are presented only to facilitate financial analysis. Data in these columns does not present consolidated financial position, results of operations, or cash flows in conformity with generally accepted accounting principles. Such data is not comparable to a consolidation since interfund eliminations have not been made.

## **2. COMPONENT UNITS**

The Commonwealth follows the provisions of Governmental Accounting Standards Board Statement No. 14, *The Financial Reporting Entity*. The general purpose financial statements include the financial activities or specified financial statements of the following discretely presented component units that were audited by other auditors.

Agricultural Development Administration  
Agricultural Services Administration (balance sheet and statement of operations only)  
Automobile Accident Compensation Administration  
Commercial and Agricultural Credit and Development Corporation  
Economic Development Bank for Puerto Rico  
Employment and Training Enterprises Corporation  
Farm Insurance Corporation of Puerto Rico  
Fine Arts Center Corporation  
Industries for the Blind, Mentally Retarded and Other Disabled Persons of Puerto Rico  
Institutional Trust of the National Guard of Puerto Rico  
Land Authority of Puerto Rico  
Musical Arts Corporation and Subsidiaries  
Puerto Rico and Caribbean Cardiovascular Center Corporation  
Puerto Rico Electric Power Authority  
Puerto Rico Housing Bank and Finance Agency  
Puerto Rico Industrial Development Company  
Puerto Rico Medical Services Administration  
Puerto Rico Metropolitan Bus Authority  
Puerto Rico Public Broadcasting Corporation  
Recreational Development Company of Puerto Rico  
Right to Employment Administration  
Solid Waste Authority of Puerto Rico  
Sugar Corporation of Puerto Rico  
Tourism Company of Puerto Rico  
Trust for the Development, Operation and Conservation of National Parks  
University of Puerto Rico

Condensed financial statements of discretely presented component units are as follows (expressed in thousands):

|   | Puerto Rico<br>Electric Power<br>Authority | Puerto Rico<br>Aqueduct<br>and Sewer<br>Authority<br>(Unaudited) | Puerto Rico<br>Telephone<br>Authority | State<br>Insurance<br>Fund<br>Corporation | Puerto Rico<br>Housing Bank<br>and Finance<br>Agency | Economic<br>Development<br>Bank for<br>Puerto Rico | Puerto Rico<br>Industrial<br>Development<br>Company | Puerto Rico<br>Ports<br>Authority | Puerto Rico<br>Municipal<br>Finance Agency | Other<br>Entities   | Total<br>Other<br>Component<br>Units |
|---|--|--|---------------------------------------|---|--|--|---|-----------------------------------|--|---------------------|--------------------------------------|
| <b>Assets and Other Debits</b>  |  |  |                                       |   |  |  |   |                                   |  |                     |                                      |
| Current assets  | \$ 1,198,494                               | \$ 225,356   | \$ 615,575                            | \$ 943,893                                | \$ 371,110   | \$ 696,303   | \$ 85,344   | \$ 83,437                         | \$ 291,526                                 | \$ 814,198          | \$ 5,325,236                         |
| Due from:   |  |  |                                       |   |  |  |   |                                   |  |                     |                                      |
| Primary government  |  | 110,403  |                                       |   |  |  |   |                                   |  | 105,143             | 215,546                              |
| Other component units   |  |  |                                       |   |  |  |   |                                   |  | 2,414               | 2,414                                |
| Fixed assets, net   | 2,608,077                                  | 2,894,304  | 1,587,284                             | 12,605                                    | 1,332  | 1,190  | 504,741   | 449,849                           |  | 769,508             | 8,828,890                            |
| Amount to be provided for<br>the retirement of bonds<br>and notes payable                           |  |  |                                       |   | 400,495  |  |   |                                   |  | 13,989              | 414,484                              |
| Amount to be provided for<br>payment of accrued<br>compensated absences<br>and other long-term debt |  |  |                                       |   |  |  |   |                                   |  | 10,585              | 10,585                               |
| <b>Total</b>  | <b>\$ 3,916,974</b>                        | <b>\$ 3,119,660</b>  | <b>\$ 2,202,859</b>                   | <b>\$ 956,498</b>                         | <b>\$ 772,937</b>                                    | <b>\$ 697,493</b>                                  | <b>\$ 590,085</b>                                   | <b>\$ 533,286</b>                 | <b>\$ 291,526</b>                          | <b>\$ 1,715,837</b> | <b>\$ 14,797,155</b>                 |
| <b>Liabilities</b>  |  |  |                                       |   |  |  |   |                                   |  |                     |                                      |
| Current liabilities   | \$ 570,638                                 | \$ 308,450   | \$ 372,729                            | \$ 910,863                                | \$ 168,638   | \$ 601,517   | \$ 26,119   | \$ 85,838                         | \$ 8,673                                   | \$ 634,967          | \$ 3,688,432                         |
| Due to:   |  |  |                                       |   |  |  |   |                                   |  |                     |                                      |
| Primary government  |  |  |                                       |   |  |  |   |                                   |  | 45,601              | 45,601                               |
| Other component units   |  |  |                                       |   |  |  |   |                                   |  | 40,700              | 40,700                               |
| Other governmental entities   |  |  |                                       |   |  |  |   |                                   |  | 278                 | 278                                  |
| Advances from:  |  |  |                                       |   |  |  |   |                                   |  |                     |                                      |
| Primary government  | 30,000                                     | 280,827  | 18,850                                |   | 13,420   | 24,000   | 14,454  | 47,076                            |  | 490,052             | 875,829                              |
| Notes payable   | 110,000                                    |  |                                       |   |  |  | 15,666  |                                   |  | 192,032             | 360,348                              |
| Bonds payable   | 2,906,566                                  | 445,375  | 1,013,489                             |   | 487,395  |  | 201,546   | 137,493                           | 270,889                                    | 632                 | 5,463,385                            |
| <b>Total liabilities</b>  | <b>\$ 3,617,204</b>                        | <b>\$ 1,034,652</b>  | <b>\$ 1,405,068</b>                   | <b>\$ 910,863</b>                         | <b>\$ 669,453</b>                                    | <b>\$ 625,517</b>                                  | <b>\$ 257,785</b>                                   | <b>\$ 270,407</b>                 | <b>\$ 279,562</b>                          | <b>\$ 1,404,262</b> | <b>\$ 10,474,773</b>                 |
| Fund equity (deficit)   | 299,770                                    | 2,085,008  | 797,791                               | 45,635                                    | 103,484  | 71,976   | 332,300   | 262,879                           | 11,964                                     | 311,575             | 4,322,382                            |
| <b>Total</b>  | <b>\$ 3,916,974</b>                        | <b>\$ 3,119,660</b>  | <b>\$ 2,202,859</b>                   | <b>\$ 956,498</b>                         | <b>\$ 772,937</b>                                    | <b>\$ 697,493</b>                                  | <b>\$ 590,085</b>                                   | <b>\$ 533,286</b>                 | <b>\$ 291,526</b>                          | <b>\$ 1,715,837</b> | <b>\$ 14,797,155</b>                 |

| Statement of Operations  | Puerto Rico                                |  |                                       |                                   |  |  |   |                                   |  |                   | Total<br>Other<br>Component<br>Units |
|--|--|--|---------------------------------------|-----------------------------------|--|--|---|-----------------------------------|--|-------------------|--------------------------------------|
|  | Puerto Rico<br>Electric Power<br>Authority | Puerto Rico<br>Aqueduct<br>and Sewer<br>Authority<br>(Unaudited) | Puerto Rico<br>Telephone<br>Authority | State<br>Insurance<br>Corporation | Puerto Rico<br>Housing Bank<br>and Finance<br>Agency | Economic<br>Development<br>Bank for<br>Puerto Rico | Puerto Rico<br>Industrial<br>Development<br>Company | Puerto Rico<br>Ports<br>Authority | Puerto Rico<br>Municipal<br>Finance Agency | Other<br>Entities |                                      |
| Operating revenues   | \$ 1,349,605                               | \$ 297,547   | \$ 905,352                            | \$ 356,343                        | \$ 19,231  | \$ 35,664  | \$ 51,782   | \$ 92,612                         | \$ 18,863                                  | \$ 692,369        | \$ 3,819,368                         |
| Operating expenses   | 1,077,417                                  | 306,943  | 636,507                               | 355,609                           | 13,544   | 37,858   | 36,409  | 128,694                           | 17,445                                     | 828,514           | 3,438,940                            |
| Operating income (loss)  | 272,188                                    | (9,396)  | 268,845                               | 734                               | 5,687  | (2,194)  | 15,373  | (36,082)                          | 1,418                                      | (136,145)         | 380,428                              |
| Non-operating revenues<br>(expenses)   | (253,895)                                  | (32,487)   | (178,483)                             | 32,875                            | (5,391)  | 3,466  | (22,607)  | (207)                             | (449)                                      | (49,924)          | (507,102)                            |
| Income (loss) before<br>operating transfers  | 18,293                                     | (41,883)   | 90,362                                | 33,609                            | 296  | 1,272  | (7,234)   | (36,289)                          | 969  | (186,069)         | (126,674)                            |
| Operating transfers from (to):   |  |  |                                       | (14,904)                          |  |  |   |                                   |  |                   |                                      |
| Primary government<br>Component units  |  |  |                                       |                                   |  |  |   |                                   |  | 81,213            | 66,309                               |
|  |  |  |                                       |                                   |  |  |   |                                   |  | 9,500             | 9,500                                |
| Operating transfers, net   |  |  |                                       |                                   |  |  |   |                                   |  | 90,713            | 75,809                               |
| Net income (loss)  | 18,293                                     | (41,883)   | 90,362                                | 18,705                            | 296  | 1,272  | (7,234)   | (36,289)                          | 969  | (95,356)          | (50,865)                             |
| Excess of revenues over<br>(under) expenditures<br>from governmental<br>operations |  |  |                                       |                                   | 20,282   |  |   |                                   |  | 19,516            | 39,798                               |
| Retained earnings<br>(deficit) fund balance<br>beginning of year                   | 188,288                                    | 390,688  | 707,931                               | 39,824                            | 81,556   | 17,720   | 38,395  | (16,988)                          | 14,236                                     | (437,806)         | 1,023,844                            |
| Restatement  | (27,525)                                   |  | (7,070)                               |                                   |  |  |   |                                   |  | 1,077             | (33,518)                             |
| Other adjustments  |  |  | 1,606                                 |                                   |  |  | 1,091   | 17,681                            | (3,241)                                    | (15,714)          | 1,423                                |
| As restated  | 160,763                                    | 390,688  | 702,467                               | 39,824                            | 81,556   | 17,720   | 39,486  | 693                               | 10,995                                     | (452,443)         | 991,749                              |
| Contributions  |  |  |                                       |                                   | 1,350  |  |   |                                   |  | 14                | 1,364                                |
| Depreciation on fixed<br>assets acquired<br>through contributed<br>capital         |  | 38,392   |                                       |                                   |  |  |   |                                   |  | 3,728             | 42,120                               |
| Retained earnings (deficit)/<br>fund balance end of year                           | \$ 179,056                                 | \$ 387,197   | \$ 792,829                            | \$ 58,529                         | \$ 103,484   | \$ 18,992  | \$ 32,252   | \$ (35,596)                       | \$ 11,964                                  | \$ (524,541)      | \$ 1,024,166                         |

Condensed financial statements of the public university funds are as follows (expressed in thousands):

|  | University of<br>Puerto Rico | Retirement<br>System    | Eliminations             | Total                     |
|--|------------------------------|-------------------------|--------------------------|---------------------------|
| <b>ASSETS AND OTHER DEBITS</b>           |                              |                         |                          |                           |
| Current assets                           | \$126,424                    | \$365,309               | \$(9,873)                | \$ 481,860                |
| Due from primary government              | 32,000                       |                         |                          | 32,000                    |
| Due from other component units           | 32,276                       |                         |                          | 32,276                    |
| Fixed assets - net                       | <u>496,788</u>               | <u>183</u>              | <u>          </u>        | <u>496,971</u>            |
| <b>Total Assets and Other Debits</b>     | <b><u>\$687,488</u></b>      | <b><u>\$365,492</u></b> | <b><u>\$(9,873)</u></b>  | <b><u>\$1,043,107</u></b> |
| <b>LIABILITIES AND FUND EQUITY</b>       |                              |                         |                          |                           |
| Current liabilities                      | \$ 99,725                    | \$ 20,714               | \$(9,873)                | \$ 110,566                |
| Advances from primary government         | 58,982                       |                         |                          | 58,982                    |
| Notes payable                            | 542                          |                         |                          | 542                       |
| Bonds payable                            | 174,046                      |                         |                          | 174,046                   |
| Other long term liabilities              | <u>14,033</u>                | <u>          </u>       | <u>          </u>        | <u>14,033</u>             |
| <b>Total Liabilities</b>                 | <b>347,328</b>               | <b>20,714</b>           | <b>(9,873)</b>           | <b>358,169</b>            |
| <b>Fund Equity</b>                       | <b><u>340,160</u></b>        | <b><u>344,778</u></b>   | <b><u>          </u></b> | <b><u>684,938</u></b>     |
| <b>Total Liabilities and Fund Equity</b> | <b><u>\$687,488</u></b>      | <b><u>\$365,492</u></b> | <b><u>\$(9,873)</u></b>  | <b><u>\$1,043,107</u></b> |

The Commonwealth has not been able to include the audited financial activities of certain entities (or certain specific financial statements) as required by generally accepted accounting principles. The entities for which audited financial activities have not been included in the corresponding columns are as follows:

- A. The general purpose financial statements do not include the financial statements of the Office for the Liquidation of the Accounts of the Puerto Rico Urban Renewal and Housing Corporation, nor the statement of cash flows of the Agricultural Services Administration.

- B. The general purpose financial statements include unaudited financial activities of the following entities because their activities are being audited by other auditors who have not yet concluded and reported on the entities:

**Enterprise Funds**

Health Facilities and Services Administration of Puerto Rico - This entity's unaudited financial information represent 66% of total assets and 14% of total operating revenues of the enterprise funds.

**Trust and Agency Funds**

Annuity and Pension System for the Teachers of Puerto Rico  
State Unemployment Insurance Fund

The above entities unaudited financial information represent 60% and 57% of the total assets and total operating revenues, respectively, of the trust and agency funds.

**Component Units - Other**

Puerto Rico Aqueduct and Sewer Authority - which represents 21% and 8% of total assets and total operating revenues of the component units - other.

**3. STEWARDSHIP, COMPLIANCE AND ACCOUNTABILITY**

**A. Budgetary Control**

Commonwealth law requires that a balanced budget be approved by the Legislature. The Governor presents an annual budget to the Legislature which includes estimates of revenues, expenditures and other financing sources and uses anticipated during the coming fiscal year.

Before signing the appropriation act, the Governor may veto any specific item, subject to legislative override. Further changes to the budget established in the annual appropriation account may be made via supplemental appropriation or other legislative acts. These also must be approved by the Legislature and signed by the Governor and are subject to the line item veto.

The appropriated budget is prepared by fund, function and department. Commonwealth's department heads may transfer appropriations within a department. The legal level of budgetary control is the department level.

Encumbrance accounting is employed in governmental funds. For budgetary purposes, the encumbrances (i.e., purchase orders, contracts) are considered expenditures when incurred. For GAAP reporting purposes, encumbrances outstanding at year end are reported as reservations of fund balances and do not constitute expenditures or liabilities because the commitments will be honored during the subsequent year.

The unencumbered balance of any appropriation at the end of the fiscal year will lapse three years after the end of such fiscal year or at the date prescribed by the Secretary of the Treasury. Others are continuing accounts for which the Legislature has authorized that an unspent balance from the prior year be carried forward and made available for current spending. In addition, the Legislature may direct that certain revenues be retained and made available for spending within a specific appropriation account.

Generally, expenditures may not exceed the level of spending authorized for an individual appropriation account. However, the Commonwealth is statutorily required to pay debt service, regardless of whether such amounts are appropriated.

Appropriations are enacted for the general fund, debt service funds and capital projects funds. For these funds, a Combined Statement of Revenues and Expenditures - Budget and Actual - Statutory Basis - General, Debt Service, and Capital Projects funds is included.

The Commonwealth's Treasury Department and the Office of Management and Budget have the responsibility to ensure that budgetary spending control is maintained on an individual appropriation account basis. Budgetary control is exercised through the Commonwealth Integrated Financial Accounting System (CIFAS). CIFAS ensures that encumbrances or expenditures are not processed if they exceed the appropriation account's total available spending authorization, which is considered its budget.

**B. Budget/GAAP Reconciliation**

The following schedule reconciles the amounts on the Combined Statement of Revenues and Expenditures - Budget and Actual - Statutory Basis - to the amounts on the Combined Statement of Revenues and Expenditures for the General, Debt Service, and Capital Projects funds (expressed in thousands):

|  | General          | Debt<br>Service  | Capital<br>Projects |
|--|------------------|------------------|---------------------|
| Excess (deficiency) of revenues and other sources over expenditures and other uses - statutory basis | \$331,592        | \$ (4,019)       | \$141,247           |
| Entity differences:  |                  |                  |                     |
| Excess (deficiency) of revenues and other sources over expenditures and other uses for:              |                  |                  |                     |
| Non-budgeted funds   | 207,385          |                  | 7,636               |
| Inclusion of blended component units   |                  | 19,695           | 111,788             |
| Timing differences:  |                  |                  |                     |
| Adjustment to encumbrances   | 40,918           |                  | 5,607               |
| Adjustment to notes payable  |                  | 5,000            |                     |
| Adjustment to interest payable   | _____            | (6,630)          | _____               |
| Sub total carried forward  | <u>\$579,895</u> | <u>\$ 14,046</u> | <u>\$266,278</u>    |

|  | General           | Debt<br>Service | Capital<br>Projects |
|--|-------------------|-----------------|---------------------|
| Subtotal from prior page   | \$579,895         | \$ 14,046       | \$266,278           |
| Basis of accounting differences:   |                   |                 |                     |
| Net increase in taxes receivable   | 3,386             |                 |                     |
| Net increase (decrease) in other receivables<br>and other assets   | (200)             | 5,105           |                     |
| Net (increase) decrease in accounts payable<br>and other liabilities   | <u>(48,847)</u>   | <u>500</u>      | <u>(3,345)</u>      |
| Excess of revenues and other financing<br>sources over expenditures and other<br>financing uses (GAAP basis) | <u>\$ 534,234</u> | <u>\$19,651</u> | <u>\$262,933</u>    |

**C. Deficit Fund Equity**

The following component units reflect a deficit fund equity at June 30, 1994 (expressed in thousands):

**Enterprise Fund:**

Health Facilities and Services Administration of Puerto Rico (Unaudited) \$480,255

**Public University Funds:**

Unexpended plant funds \$ 1,866

**Component Units - Other:**

|   |           |
|---|-----------|
| Puerto Rico Maritime Shipping Authority   | \$263,331 |
| Puerto Rico Land Authority  | 55,826    |
| Corporation of Stocks and Deposits Insurance for the Savings and<br>Loan Cooperatives     | 12,235    |
| Employment and Training Enterprises Corp.   | 5,280     |
| Agricultural Development Administration   | 1,761     |
| Musical Arts Corporation and Subsidiaries   | 1,418     |
| Industries for the Blind, Mentally Retarded, and Other Disabled Persons<br>of Puerto Rico | 138       |

Except for the Puerto Rico Maritime Shipping Authority, the Commonwealth and these entities are designing plans that will either increase revenues or decrease expenditures in order for them to cover these deficits.

For the Puerto Rico Maritime Shipping Authority, the Commonwealth sold the operations of this entity to a group of private investors by means of a public bid. The sole term include, among other things, that the Commonwealth will assume the repayment responsibility of approximately \$300 million in debt. See Note 18.

#### 4. DEPOSITS AND INVESTMENTS

Under Commonwealth statutes, public funds deposited in commercial banks must be fully collateralized for the amount deposited in excess of federal depository insurance. All securities pledged as collateral are held by the Secretary of the Treasury, or an agent, in the Commonwealth's name. In addition, the Commonwealth maintains deposits with the Government Development Bank for Puerto Rico, an internal service fund, the Economic Development Bank for Puerto Rico, a discretely presented component unit, and the United States Government (for unemployment insurance).

Cash, cash equivalents and investments of the primary government at June 30, 1994 consist of (expressed in thousands):

##### Primary Government

|                           | Unrestricted     | Included in<br>Restricted Assets | Total            |
|---------------------------|------------------|----------------------------------|------------------|
| Cash and cash equivalents | \$ 2,474,325     | \$ 453,834                       | \$ 2,928,159     |
| Investments               | <u>4,147,468</u> | <u>2,210,487</u>                 | <u>6,357,955</u> |
| Total                     | <u>6,621,793</u> | <u>2,664,321</u>                 | <u>9,286,114</u> |

##### Primary Government-Unaudited

|                            |                     |                     |                      |
|----------------------------|---------------------|---------------------|----------------------|
| Cash and cash equivalents  | 864,499             | 11,447              | 875,946              |
| Investments                | <u>940,949</u>      | <u>-</u>            | <u>940,949</u>       |
| Total - Unaudited          | <u>1,805,448</u>    | <u>11,447</u>       | <u>1,816,895</u>     |
| Total - primary government | <u>\$ 8,427,241</u> | <u>\$ 2,675,768</u> | <u>\$ 11,103,009</u> |

Unaudited information of cash, cash equivalents and investments corresponds to the Annuity and Pension System for the Teachers of Puerto Rico, included as part of the pension trust funds, the State Unemployment Insurance Fund, included as part of the expendable trust fund, and of the Health Facilities and Services Administration of Puerto Rico included in the enterprise funds.

The carrying amount of deposits of the primary government at June 30, 1994 consists of (expressed in thousands):

|   | Primary<br>Government | Primary<br>Government<br>(Unaudited) | Primary<br>Government<br>Total |
|---|-----------------------|--------------------------------------|--------------------------------|
| Carrying amount of deposits in commercial banks   | \$1,256,471           | \$ 37,166                            | \$1,293,637                    |
| Carrying amount of deposits in US Government      | -                     | 697,535                              | 697,535                        |
| Carrying amount of deposits in governmental banks | <u>1,671,688</u>      | <u>141,245</u>                       | <u>1,812,933</u>               |
| Total carrying amount of deposits                 | <u>\$2,928,159</u>    | <u>\$ 875,946</u>                    | <u>\$3,804,105</u>             |
| Bank balance of deposits in commercial banks      | \$1,189,399           | \$ 47,626                            | \$1,237,025                    |
| Amount of deposits insured or collateralized      | <u>366,255</u>        | <u>30,333</u>                        | <u>396,588</u>                 |
| Amount of deposits uninsured or uncollateralized  | <u>\$ 823,144</u>     | <u>\$ 17,293</u>                     | <u>\$ 840,437</u>              |

The amount of the bank balance of deposits in commercial banks uninsured or uncollateralized at June 30, 1994 shown above, mainly correspond to the Government Development Bank for Puerto Rico (GDB), an internal service fund, and the Puerto Rico Infrastructure Financing Authority, a blended component unit.

The approximately \$698 million on deposit with the US Government represents unemployment insurance taxes collected from employers which are transferred to the Federal Unemployment Insurance Trust Fund in the US Treasury.

Deposits in governmental banks represent the balance of interest and noninterest bearing accounts in GDB and the Economic Development Bank for Puerto Rico (EDB), amounting to approximately \$1,783 million and \$30 million, respectively. The deposit liability at GDB and EDB is substantially related to deposits from other component units and of the Commonwealth. Such deposit liability is not in agreement with governmental cash balances shown because of reconciling items such as outstanding checks, and deposits in transit.

The bank balance of GDB's deposits at June 30, 1994 is broken down as follows (expressed in millions):

|   |                 |
|---|-----------------|
| Primary government                          | \$ 1,721        |
| Public university funds                     | 19              |
| Other discretely presented components units | <u>934</u>      |
| Total reporting entity                      | 2,674           |
| Municipalities and omitted component unit   | 401             |
| Other non-governmental entities             | <u>138</u>      |
| Total deposits per GDB                      | <u>\$ 3,213</u> |

No collateral is maintained for cash accounts in GDB and EDB at June 30, 1994. Collateral is maintained for certain checking accounts of the Secretary of the Treasury in GDB. At June 30, 1994, securities of the primary government with a carrying value of approximately \$216.8 million were pledged as collateral for these accounts.

Pursuant to statutory authority, the Secretary of the Treasury may invest in obligations of the Commonwealth, obligations of the United States, or in pools of obligations of the municipalities of Puerto Rico. The component units and the retirement systems may invest in those securities authorized by the legal provisions set forth in their organic acts such as stocks, corporate bonds, obligations of the United States, mortgage loans and others. The Commonwealth's investments are categorized to provide an indication of the level of risk assumed by the Commonwealth at year end. Risk categories are described as follows:

- Category 1: Insured or registered, or securities held by the Commonwealth or its agent in the Commonwealth's name.
- Category 2: Uninsured and unregistered, with securities held by the counterparty's trust department or agent in the Commonwealth's name.
- Category 3: Uninsured and unregistered, with securities held by the counterparty, or by its trust department or agent but not in the Commonwealth's name.

Investments at June 30, 1994 of the primary government are as follows (expressed in thousands):

|              | Primary<br>Government | Primary<br>Government<br>(Unaudited) | Total               |
|--------------|-----------------------|--------------------------------------|---------------------|
| Unrestricted | \$ 4,147,468          | \$ 940,949                           | \$ 5,088,417        |
| Restricted   | <u>2,210,487</u>      | <u>-</u>                             | <u>2,210,487</u>    |
| Total        | <u>\$ 6,357,955</u>   | <u>\$ 940,949</u>                    | <u>\$ 7,298,904</u> |

Collateral risk classification for short-term investments and investments of the primary government are as follows (expressed in thousands):

**Primary Government**

|                                       | 1                  | Category<br>2 | 3                | Carrying<br>Amount | Market<br>Value    |
|---------------------------------------|--------------------|---------------|------------------|--------------------|--------------------|
| <b><u>Unrestricted</u></b>            |                    |               |                  |                    |                    |
| US Government and agencies securities | \$2,261,961        | \$            | \$               | \$2,261,961        | \$2,250,534        |
| Mortgage-backed securities            | 636,319            |               |                  | 636,319            | 631,367            |
| Stocks                                | 313,906            |               | 3,250            | 317,156            | 356,589            |
| Corporate bonds                       | 280,026            |               |                  | 280,026            | 274,895            |
| Repurchase agreements                 | 20,150             |               | 117,707          | 137,857            | 137,857            |
| Trading securities                    | 87,552             |               |                  | 87,552             | 87,552             |
| Commonwealth securities               | 3,640              |               |                  | 3,640              | 2,860              |
| Short-term investments                | <u>536</u>         | <u>-</u>      | <u>-</u>         | <u>536</u>         | <u>536</u>         |
|                                       | <u>\$3,604,090</u> | <u>-</u>      | <u>\$120,957</u> | <u>3,725,047</u>   | <u>3,742,190</u>   |
| Mortgage loans                        |                    |               |                  | <u>10,103</u>      | <u>10,103</u>      |
| Total - unrestricted                  |                    |               |                  | <u>\$3,735,150</u> | <u>\$3,752,293</u> |

**Primary Government...continued**

|                                       | 1                  | Category<br>2    | 3                | Carrying<br>Amount | Market<br>Value    |
|---------------------------------------|--------------------|------------------|------------------|--------------------|--------------------|
| <u>Unrestricted</u>                   | <u>\$3,604,090</u> | <u>\$ -</u>      | <u>\$120,957</u> | <u>\$3,735,150</u> | <u>\$3,752,293</u> |
| <u>Restricted</u>                     |                    |                  |                  |                    |                    |
| US Government and agencies securities | \$1,084,348        | \$178,784        |                  | \$1,263,132        | \$1,271,885        |
| Mortgage-backed securities            |                    | 385,472          |                  | 385,472            | 390,074            |
| Commercial paper                      |                    | 19,976           |                  | 19,976             | 19,976             |
| Repurchase agreements                 |                    |                  | 17,014           | 17,014             | 17,014             |
| Corporate bonds                       | <u>6,484</u>       | <u>        </u>  | <u>        </u>  | <u>6,484</u>       | <u>6,484</u>       |
|                                       | <u>1,090,832</u>   | <u>584,232</u>   | <u>17,014</u>    | <u>1,692,078</u>   | <u>1,705,433</u>   |
| Annuity contracts                     |                    |                  |                  | 98,367             | 98,367             |
| Fixed rate contracts                  |                    |                  |                  | <u>801,436</u>     | <u>831,943</u>     |
| Total - restricted                    |                    |                  |                  | <u>2,591,881</u>   | <u>2,635,743</u>   |
| Total                                 | <u>\$4,694,922</u> | <u>\$584,232</u> | <u>\$137,971</u> | <u>\$6,327,031</u> | <u>\$6,388,036</u> |

Unrestricted investments of the primary government include approximately \$562 million of investments of the Employees' Retirement System of the Government of Puerto Rico and its Instrumentalities, and the Puerto Rico Judiciary Retirement System. Such investments have been presented in the combined financial statements at their market values which as of June 30, 1994 approximate to \$597 million.

Unrestricted investments with a carrying amount of approximately \$399 million have been presented in the combined financial statements at their market value of approximately \$395 million. Such investments correspond to the Government Development Bank for Puerto Rico, an internal service fund.

Restricted investments of the primary government include approximately \$381 million of Puerto Rico Highway and Transportation Authority, a blended component unit. Such investments have been presented in the combined financial statements as cash and investments in the capital projects and debt service funds.

**Primary Government - Unaudited**

|                                       | Carrying<br>Amount | Market<br>Value    |
|---------------------------------------|--------------------|--------------------|
| <u>Unrestricted</u>                   |                    |                    |
| Stocks                                | \$ 407,605         | \$ 500,700         |
| US Government and agencies securities | 341,477            | 319,290            |
| Corporate bonds                       | 130,728            | 108,784            |
| Short-term investments                | 40,387             | 39,711             |
| Mortgage-backed securities            | <u>30,647</u>      | <u>31,876</u>      |
| Sub-total                             | 950,844            | 1,000,361          |
| Discounts, net of premiums            | <u>9,895</u>       | <u>-</u>           |
| Total unrestricted - unaudited        | <u>\$ 940,949</u>  | <u>\$1,000,361</u> |

The carrying amount of investments included as unaudited corresponds to the Annuity and Pension System for the Teachers of Puerto Rico, included as part of the pension trust funds.

**Public University Funds**

Cash, cash equivalents and investments of the public university funds at June 30, 1994 consist of (expressed in thousands):

|                           | Unrestricted     | Restricted      | Total            |
|---------------------------|------------------|-----------------|------------------|
| Cash and cash equivalents | \$ 30,622        | \$ 1,626        | \$ 32,248        |
| Investments               | <u>263,857</u>   | <u>1,464</u>    | <u>265,321</u>   |
| Total                     | <u>\$294,479</u> | <u>\$ 3,090</u> | <u>\$297,569</u> |

The carrying amount of deposits of the public university funds at June 30, 1994 consist of (expressed in thousands):

|  |                  |
|--|------------------|
| Carrying amount of deposits in commercial banks                              | \$ 3,968         |
| Carrying amount of deposits in governmental banks                            | <u>28,280</u>    |
| Total carrying amount of deposits  | <u>\$ 32,248</u> |
| Bank balance of deposits in commercial banks fully insured or collateralized | <u>\$ 25,057</u> |

Short-term investments and investments of the public university funds are as follows (expressed in thousands):

|                                       | Carrying Amount  | Market Value      |
|---------------------------------------|------------------|-------------------|
| <u>Unrestricted</u>                   |                  |                   |
| Stocks                                | \$ 81,748        | \$ 95,816         |
| US Government and agencies securities | 95,595           | 94,544            |
| Corporate bonds                       | 27,659           | 27,689            |
| Short-term investments                | 17,201           | 17,201            |
| Foreign and municipal bonds           | 16,457           | 17,020            |
| Mortgage loans                        | 5,759            | 5,529             |
| Mortgage-backed securities            | 5,282            | 4,963             |
| Others                                | <u>1,182</u>     | <u>1,182</u>      |
| Total unrestricted                    | <u>\$250,883</u> | <u>\$ 263,944</u> |

Unrestricted investments of the public university funds include approximately \$226 million in investments at the University of Puerto Rico Retirement System. Such investments have been presented in the combined financial statements at their market value, which as of June 30, 1994 amount to approximately \$239 million. Unrestricted investments are classified as Category 1.

Restricted investments included in the public university funds have a carrying amount of approximately \$1.5 million, which approximates market, and are classified as Category 1.

### Component Units - Other

Cash, cash equivalents and investments of the component units - other at June 30, 1994 consist of (expressed in thousands):

|                           | Unrestricted       | Restricted         | Total              |
|---------------------------|--------------------|--------------------|--------------------|
| Cash and cash equivalents | \$1,104,785        | \$ 861,944         | \$1,966,729        |
| Investments               | <u>1,028,615</u>   | <u>818,703</u>     | <u>1,847,318</u>   |
| Total                     | <u>\$2,133,400</u> | <u>\$1,680,647</u> | <u>\$3,814,047</u> |

The above amounts include approximately \$20.3 million of unrestricted cash, approximately \$48.4 million of restricted cash, and approximately \$34.7 million of restricted investments that belong to the Puerto Rico Aqueduct and Sewer Authority, an unaudited entity.

The carrying amount of the component units - other at June 30, 1994 consist of (expressed in thousands):

|   |                    |
|---|--------------------|
| Carrying amount of deposits in commercial banks   | \$ 989,098         |
| Carrying amount of deposits in governmental banks | <u>977,631</u>     |
| Total carrying amount of deposits                 | <u>\$1,966,729</u> |

At June 30, 1994, the bank balance of deposits with governmental banks amount to approximately \$983 million. Such balance was uninsured and uncollateralized.

|  |                   |
|--|-------------------|
| Bank balance of deposits in commercial banks     | \$ 983,080        |
| Amount of deposits insured or collateralized     | <u>753,855</u>    |
| Amount of deposits uninsured or uncollateralized | <u>\$ 229,225</u> |

The above include the following unaudited amounts that belong to the Puerto Rico Aqueduct and Sewer Authority: approximately \$62.3 and \$6.4 million of carrying amount in commercial and governmental banks, respectively; approximately \$63.5 of bank balance of deposits in commercial banks, of which approximately \$27.2 million are uninsured and uncollateralized.

Collateral risk classification for short-term investments and investments of component units - other are as follows (expressed in thousands):

|                                       | Category           |                   | Carrying Amount     | Market Value       |
|---------------------------------------|--------------------|-------------------|---------------------|--------------------|
|                                       | 1                  | 2                 |                     |                    |
| <u>Unrestricted</u>                   |                    |                   |                     |                    |
| US Government and agencies securities | \$ 381,312         | \$ -              | \$ 381,312          | \$ 368,186         |
| Repurchase agreements                 | 330,732            | -                 | 330,732             | 330,882            |
| Mortgage-backed securities            | 105,142            | 10,666            | 115,808             | 114,075            |
| Stocks                                | 6,205              | 83,818            | 90,023              | 96,691             |
| Commercial paper                      | 31,374             | 4,982             | 36,356              | 34,129             |
| Corporate bonds                       |                    | 33,470            | 33,470              | 33,132             |
| Other                                 | <u>50,625</u>      | <u>-</u>          | <u>50,625</u>       | <u>45,820</u>      |
|                                       | <u>905,390</u>     | <u>132,936</u>    | 1,038,326           | 1,022,915          |
| Mortgage loans                        |                    |                   | 2,245               | 2,245              |
| Real estate                           |                    |                   | <u>937</u>          | <u>937</u>         |
| Total - unrestricted                  |                    |                   | <u>1,041,508</u>    | <u>1,026,097</u>   |
| <u>Restricted</u>                     |                    |                   |                     |                    |
| US Government and agencies securities | 456,496            | 2,104             | 458,600             | 442,404            |
| Commonwealth securities               | 207,220            | -                 | 207,220             | 207,220            |
| Repurchase agreements                 | 842                | 71,500            | 72,342              | 72,261             |
| Mortgage-backed securities            | <u>3,854</u>       | <u>7,412</u>      | <u>11,266</u>       | <u>11,266</u>      |
|                                       | <u>668,412</u>     | <u>81,016</u>     | 749,428             | 733,151            |
| Fixed rate contracts                  |                    |                   | <u>69,276</u>       | <u>69,276</u>      |
| Total - restricted                    |                    |                   | <u>818,704</u>      | <u>802,427</u>     |
| Total                                 | <u>\$1,573,802</u> | <u>\$ 213,952</u> | <u>\$ 1,860,212</u> | <u>\$1,828,524</u> |

Unrestricted investments with a carrying amount of approximately \$201 million have been presented in the component units - other column at their market value of approximately \$188 million. Such investments correspond to the State Insurance Fund Corporation.

The restricted amounts include approximately \$34.7 million that belong to the Puerto Rico Aqueduct and Sewer Authority, an unaudited entity, and which are included as Category 1 in US Government and agencies securities.

## 5. RECEIVABLES

Taxes receivable at June 30, 1994 are as follows (expressed in thousands):

|              | General Fund     | Trust and<br>Agency Funds<br>(Unaudited) |
|--------------|------------------|--|
| Income       | \$ 46,216        | \$ -                                     |
| Excise       | 28,972           |  |
| Other        | 1,605            |  |
| Unemployment |                  | <u>54,789</u>                            |
| Total        | <u>\$ 76,793</u> | <u>\$ 54,789</u>                         |

On July 1, 1992, the functions of levying and collections of property taxes were transferred to the Municipal Revenues Collection Center, a separate legal entity that is not a component unit of the Commonwealth. The real and personal property tax is levied each July 1 and May 15, respectively, on the assessed values as of the prior January 1, for all properties located in Puerto Rico. Assessed values of real property are established at the estimated current value existing in the year 1957, and of personal property at the current value at the date of the assessment. From the assessed value, 1.03% of real and personal property tax collections belongs to the Commonwealth and is recorded in the debt service funds because it is restricted for the payment of general obligation bonds and notes.

The Commonwealth grants exoneration over real and personal property tax on the first \$15,000 of the assessed value of residential units occupied by the owner, and on the first \$50,000 in personal property of business enterprises if the taxpayer does not exceed \$150,000 in sales volume. The amount paid by the Commonwealth to the municipalities through the Municipal Revenues Collection Center for this exoneration during the year ended June 30, 1994 was approximately \$121.3 million and was recorded as intergovernmental expenditures in the general fund.

## 6. INTERFUND TRANSACTIONS

Interfund receivables and payables at June 30, 1994 are summarized as follows (expressed in thousands):

|                         | Primary<br>Government | Public<br>University<br>Funds | Component<br>Units - Other |
|-------------------------|-----------------------|-------------------------------|----------------------------|
| Due from:               |                       |                               |                            |
| Other funds             | \$ 91,975             | \$ -                          | \$ -                       |
| Primary government      |                       | 32,000                        | 215,546                    |
| Component units - other | <u>57,968</u>         | <u>32,276</u>                 | <u>2,414</u>               |
| Total                   | <u>\$149,943</u>      | <u>\$64,276</u>               | <u>\$217,960</u>           |
| Due to:                 |                       |                               |                            |
| Other funds             | \$ 91,975             | \$ -                          | \$ -                       |
| Primary government      |                       |                               | 45,601                     |
| Component units - other | 184,442               |                               | 8,424                      |
| Public university funds | <u>32,000</u>         |                               | <u>32,276</u>              |
| Total                   | <u>\$308,417</u>      | <u>\$ -</u>                   | <u>\$ 86,301</u>           |

The amounts due to/from within the primary government include approximately \$19 million pertaining to the Health Facilities and Services Administration of Puerto Rico, an unaudited entity within the enterprise funds.

The difference between due to/from is mainly due to:

- a. The Puerto Rico Land Administration, an internal service fund, reported a receivable from the Office for the Liquidation of the Accounts of the Puerto Rico Urban Renewal Housing Corporation (the Office) for approximately \$12,367,000, which is an omitted component unit.
- b. Several differences reported by the blended and discretely presented component units in their separately issued financial statements.
- c. Reconciling items between component units with different fiscal years.

The amount of advances to and from the different funds are summarized as follows (expressed in thousands):

|                         | Primary<br>Government | Public<br>University<br>Funds | Component<br>Units - Other |
|-------------------------|-----------------------|-------------------------------|----------------------------|
| Advances to:            |                       |                               |                            |
| Other funds             | \$ 539,429            | \$ -                          | \$ -                       |
| Component units - other | 978,500               |                               |                            |
| Public university funds | <u>58,982</u>         | <u>          </u>             | <u>          </u>          |
| Total                   | <u>\$1,576,911</u>    | <u>\$          </u>           | <u>\$          </u>        |
| Advances from:          |                       |                               |                            |
| Other funds             | \$ 539,429            | \$ -                          | \$ -                       |
| Primary government      | <u>          </u>     | <u>58,982</u>                 | <u>875,829</u>             |
| Total                   | <u>\$ 539,429</u>     | <u>\$ 58,982</u>              | <u>\$ 875,829</u>          |

The amount advanced to/from includes approximately \$ 326 million pertaining to the Health Facilities and Services Administration of Puerto Rico, an unaudited entity within the enterprise funds of the primary government. Also, the difference between the advances to / from component units - other is because the primary government has an advance to an omitted component unit of approximately \$102.7 million.

### Operating Transfers

Operating transfers-out of the general fund for the year ended June 30, 1994 include the annual appropriation to the University of Puerto Rico, included within the public university funds, amounting to approximately \$356 million and the annual appropriation to the debt service funds amounting to approximately \$351 million. In addition, the general and capital projects funds made operating transfers of approximately \$802 million (\$542 million to the Health Facilities and Services Administration of Puerto Rico, an enterprise fund) and \$54 million, respectively, to subsidize the operations of and provide capital contributions to certain component units and executive agencies recorded primarily within the primary government and discretely presented component units.

These amounts differ from operating transfers from other funds due to the exclusion of one component unit for which the financial statements as of June 30, 1994, are not available, or the inclusion of financial statements of certain component units with different fiscal years end and/or certain operating transfers reported as contributed capital.

**7. RESTRICTED ASSETS**

Restricted assets of the primary government is comprised of the following cash, cash equivalents and investments (expressed in thousands):

**Primary Government**

**General Fund**

Cash and cash equivalents for the payment of:

Special promissory notes

Tax revenue anticipation notes

\$ 119,634

104,031

Total cash and cash equivalents

223,665

Investments for the payment of tax revenue anticipation notes

613,819

Total restricted assets in the general fund

837,484

**Internal Service Funds**

Cash and cash equivalents for the payment of:

Construction funds

Bond sinking fund, redemption and reserve accounts

Long-term debt

35,530

7,352

187,287

Total cash and cash equivalents

230,169

Investments for the payment of:

Construction funds

Bond sinking fund, redemption and reserve accounts

Long-term debt

3,982

70,841

1,423,478

Total investments

1,498,301

Total restricted assets in the internal service funds

1,728,470

**Enterprise Funds**

Investments for the payment of lottery prizes

Cash and cash equivalents for the payment of bond sinking fund (unaudited):

98,367

11,447

Total restricted assets in the enterprise funds

109,814

Total restricted assets of the primary government.

\$2,675,768

### Public University Funds

Restricted assets of public university funds include cash and cash equivalents, investments and receivables as follows: (expressed in thousands):

|                               |                 |
|-------------------------------|-----------------|
| Pediatric Hospital operations | \$47,605        |
| Federal grants and contracts  | 14,110          |
| Other                         | <u>3,242</u>    |
| Total                         | <u>\$64,957</u> |

### Component Units - Other

Restricted assets of the component units - other are as follows (expressed in thousands):

#### Cash and Cash Equivalents

|   |                |
|---|----------------|
| Debt service and sinking fund requirements              | \$ 329,860     |
| Construction funds                                      | 201,894        |
| Funds under section 936 of the US Internal Revenue Code | 140,670        |
| Renewal and replacement funds                           | 92,545         |
| Death and disability funds                              | 65,311         |
| Purchase of assets                                      | 14,210         |
| Revenue funds   | 6,412          |
| Other   | <u>11,042</u>  |
| Total cash and cash equivalents                         | <u>861,944</u> |

#### Investments

|   |                |
|---|----------------|
| Debt service and sinking fund requirements              | 747,553        |
| Construction funds                                      | 50,451         |
| Funds under section 936 of the US Internal Revenue Code | 9,986          |
| Renewal and replacement funds                           | 9,711          |
| Other   | <u>1,002</u>   |
| Total investments                                       | <u>818,703</u> |

Total restricted assets of component units - other \$1,680,647

The above amounts include unaudited information of the Puerto Rico Aqueduct and Sewer Authority of approximately \$48.4 million in cash and cash equivalents as follows: approximately \$36.7 million for debt service and sinking fund requirements, and \$11.7 million for construction funds. In addition, restricted investments for debt service requirements include unaudited information for approximately \$34.7 million.

**8. FIXED ASSETS**

**Primary Government (Unaudited):**

Activity in the general fixed assets account group for the fiscal year ended June 30, 1994, was as follows (expressed in thousands):

|                          | Balance<br>July 1, 1993   | Additions               | Retirements            | Balance<br>June 30, 1994  |
|--------------------------|---------------------------|-------------------------|------------------------|---------------------------|
| Land                     | \$ 115,860                | \$ 105                  | \$ 1,339               | \$ 114,626                |
| Buildings                | 452,263                   | 46,695                  | 786                    | 498,172                   |
| Equipment                | 838,814                   | 297,643                 | 38,712                 | 1,097,745                 |
| Construction in progress | 481,517                   | 105,440                 | -                      | 586,957                   |
| Other assets             | <u>105,951</u>            | <u>166</u>              | <u>36</u>              | <u>106,081</u>            |
| <b>Total</b>             | <b><u>\$1,994,405</u></b> | <b><u>\$450,049</u></b> | <b><u>\$40,873</u></b> | <b><u>\$2,403,581</u></b> |

Fixed assets for the proprietary and fiduciary fund types as of June 30, 1994, were as follows (expressed in thousands):

|                               | Enterprise<br>Funds      | Internal<br>Service<br>Funds | Fiduciary<br>Funds     |
|-------------------------------|--------------------------|------------------------------|------------------------|
| Land                          | \$                       | \$ 56,712                    | \$ 2,918               |
| Buildings                     | 182,262                  | 1,206,856                    | 8,994                  |
| Equipment                     | 98,362                   | 4,460                        | 10,257                 |
| Construction in progress      |                          | 135,654                      | 342                    |
| Other                         | <u>11,315</u>            | <u>229</u>                   | <u>5,946</u>           |
| Total                         | 291,939                  | 1,403,911                    | 28,457                 |
| Less Accumulated depreciation | <u>(134,241)</u>         | <u>(365,456)</u>             | <u>(6,178)</u>         |
| <b>Fixed assets, net</b>      | <b><u>\$ 157,698</u></b> | <b><u>\$1,038,455</u></b>    | <b><u>\$22,279</u></b> |

Enterprise funds include unaudited information of fixed assets amounting to approximately \$147.5 million, or 93.6%, of the enterprise funds' fixed assets related to the Health Facilities and Services Administration of Puerto Rico. Fiduciary funds include unaudited information of fixed assets amounting to approximately \$14.8 million, or 66%, of the fiduciary funds' fixed assets related to the Annuity and Pension System for the Teachers of Puerto Rico, and to the State Unemployment Insurance Fund.

**Discretely Presented Component Units:**

|  | <b>Public<br/>University<br/>Funds</b> | <b>Component<br/>Units - Other</b> |
|--|--|------------------------------------|
| Land   | \$ 18,139                              | \$ 409,401                         |
| Buildings and improvements                     | 262,299                                | 7,402,522                          |
| Equipment                                      | 172,506                                | 3,182,121                          |
| Construction in progress                       | 46,020                                 | 1,351,422                          |
| Other assets                                   | <u>-</u>                               | <u>475,021</u>                     |
| <b>Total</b>                                   | <b>498,964</b>                         | <b>12,820,487</b>                  |
| Less accumulated depreciation and amortization | <u>(1,993)</u>                         | <u>(3,991,597)</u>                 |
| <b>Fixed assets - net</b>                      | <b><u>\$496,971</u></b>                | <b><u>\$8,828,890</u></b>          |

The component units - other fixed asset includes the following information that belongs to the Puerto Rico Aqueduct and Sewer Authority, which are unaudited (expressed in thousands):

|  |                           |
|--|---------------------------|
| Land   | \$ 16,457                 |
| Buildings and improvements                     | 3,085,856                 |
| Construction in progress                       | 367,584                   |
| Other assets                                   | <u>39,735</u>             |
| <b>Total</b>                                   | <b>3,509,632</b>          |
| Less accumulated depreciation and amortization | <u>(615,328)</u>          |
| <b>Fixed assets - net</b>                      | <b><u>\$2,894,304</u></b> |

**9. OBLIGATIONS UNDER LEASE/PURCHASE ARRANGEMENTS**

The Commonwealth is obligated under capital leases with third parties that expire through 2018 for buildings and equipment used by certain Commonwealth departments. At June 30, 1994, the capitalized cost of the buildings and equipment amounted to approximately \$23.8 million and is included in the general fixed assets account group. The present value of future minimum capital lease payments as of June 30, 1994, included in other long-term liabilities in the general long-term debt account group is as follows (expressed in thousands):

| <b>Year Ending<br/>June 30,</b>                | <b>Amount</b>           |
|--|-------------------------|
| 1995   | \$ 3,484                |
| 1996   | 3,502                   |
| 1997   | 3,520                   |
| 1998   | 2,924                   |
| 1999   | 2,815                   |
| Thereafter                                     | <u>40,691</u>           |
| <b>Total minimum lease payments</b>            | <b>56,936</b>           |
| Less: amount representing interest             | <u>34,579</u>           |
| <b>Present value of minimum lease payments</b> | <b><u>\$ 22,357</u></b> |

The Commonwealth is also committed under numerous operating leases, excluding those with the Public Buildings Authority, covering real property and equipment. Rental expenditures within the general fund for the year ended June 30, 1994, under such operating leases were approximately \$132.3 million. Management believes that the summary of the future minimum rental commitments under noncancelable real property and equipment leases with terms exceeding one year is not significant.

## 10. NOTES PAYABLE

Notes payable in the general fund includes \$700 million of tax revenues anticipation notes due on July 29, 1994 and approximately \$4.7 million owed by the Commonwealth General Services Administration. The proceeds of the tax revenues anticipation notes were used to cover a temporary cash deficiency resulting from the timing difference between the time tax collections are received and the payment of current expenditures.

## 11. LONG-TERM DEBT

### Governmental Funds Operations

#### Summary of General Long-Term Debt

The following schedule shows the changes in the general long-term debt account group for the year ended June 30, 1994 (expressed in thousands):

|                                       | Balance at<br>July 1, 1993 | Debt<br>Issued            | Debt paid<br>and defeased | Other Net<br>Increases<br>(Decreases) | Balance at<br>June 30, 1994 |
|---------------------------------------|----------------------------|---------------------------|---------------------------|---------------------------------------|-----------------------------|
| Bonds payable                         | \$4,891,447                | \$2,424,820               | \$1,757,910               | \$ 17,250                             | \$ 5,575,607                |
| Notes payable                         | 195,000                    |                           | 75,000                    |                                       | 120,000                     |
| Due to component units                | 161,277                    |                           | 18,874                    |                                       | 142,403                     |
| Advances from other funds             | 235,384                    |                           | 22,200                    |                                       | 213,184                     |
| Due to other governmental<br>entities | 140,000                    |                           |                           | 50,788                                | 190,788                     |
| Compensated absences                  | 465,477                    |                           |                           | 192,739                               | 658,216                     |
| Other long-term liabilities           | <u>377,127</u>             | <u>          </u>         | <u>          </u>         | <u>(76,593)</u>                       | <u>300,534</u>              |
| <b>Total</b>                          | <b><u>\$6,465,712</u></b>  | <b><u>\$2,424,820</u></b> | <b><u>\$1,873,984</u></b> | <b><u>\$ 184,184</u></b>              | <b><u>\$ 7,200,732</u></b>  |

The debt paid and defeased includes approximately \$876.7 million of defeased general obligation bonds during the year ended June 30, 1994.

**A. Debt Limitation**

The Constitution authorizes the contracting of debts as determined by the Legislature. Nevertheless, the Constitution provides that direct obligations of the Commonwealth evidenced by bonds or notes and backed by the full faith, credit and taxing power of the Commonwealth, 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 issued thereafter 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, exceed 15% of the average annual revenues raised under the provisions of Commonwealth legislation and conveyed into the Treasury (hereinafter "internal revenues") in two fiscal years preceding the then current fiscal year. Section 2, Article VI of the Constitution 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 (collected through June 30, 1992) and excise taxes. Certain revenues, such as federal excise taxes on offshore shipments of alcoholic beverages, tobacco products and customs duties, which are collected by the United States Government and returned to the Commonwealth, and motor vehicle fuel taxes and license fees, which are allocated to the Puerto Rico Highway and Transportation Authority, a blended component unit, are not included as revenues for the purpose of calculating the debt limit, although they may be available for the payment of debt service. The Commonwealth has never defaulted on the payment of principal or interest on any of its general long-term debt obligations.

Future maximum annual debt service for the Commonwealth's general obligation debt outstanding as of June 30, 1994 is approximately \$390 million. This amount represents 10.17% of the average internal revenues of approximately \$3,835 million for the years ended on June 30, 1993 and June 30, 1992.

**B. Bonds Payable**

The Constitution of the Commonwealth provides that public debt will constitute a first claim on the available revenues of the Commonwealth. Public debt includes general obligations and notes of the Commonwealth and any payment required to be made by the Commonwealth under its guarantees of bonds issued by blended or discretely presented component units. The good faith, credit and taxing power of the Commonwealth are irrevocably pledged for the prompt payment of the principal and interest of the general obligation bonds.

Law No. 83 of 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 levy is performed by the Municipal Revenues Collection Center (MRCC), a municipal corporation. MRCC is required to remit the 1.03% of property tax collected to the Commonwealth to be used by the Commonwealth's debt service funds for payment of debt service on general obligations and notes of the Commonwealth.

For financial reporting purposes, long-term bonds are carried at their face amount, without premium or discount. The outstanding amount represents the total principal to be repaid; for capital appreciation bonds, it represents total principal and interest to be repaid.

Bonds payable outstanding at June 30, 1994 are as follows (expressed in thousands):

|  | General<br>Obligation | Revenue<br>Bonds    | Total               |
|--|-----------------------|---------------------|---------------------|
| Term bonds payable through 2023; interest payable semiannually at rates varying from 3% to 9%  | \$ 1,618,060          | \$ 959,265          | \$ 2,577,325        |
| Serial bonds payable through 2011; interest payable semiannually at rates varying from 3.75% to 7.8%   | 1,360,320             | 974,525             | 2,334,845           |
| Capital appreciation bonds payable through 2011; no interest rate, yield ranging from 7% to 7.8%.<br>Net of unaccreted discount of \$275 million | 244,057               |                     | 244,057             |
| Bond payment obligation payable through 2008; interest payable at rates varying from 3.5% to 5.5%  | 33,450                |                     | 33,450              |
| Bond payment obligation payable through 2009; interest payable at rates varying from 3.5% to 5.5%  | 44,240                |                     | 44,240              |
| Bond payment obligation payable through 2010; interest payable at rates varying from 1.5% to 5.5%  | 48,220                |                     | 48,220              |
| Deferred interest bonds payable through 2002; interest payable semiannually at 8%  | 50,000                |                     | 50,000              |
| Auction rate notes payable from 2007 through 2008; interest payable in arrears from 2007 through 2008 at rates varying from 2.65% to 11.564%     | 26,700                |                     | 26,700              |
| Auction rate notes payable from 2015 through 2020; interest payable in arrears from 2015 through 2020 at rates varying from 2.65% to 11.662%     | 94,900                |                     | 94,900              |
| Yield curve notes payable from 2007 through 2008; no interest rate, yield of 8.914%  | 26,700                |                     | 26,700              |
| Yield curve notes payable from 2015 through 2020; no interest rate, yield of 9.012%  | <u>94,900</u>         |                     | <u>94,900</u>       |
| Total  | 3,641,547             | 1,933,790           | 5,575,337           |
| Savings Bonds  | <u>270</u>            |                     | <u>270</u>          |
| Total bonds payable  | <u>\$ 3,641,817</u>   | <u>\$ 1,933,790</u> | <u>\$ 5,575,607</u> |

On July 15, 1993, the Puerto Rico Highway and Transportation Authority (PRHTA), a blended component unit, issued approximately \$1.2 billion in revenue bonds, of which approximately \$410.3 million were new and approximately \$751.3 million were refunding bonds. The new funds will be used to finance or refinance a portion of the costs of various projects under the PRHTA's current Priorities Construction Program.

The refunding bonds were issued to advance refund all the outstanding bonds amounting to approximately \$637.7 million. From the refunding bonds, approximately \$723.9 million were deposited, together with other available monies, into an irrevocable escrow fund with the fiscal agent under the bond resolution.

The refunding will permit the PRHTA to realize annual savings on its debt service requirements on outstanding bonds. The total cash flow savings amount to approximately \$72 million and the net economic gain from such refunding amounts to approximately \$32 million.

From the serial revenue bonds payable, approximately \$276.4 million of bonds issued by the Puerto Rico Infrastructure Financing Authority (PRIFA), a blended component unit, are payable solely from, and secured by, a pledge of federal excise taxes and other monies deposited to the credit of a sinking fund established pursuant to a trust agreement.

Beginning with the fiscal year ended June 30, 1990, and in each of the following twenty-eight fiscal years, the first \$40 million of federal excise taxes received by the Commonwealth will be transferred to PRIFA for deposit to PRIFA's infrastructure fund (Infrastructure Fund). The maximum principal and interest requirements on these revenue bonds in any fiscal year is approximately \$37 million. Federal excise taxes consist of taxes received by the Commonwealth from the United States in connection with rum and other articles subject to federal excise tax produced in Puerto Rico and sold in the United States. Rum is the only article currently produced in Puerto Rico subject to federal excise tax, the proceeds of which are required to be transferred back to the Commonwealth.

The federal excise taxes securing the bonds are subject to a number of factors, including the continued imposition and remittance of such taxes to the Commonwealth and conditions affecting the Puerto Rico rum industry. If the federal excise taxes received by the Commonwealth in any fiscal year are insufficient to deposit \$40 million into the Infrastructure Fund, PRIFA shall request, and the Commonwealth shall include in the budget for the corresponding fiscal year, the appropriation needed to cover such insufficiency. The Legislature, however, is not legally obligated to make the necessary appropriation to cover such insufficiency.

During the year ended June 30, 1994, the following changes occurred in the bonds payable (expressed in thousands):

|                            | Outstanding<br>July 1, 1993 | Issued             | Discount<br>Accretion<br>(Redeemed) | Outstanding<br>June 30, 1994 |
|----------------------------|-----------------------------|--------------------|-------------------------------------|------------------------------|
| Term bonds                 | \$ 2,846,150                | \$1,120,290        | \$ (1,389,115)                      | \$ 2,577,325                 |
| Serial bonds               | 1,574,984                   | 1,128,620          | (368,759)                           | 2,334,845                    |
| Capital appreciation bonds | 226,807                     |                    | 17,250                              | 244,057                      |
| Bond payment obligations   |                             | 125,910            |                                     | 125,910                      |
| Auction rate notes         | 121,600                     |                    |                                     | 121,600                      |
| Yield curve notes          | 121,600                     |                    |                                     | 121,600                      |
| Deferred interest bonds    |                             | 50,000             |                                     | 50,000                       |
| Savings bonds              | <u>306</u>                  | <u>          </u>  | <u>(36)</u>                         | <u>270</u>                   |
| Total                      | <u>\$ 4,891,447</u>         | <u>\$2,424,820</u> | <u>\$ (1,740,660)</u>               | <u>\$ 5,575,607</u>          |

Fixed maturities of general obligations and of revenue bonds payable principal, including accrued interest of capital appreciation bonds are as follows (expressed in thousands):

| Year Ending<br>June 30 | Principal          | Interest           | Total               |
|------------------------|--------------------|--------------------|---------------------|
| 1995                   | \$ 240,410         | \$ 316,345         | \$ 556,755          |
| 1996                   | 255,545            | 298,512            | 554,057             |
| 1997                   | 260,150            | 289,677            | 549,827             |
| 1998                   | 258,211            | 278,094            | 536,305             |
| 1999                   | 250,241            | 268,045            | 518,286             |
| Thereafter             | <u>4,223,047</u>   | <u>3,134,907</u>   | <u>7,357,954</u>    |
| Total                  | 5,487,604          | <u>\$4,585,580</u> | <u>\$10,073,184</u> |
| Plus accreted discount | <u>87,733</u>      |                    |                     |
| Total                  | <u>\$5,575,337</u> |                    |                     |

**C. Notes Payable**

The Commonwealth issued \$210 million in special promissory notes on June 29, 1989 of which \$120 million remain outstanding as of June 30, 1994. These notes are payable from the revenues received from taxes levied, due and to be collected by the Commonwealth and revenues segregated pursuant to joint resolution Number 3 approved on October 16, 1985. Such resolution was enacted to reimburse to the general fund advances made to certain entities in previous fiscal years. These notes bear interest at rates from 82.5% to 85% of the applicable London Interbank Bid Quotation Rate (LIBID), but not to exceed 12% per annum. Interest is payable quarterly.

The general fund includes restricted assets of approximately \$120 million in interest bearing accounts which guarantee payment of the special promissory notes (see Note 7). Debt service requirements for the principal of these notes are as follows (expressed in thousands):

| Year Ending<br>June 30 | Amount            |
|------------------------|-------------------|
| 1995                   | \$ 90,000         |
| 1996                   | <u>30,000</u>     |
| Total                  | <u>\$ 120,000</u> |

**D. Due to Component Units**

The amounts due to component units include the following (expressed in thousands):

|                                      |                   |
|--------------------------------------|-------------------|
| Puerto Rico Electric Power Authority | \$ 110,403        |
| University of Puerto Rico            | <u>32,000</u>     |
| Total                                | <u>\$ 142,403</u> |

The amount due to the Puerto Rico Electric Power Authority (PREPA), a discretely presented component unit, consists of the following (expressed in thousands):

|  |                          |
|--|--------------------------|
| Fuel adjustment subsidy                    | \$ 88,601                |
| Rural irrigation system cost reimbursement | <u>21,802</u>            |
| <b>Total</b>                               | <b><u>\$ 110,403</u></b> |

On October 29, 1991, the Commonwealth entered into an agreement with PREPA for the payment of the outstanding fuel adjustment subsidy as of June 30, 1991. Under this agreement, the Commonwealth will pay the outstanding balance over a fifteen-year period in installments of approximately \$6 million per year, without interest. On August 29, 1994 and September 6, 1994, the Commonwealth made payments amounting to approximately \$12.7 million for fiscal years 1994 and 1995.

The rural irrigation system cost reimbursement debt is repaid by the Commonwealth by offsetting certain contributions in lieu of taxes that PREPA must remit to the Commonwealth. The yearly amortization will vary depending on the electric gross sales for the year. The amortized amount for the year ended June 30, 1994 was approximately \$4.9 million.

The Commonwealth agreed to pay the University of Puerto Rico \$46 million for certain taxes imposed and collected under Act No. 2 of October 8, 1987 related to the sale of crude oil that should have been included in the annual revenues used to determine the appropriation to the University of Puerto Rico. The Commonwealth paid \$14 million during the year ended June 30, 1994, and will pay two installments of \$16 million each for the years ending June 30, 1995 and 1996, respectively.

**E. Advances from Other funds**

The advances from other funds at June 30, 1994, consist of loans owed by the Commonwealth to the Government Development Bank for Puerto Rico (GDB), an internal service fund, for the following purposes (expressed in thousands):

|  |                          |
|--|--------------------------|
| Public schools infrastructure improvement loan | \$ 102,324               |
| Disaster assistance loan                       | 93,860                   |
| Law 89 loan                                    | <u>17,000</u>            |
| <b>Total</b>                                   | <b><u>\$ 213,184</u></b> |

The public schools infrastructure improvement loan was taken to provide additional funds for major repairs and improvements of the public schools in Puerto Rico. This activity is administered by the Office for the Improvement of the Public Schools of Puerto Rico. The loan will be paid by the Commonwealth using the contributions in lieu of taxes that the Commonwealth will collect from the Puerto Rico Telephone Authority, a discretely presented component unit, of at least \$20 million per year.

Debt service requirements in future years are as follows (expressed in thousands):

| Year Ending<br>June 30, | Principal        | Interest         | Total            |
|-------------------------|------------------|------------------|------------------|
| 1995                    | \$ 11,299        | \$ 8,701         | \$ 20,000        |
| 1996                    | 12,259           | 7,741            | 20,000           |
| 1997                    | 13,301           | 6,699            | 20,000           |
| 1998                    | 14,431           | 5,569            | 20,000           |
| 1999                    | 15,658           | 4,342            | 20,000           |
| Thereafter              | <u>35,376</u>    | <u>4,624</u>     | <u>40,000</u>    |
| Total                   | <u>\$102,324</u> | <u>\$ 37,676</u> | <u>\$140,000</u> |

The disaster assistance loan consists of the amount owed to GDB of approximately \$93.9 million to repay a debt for such amount to the Federal Emergency Management Agency, which covered the Commonwealth's share for the relief grants for the residents of Puerto Rico as a result of Hurricane Hugo. Debt service requirements in future years are as follows (expressed in thousands):

| Year Ending<br>June 30, | Principal        | Interest         | Total            |
|-------------------------|------------------|------------------|------------------|
| 1995                    | \$ 7,462         | \$ 4,693         | \$ 12,155        |
| 1996                    | 7,835            | 4,320            | 12,155           |
| 1997                    | 8,227            | 3,928            | 12,155           |
| 1998                    | 8,638            | 3,517            | 12,155           |
| 1999                    | 9,070            | 3,085            | 12,155           |
| Thereafter              | <u>52,628</u>    | <u>8,150</u>     | <u>60,778</u>    |
| Total                   | <u>\$ 93,860</u> | <u>\$ 27,693</u> | <u>\$121,553</u> |

Law 89, which was enacted to provide future appropriations for liquidating back-pay owed to teachers and other employees, authorized the Commonwealth to take a loan of \$17 million from GDB to pay a portion of the back pay owed to the teachers and other employees. This Law establishes that any employee that had not received a salary raise in five years, the sixth year there is an obligation to provide a pay raise. The loan will be paid during fiscal year 1994-95.

**F. Due to Other Governmental Entities**

The amounts due to other governmental entities include the following (expressed in thousands):

|                                     |                  |
|-------------------------------------|------------------|
| Municipalities of Puerto Rico       | \$180,000        |
| Federal Emergency Management Agency | <u>10,788</u>    |
| Total                               | <u>\$190,788</u> |

During August, 1994, the Commonwealth reached an agreement to pay to the municipalities of Puerto Rico approximately \$180 million to cover the Commonwealth's debt for property tax collected, and the exonerated property tax reimbursements which were in arrears as of June 30, 1993. The Commonwealth financed this amount by taking a line of credit from the Government Development Bank for Puerto Rico, an internal service fund.

The Federal Emergency Management Agency approved two loans to the Commonwealth for a total of approximately \$14.5 million. The proceeds of said loans were used to cover the non-federal share of the Individual and Family Grant Program related to floods occurred in January, 1992. Debt service requirements in future years are as follows (expressed in thousands):

| Year Ending<br>June 30 | Principal       | Interest       | Total           |
|------------------------|-----------------|----------------|-----------------|
| 1995                   | \$ 7,192        | \$1,074        | \$ 8,266        |
| 1996                   | <u>3,596</u>    | <u>214</u>     | <u>3,810</u>    |
| Total                  | <u>\$10,788</u> | <u>\$1,288</u> | <u>\$12,076</u> |

**G. Compensated Absences**

General long-term debt includes approximately \$346 million of accrued sick leave benefits, and approximately \$312 million of accrued vacation benefits, representing the Commonwealth's commitment to fund such costs from future operations.

**H. Other Long-Term Liabilities**

The remaining long-term liabilities include (expressed in thousands):

|   |                   |
|---|-------------------|
| Provisions for legal claims and judgments | \$ 242,585        |
| Provision for federal cost disallowances  | 33,287            |
| Obligations under capital lease           | 22,357            |
| Other                                     | <u>2,305</u>      |
| Total                                     | <u>\$ 300,534</u> |

**I. Advance Refunding and Defeased Bonds**

The Commonwealth advance refunded certain general obligation bonds through the issuance of \$958,240,000 of general obligation public improvements refunding bonds during the year ended June 30, 1994. The net proceeds of approximately \$967.9 million (which includes a premium from the sale of the bonds) were used to purchase US Government securities which were deposited in an irrevocable trust fund with an escrow agent to provide for all future debt service payments of the refunded bonds. As a result, the refunded bonds are considered to be defeased, and the liabilities therefore have been removed from the general long-term debt account group. As a result of these advance refunding, the Commonwealth decreased current year debt service payments and has taken advantage of lower interest rates, and it has decreased its aggregate debt service payments by approximately \$79.6 million over the next 28 years and obtained an economic gain (the difference between the present values of the debt service payments of the refunded and refunding bonds) of approximately \$45 million. At June 30, 1994 approximately \$843 million of the bonds refunded remain outstanding and are considered defeased.

In prior years, the Commonwealth also defeased certain general obligation and other bonds by placing the proceeds of bonds in an irrevocable trust to provide for all future debt service payments on the refunded bonds. Accordingly, the trust account assets and liabilities for the defeased bonds are not included in the general long-term debt account group. At June 30, 1994 approximately \$668.3 million of bonds outstanding from advance refunding in prior years are considered defeased.

**J. Internal Service Funds Operations**

Revenue Bonds - Revenue bonds are those bonds that are paid out from resources pledged in the internal service funds. These revenue bonds do not constitute a liability or debt of the Commonwealth. Revenue bonds outstanding at June 30, 1994, are as follows (expressed in thousands):

|                                    | Final<br>Maturity<br>Year | Interest<br>Rate | Balance            |
|------------------------------------|---------------------------|------------------|--------------------|
| Government Development Bank for PR | 2021                      | 6.8%-10.0%       | \$1,304,095        |
| Public Buildings Authority         | 2021                      | 5.5%-8.87%       | <u>1,189,065</u>   |
| Total                              |                           |                  | <u>\$2,493,160</u> |

Future amounts required to pay principal and interest on internal service funds revenue bonds at June 30, 1994, are as follows (expressed in thousands):

| Year Ending June 30 | Principal           | Interest          | Total               |
|---------------------|---------------------|-------------------|---------------------|
| 1995                | \$ 39,420           | \$ 68,247         | \$ 107,667          |
| 1996                | 271,765             | 62,725            | 334,490             |
| 1997                | 108,505             | 60,130            | 168,635             |
| 1998                | 44,220              | 59,043            | 103,263             |
| 1999                | 45,795              | 57,275            | 103,070             |
| Thereafter          | <u>2,012,440</u>    | <u>659,237</u>    | <u>2,671,677</u>    |
| Discount            | 2,522,145           | 966,657           | 3,488,802           |
|                     | <u>(28,985)</u>     |                   | <u>(28,985)</u>     |
| Total               | <u>\$ 2,493,160</u> | <u>\$ 966,657</u> | <u>\$ 3,459,817</u> |

Notes Payable - internal service funds notes payable consists of promissory notes, mortgages and revenue notes.

Notes payable outstanding at June 30, 1994, are as follows (expressed in thousands):

|                                    | Final<br>Maturity<br>Date | Interest<br>Rate | Balance            |
|------------------------------------|---------------------------|------------------|--------------------|
| Government Development Bank for PR | 1998                      | 7.25%-7.5%*      | \$1,234,777        |
| Puerto Rico Land Administration    | 1996                      | 6.05%-7.20%      | <u>5,000</u>       |
| Total                              |                           |                  | <u>\$1,239,777</u> |

\* Certain notes have variable interests based on the London Interbank Bid Quotation Rate.

Notes payable of the Government Development Bank for PR include approximately \$1.1 billion in commercial paper.

Future fixed amounts required to pay principal and interest on internal service funds notes payable at June 30, 1994, are as follows (expressed in thousands):

| Year Ending June 30, | Principal          | Interest          | Total              |
|----------------------|--------------------|-------------------|--------------------|
| 1995                 | \$1,192,677        | \$ 329            | \$1,193,006        |
| 1996                 | 34,000             | 156               | 34,156             |
| 1997                 | 3,600              |                   | 3,600              |
| 1998                 | <u>9,500</u>       | <u>          </u> | <u>9,500</u>       |
| Total                | <u>\$1,239,777</u> | <u>\$ 485</u>     | <u>\$1,240,262</u> |

#### K. Discretely Presented Component Units

##### Public University Funds

The University of Puerto Rico has issued revenue bonds designated as *University System Revenue Bonds*, the proceeds of which have been used mainly to finance new activities in connection with its educational facilities construction program and to cancel and refinance previous debts incurred.

Revenue bonds outstanding at June 30, 1994, were approximately \$174 million with interest rates varying from 2.75% to 8% and a final maturity date of 2013.

Future amounts required to pay principal and interest on University System Revenue Bonds at June 30, 1994, are as follows (expressed in thousands):

| Year Ending June 30, | Principal         | Interest          | Total             |
|----------------------|-------------------|-------------------|-------------------|
| 1995                 | \$ 6,924          | \$ 11,674         | \$ 18,598         |
| 1996                 | 7,395             | 11,205            | 18,600            |
| 1997                 | 7,821             | 10,776            | 18,597            |
| 1998                 | 8,287             | 10,311            | 18,598            |
| 1999                 | 8,793             | 9,809             | 18,602            |
| Thereafter           | 144,294           | 73,242            | 217,536           |
| Discounts            | <u>(9,468)</u>    | <u>          </u> | <u>(9,468)</u>    |
| Total                | <u>\$ 174,046</u> | <u>\$ 127,017</u> | <u>\$ 301,063</u> |

The agreements underlying the above bonds payable provide for various covenants.

Notes payable for approximately \$542,000 in the current restricted funds represent a promissory note due to a commercial bank payable in semiannual installments of principal and interest of approximately \$182,000.

Notes payable in the loan funds represent advances made by the US Department of Education for granting long-term student loans. Payment of these notes is to be made in twenty years from the collections of student loans granted. The unremitted collected amounts bear interest ranging from 5-1/8% to 7-1/4%.

Component Units - Other

Bonds and notes payable are those liabilities that are paid out of resources pledged in the other component units. These revenue bonds do not constitute a liability or debt of the Commonwealth. Bonds payable and notes payable outstanding at June 30, 1994, are as follows (expressed in thousands):

|  | Final<br>Maturity<br>Date | Interest<br>Rates | Balance             |
|--|---------------------------|-------------------|---------------------|
| <b><u>Bonds Payable:</u></b>   |                           |                   |                     |
| Puerto Rico Electric Power Authority   | 2023                      | 2% - 9.5%         | \$ 2,906,566        |
| Puerto Rico Telephone Authority  | 2022                      | 3.4% - 9.875%     | 1,013,489           |
| Puerto Rico Housing Bank and Finance Agency  | 2006                      | 2.7% - 7.5%       | 487,395             |
| Puerto Rico Aqueduct and<br>Sewer Authority (Unaudited)                                  | 2029                      | 5% - 8.8%         | 445,375             |
| Puerto Rico Municipal Finance Agency   | 2008                      | 3.75% - 9.25%     | 270,889             |
| Puerto Rico Industrial Development Company   | 2016                      | 3.88% - 8.27%     | 201,546             |
| Puerto Rico Ports Authority  | 2021                      | 5% - 7.3%         | 137,493             |
| Recreational Development Company of Puerto Rico  | 1997                      | 4% - 5.4%         | 632                 |
| Total bonds payable  |                           |                   | <u>\$ 5,463,385</u> |
| <b><u>Notes Payable:</u></b>   |                           |                   |                     |
| Puerto Rico Electric Power Authority   | 1997                      | 2.54% - 3.33%     | \$ 110,000          |
| Puerto Rico Maritime Shipping Authority  | 1995                      | 4.01% - 4.77%     | 95,067              |
| Agricultural Services Administration   | 1995                      | 5%                | 43,237              |
| Economic Development Bank for Puerto Rico  | 1996                      | Variable          | 24,000              |
| Puerto Rico Telephone Authority  | 1999                      | Variable          | 18,850              |
| Commercial and Agricultural Credit and<br>Development Corporation                        | Not fixed                 | Variable          | 18,744              |
| PR Industrial Development Company  | 2004                      | 5% - 10%          | 15,666              |
| Sugar Corporation of Puerto Rico   | Not fixed                 | Variable          | 14,783              |
| Automobile Accident Compensation<br>Administration                                       | 1999                      | 5.92% - 6.32%     | 14,324              |
| Tourism Company of Puerto Rico   | 2002                      | 4% - 8.35%        | 5,185               |
| Corporation of Stocks and Deposit<br>Insurance for the Savings and Loans<br>Cooperatives | 2003                      | N/A               | 692                 |
| Total notes payable  |                           |                   | <u>\$ 360,548</u>   |

Fixed maturities required to pay principal and interest on other component units bonds payable and notes payable with fixed maturities at June 30, 1994, were as follows (expressed in thousands):

|                      | Principal           | Interest            | Total               |
|----------------------|---------------------|---------------------|---------------------|
| <b>Bonds Payable</b> |                     |                     |                     |
| 1995                 | \$ 295,571          | \$ 305,103          | \$ 600,674          |
| 1996                 | 219,342             | 294,590             | 513,932             |
| 1997                 | 232,977             | 283,985             | 516,962             |
| 1998                 | 251,623             | 271,013             | 522,636             |
| 1999                 | 252,480             | 257,922             | 510,402             |
| Thereafter           | <u>4,451,851</u>    | <u>2,699,231</u>    | <u>7,151,082</u>    |
|                      | 5,703,844           | 4,111,844           | 9,815,688           |
| Discounts            | <u>(240,459)</u>    | <u>          </u>   | <u>(240,459)</u>    |
| Total                | <u>\$ 5,463,385</u> | <u>\$ 4,111,844</u> | <u>\$ 9,575,229</u> |
| <b>Notes Payable</b> |                     |                     |                     |
| 1995                 | \$ 131,788          | \$ 6,608            | \$ 138,396          |
| 1996                 | 95,461              | 3,955               | 99,416              |
| 1997                 | 69,281              | 1,555               | 70,836              |
| 1998                 | 13,036              | 1,150               | 14,186              |
| 1999                 | 7,597               | 724                 | 8,321               |
| Thereafter           | <u>9,858</u>        | <u>591</u>          | <u>10,449</u>       |
| Total                | <u>\$ 327,021</u>   | <u>\$ 14,583</u>    | <u>\$ 341,604</u>   |

The following is the unaudited information that belongs to the Puerto Rico Aqueduct and Sewer Authority that is included in the previous schedule of bonds payable:

|                      | Principal         | Interest          | Total               |
|----------------------|-------------------|-------------------|---------------------|
| <b>Bonds Payable</b> |                   |                   |                     |
| 1995                 | \$ 9,757          | \$ 31,980         | \$ 41,737           |
| 1996                 | 10,391            | 31,305            | 41,696              |
| 1997                 | 11,142            | 30,505            | 41,647              |
| 1998                 | 11,894            | 29,754            | 41,648              |
| 1999                 | 12,722            | 28,876            | 41,598              |
| Thereafter           | <u>396,285</u>    | <u>436,330</u>    | <u>832,615</u>      |
|                      | 452,191           | 588,750           | 1,040,941           |
| Discounts            | <u>(6,815)</u>    | <u>          </u> | <u>(6,815)</u>      |
| Total                | <u>\$ 445,376</u> | <u>\$ 588,750</u> | <u>\$ 1,034,126</u> |

## 12. RESTATEMENTS

The following table details the restatements and other adjustment to fund balances/retained earnings (deficit) for the general fund, enterprise funds, pension trust funds, public university funds, and component units - other (expressed in thousands):

|   | General           | Enterprise         | Pension Trust      | Public University | Component Units - Other |
|---|-------------------|--------------------|--------------------|-------------------|-------------------------|
| Beginning fund balances/retained earnings (deficit), as previously reported | \$(47,420)        | \$(380,952)        | \$2,092,599        | \$ 703,902        | \$1,023,844             |
| Restatements to:  |                   |                    |                    |                   |                         |
| Present effect of adoption of accounting pronouncements                     |                   |                    |                    | (40,452)          | (27,525)                |
| Correct presentation of the Lotteries                                       | (4,131)           | 4,131              |                    |                   |                         |
| Reclassifications from contributed capital                                  |                   |                    |                    |                   | 25,781                  |
| Include financial statements of funds / component units previously excluded | 31,921            |                    |                    |                   | (14,678)                |
| Correct errors in prior years' presentation                                 |                   | (5,152)            | 58,466             |                   |                         |
| Other adjustments   | _____             | _____              | _____              | _____             | _____(15,673)           |
| Beginning fund balances/retained earning (deficit), as restated             | <u>\$(19,630)</u> | <u>\$(381,973)</u> | <u>\$2,151,065</u> | <u>\$663,450</u>  | <u>\$ 991,749</u>       |

The restatement to correct the presentation of the Lotteries of approximately \$4.1 million in the general fund and enterprise funds arises because the Commonwealth changed its reporting policies regarding the Lottery of Puerto Rico and of the Additional Lottery effective July 1, 1993. The operations of the Lotteries were previously reported in the general fund. However, management believes that its reporting within the enterprise funds reflects more accurately the operations of the Lotteries in accordance with generally accepted accounting principles. In addition, the general fund was also restated for approximately \$32 million to include the fund balance of Office for the Improvements of the Public Schools, which was previously excluded.

In addition to the restatement related to the presentation of the Lotteries mentioned in the previous paragraph, the restatements in the enterprise funds include a correction of errors in prior years of approximately \$5.1 million relating to adjustments of the accounts payable of the Puerto Rico Health Facilities and Services Administration, an unaudited enterprise fund.

The restatement in the pension trust funds of approximately \$58.5 million is related to the effect of correcting the cumulative effect of the net appreciation of investments, interest income, benefits paid and other expenses recognized in previous years' financial statements of the Employees' Retirement System of the Government of Puerto Rico and Its Instrumentalities, the Judiciary Retirement System, and the Annuity and Pension System for the Teachers of Puerto Rico.

The restatement in the public university funds is related to the adoption of Governmental Accounting Standards Board Statement No. 16, *Accounting for Compensated Absences*.

The restatement in the component units - other column include approximately \$27.5 million to reflect the adoption of Governmental Accounting Standards Board Statement No. 16, *Accounting for Compensated Absences* by the Puerto Rico Electric Power Authority. In addition, it includes a reclassification from contributed capital to retained earnings of approximately \$25.8 million relating to conforming the presentation of the results of operations of the ferry system to the presentation made in prior year.

The restatement in the component unit - other of approximately \$14.7 million is related to the effect of including financial statements for the Recreational Development Company of Puerto Rico and of the Agricultural Services Administration. These entities were omitted in the previous year.

### 13. GUARANTEED AND APPROPRIATION DEBT

#### Guaranteed Debt

The Commonwealth may provide guarantees for the repayment of certain borrowings of components units to carry out designated projects. At June 30, 1994, the following component unit debts are guaranteed by the Commonwealth (expressed in thousands):

|   | Maximum<br>Guarantee | Outstanding<br>Balance |
|---|----------------------|------------------------|
| Public Buildings Authority                  | \$ 1,500,000         | \$ 1,191,999           |
| Government Development Bank for Puerto Rico | 550,000              | 267,000                |
| Puerto Rico Housing Bank and Finance Agency | 325,000              | 83,410                 |
| Puerto Rico Maritime Shipping Authority     | <u>60,000</u>        | <u>60,000</u>          |
| Total                                       | <u>\$2,435,000</u>   | <u>\$ 1,602,409</u>    |

The Farm Credit Guarantee Fund, administered by the Commercial and Agricultural Credit and Development Corporation of Puerto Rico, an other discretely presented component unit, has guaranteed, under the full faith, credit and taxing power of the Commonwealth, certain loans made by private institutions, by the former component unit Farm Credit Corporation and the Guarantee Loan Fund for Eligible Businesses. This fund guarantees loans for approximately \$19 million as of June 30, 1994.

The Puerto Rico Housing Bank and Finance Agency insures mortgages granted to low and moderate income families through its mortgage loan insurance program. The Commonwealth guarantees up to \$75 million of such mortgage loans. As of June 30, 1994, the mortgage loan insurance program was insuring loans aggregating \$261.4 million and had not issued any debenture bonds. Currently, the Commonwealth has not been called to make any direct payments pursuant to the above guarantees.

The Commonwealth has guaranteed the payments of rentals of its departments, agencies and component units to the Puerto Rico Public Buildings Authority (PBA), an internal service fund, under various lease agreements executed pursuant to the law that created PBA. Such rental payments include the amounts required by PBA for the payment of principal and interest on the guaranteed debt as authorized by law. The rental commitment to cover principal and interest on the guaranteed debt as of June 30, 1994 for the next five years and thereafter follows (expressed in thousands):

| Year Ending<br>June 30, | Principal          | Interest          |
|-------------------------|--------------------|-------------------|
| 1995                    | \$ 39,420          | \$ 68,356         |
| 1996                    | 41,765             | 62,725            |
| 1997                    | 40,605             | 60,130            |
| 1998                    | 40,620             | 59,043            |
| 1999                    | 45,795             | 57,275            |
| Thereafter              | <u>1,005,629</u>   | <u>659,237</u>    |
| Total                   | <u>\$1,213,834</u> | <u>\$ 966,766</u> |

#### Appropriation Debt

The following represents the outstanding balances of debt payable by appropriations as set forth in enacted legislation of the Commonwealth at June 30, 1994 (expressed in thousands):

#### Enterprise Funds:

|  |                   |
|--|-------------------|
| Health Facilities and Services Administration of Puerto Rico (Unaudited) | <u>\$ 326,245</u> |
|--|-------------------|

#### General Long-Term Debt Account Group:

|  |                 |
|--|-----------------|
| Importing and Distribution Corporation | \$ 2,028        |
| Cooperative Development Company        | 1,400           |
| Public Housing Administration          | <u>941</u>      |
| Total                                  | <u>\$ 4,369</u> |

#### Component Units - Other:

|  |                  |
|--|------------------|
| Puerto Rico Housing Bank and Finance Agency  | \$583,537        |
| Sugar Corporation of Puerto Rico   | 108,932          |
| Agricultural and Commercial Credit and Development Corporation   | 24,000           |
| Economic Development Bank for Puerto Rico  | 24,000           |
| Puerto Rico Metropolitan Bus Authority   | 16,909           |
| Office for the Liquidation of the Accounts of the Puerto Rico Urban<br>Renewal and Housing Corporation | 13,943           |
| Puerto Rico Industrial Development Company   | 7,650            |
| Tourism Company of Puerto Rico   | 6,796            |
| Agricultural Services Administration   | 2,785            |
| Puerto Rico Aqueduct and Sewer Authority (Unaudited)   | 2,522            |
| Puerto Rico and Caribbean Cardiovascular Center Corporation  | 1,542            |
| Fine Arts Center Corporation   | <u>122</u>       |
| Total  | <u>\$792,738</u> |

## 14. COMMITMENTS AND CONTINGENCIES

### Primary Government

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, persons are authorized to sue the Commonwealth only for causes of actions set forth in said Act to a maximum amount of \$75,000 or \$150,000 if it 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, the Commonwealth may provide its officers and employees with legal representation, as well as assume the payment of any judgment that may be entered against them. There is no maximum amount on the payment of such judgment.

With respect to pending and threatened litigation, excluding the litigation mentioned in the following two paragraphs, the Commonwealth has reported liabilities of approximately \$108.8 million for awarded and anticipated unfavorable judgments. This amount was included as other long-term liabilities in the general long-term debt account group and represents the amount estimated as a probable liability or a liability with a fixed or expected due date which will require future available financial resources for its payment. Management believes that the ultimate liability in excess of amounts provided would not be significant.

The Commonwealth and various component units are defendants in a lawsuit alleging violations of individuals' civil rights. Preliminary hearings and discovery proceedings are in progress. The amounts claimed exceed \$50 billion; however, the ultimate liability cannot be presently determined. It is the opinion of management that the plaintiff's damage claim is excessive and exaggerated. No provisions for any liability that may result upon adjudication of this lawsuit has been recognized in the general purpose financial statements.

In 1979, various inmates under the custody of the Administration of Corrections of the Commonwealth filed a complaint in the United States District Court for the District of Puerto Rico (the Court) alleging that the conditions of confinement violated their rights under the United States and the Commonwealth's Constitution. In 1980, the Court rendered an order requiring that the Commonwealth provide a fixed living space per inmate. The Court has imposed daily fines on the Commonwealth because of its noncompliance with the order amounting to approximately \$133.7 million through June 30, 1994 which is recorded as other long-term liabilities in the general long-term debt account group. In December, 1991, a stipulation was entered into between the inmates and the Commonwealth. Based on such stipulation fines were paid through November 7, 1991; thereafter they were to be calculated only, but would be permanently discharged if the Commonwealth complied with the terms of the stipulation. The fines paid by the Commonwealth are being maintained in a fund by the federal government and may be available to the Commonwealth for authorized projects related to confinement. The stipulation authorizes the Court to release a portion of fine funds to finance certain costs for two projects related to confinement. The Commonwealth has filed two motions requesting a discharge of these fines. The first motion was opposed by the plaintiffs' counsel and the Court ordered hearings commencing in June 1993 to solve this matter. In addition, the Court ordered the federal government to cease and permanently discharge any fines assessed or calculated following January 2, 1993. However, a federal monitor for this case decided that the Commonwealth recently failed to comply with certain requirements of the stipulation. Therefore, during fiscal year 1993-94, the Commonwealth has been assessed further penalties. Currently the Commonwealth is designing plans to comply with the stipulations, which include the construction and opening of three new penitentiaries.

During February, 1994, the Commonwealth obtained the approval from the Government Development Bank for Puerto Rico (GDB), an internal service fund, for a \$200 million revolving credit line to be used by the Health Facilities and Services Administration of Puerto Rico, an enterprise fund. Any unpaid amount as of June 30, 1997 is expected to be repaid from annual appropriations of the Commonwealth based on recommendations of the Puerto Rico Office of Management and Budget.

The Commonwealth's escheated bank accounts regulations require from the financial institutions doing business in Puerto Rico the remittance to the Commonwealth of all deposit accounts under their custody that have remained inactive for a period of five years. The Commonwealth is responsible for reimbursing any claims received from the owners of those accounts for a period of 10 years from the date of receipt from the financial institution. The balance of unclaimed escheated bank account as of June 30, 1994 is approximately \$28.2 million. The Commonwealth has not recorded any liability for future claims because trend information for claims paid is not readily available.

The Commonwealth's minimum annual payments related to unpaid awards for the Additional Lottery, an enterprise fund, during the next five years amounts to approximately \$9.6 million from 1995 through 1999 inclusive, and \$122 million thereafter. Imputed interest amounts to approximately \$71.9 million at June 30, 1994.

The Government Development Bank for Puerto Rico (GDB), an internal service fund, entered into various interest rate swaps during 1994. These interest rate swaps are hedging investments in mortgage-backed securities. Interest rate swaps involve the exchange of fixed and floating rate interest payment obligations without the exchange of the underlying principal amounts. Entering into interest rate agreements involves the risk of dealing with counterparties and their ability to meet the terms of the contracts and the interest rate risk associated with unmatched positions. Notional principal amounts often are used to express the volume of these transactions, but the amounts potentially subject to credit risk are much smaller. The notional principal amount of interest rate swap contracts outstanding at June 30, 1994 was approximately \$34.9 million where GDB is the fixed rate payer and the counterparties are the floating rate payer using Libor rate. Settlements are made monthly.

The provision for losses on letters of credit and guarantees relating to the Tourism Fund, which is part of the Government Development Bank for Puerto Rico, an internal service fund, is charged to income to the extent that losses are not recoverable from the Commonwealth. The Executive Director of the Tourism Fund shall certify each year to the Director of the Office of Management and Budget of the Commonwealth the amount, if any, that is necessary to reimburse the Tourism Fund for disbursements made during the previous year in excess of its earnings to cover the payment of principal and interest on obligations guaranteed by the Tourism Fund. The Director of the Office of Management and Budget shall include the amount required to be reimbursed to the Tourism Fund in the general budget of the Commonwealth for the following fiscal year for the Legislature's consideration and approval.

In March 1992, the Puerto Rico Highway and Transportation Authority (PRHTA), a blended component unit, issued Special Facility Revenue Bonds amounting to approximately \$117 million for facilitating the construction of a toll bridge which spans the San José Lagoon between the municipalities of San Juan and Carolina. PRHTA entered into a Concession Agreement with a private entity for the operation and maintenance of the bridge. The initial term of this agreement is 35 years. Under certain circumstances, the Concession Agreement may be terminated and PRHTA is then to assume all the obligations of the principal and interest on the Bonds which, pursuant to the Loan Agreement, will be paid from the proceeds of the use and operation of the toll bridge. At June 30, 1994, the outstanding balance of the debt, including interest, and the sinking fund balances are \$120.1 and \$13.3 million, respectively.

The Commonwealth receives financial assistance from the federal government in the form of grants and entitlements. Non-cash federal financial assistance programs received by the Commonwealth amounted to approximately \$17 million. Receipt of grants is generally conditioned upon compliance with terms and conditions of the grant agreements and applicable federal regulations, including the expenditure of resources for eligible purposes. Substantially all grants are subject to audit under the Single Audit Act of 1984 all of which are performed at the individual agency level. Disallowances as a result of these audits may become liabilities of the Commonwealth. At June 30, 1994, based on an evaluation of pending disallowances, the Commonwealth has recorded approximately \$33 million as other long-term liabilities in the general long-term debt account group for this purpose. The United States Congress is studying several cost-reduction measures to balance the federal budget deficit. As part of this process, the Congress is considering reductions to the federal financial assistance programs in which the Commonwealth, together with the States, participates. Management of the Commonwealth believes that the future outcome of any changes in federal financial assistance programs does not have a material effect on the general purpose financial statements.

The Puerto Rico Highway and Transportation Authority's construction commitments as of June 30, 1994 amounted to approximately \$256 million.

The Public Buildings Authority's construction commitments as of June 30, 1994 amounted to \$131 million.

#### **Public University Funds**

The University of Puerto Rico (UPR) capital construction program for educational facilities for the fiscal year ending on June 30, 1995 amounts to approximately \$60 million. This program is intended to be permanently financed substantially with a future bond issuance.

UPR participates in a number of federal financial assistance programs. These programs are subject to audits in accordance with the provisions of the Single Audit Act of 1984 or to compliance audit by grantor agencies. Although these programs have been audited through June 30, 1994 under the Single Audit Act of 1984 and through various dates by grantor agencies, the resolution of certain previously identified questioned costs has not occurred. The amount, if any, of expenditures which may be disallowed by the granting agencies cannot be determined at this time, although, UPR's management expects such amounts, if any, to be immaterial.

#### **Component Units - Other**

##### **Puerto Rico Electric Power Authority (PREPA)**

The Puerto Rico Electric Power Authority (PREPA) is a party to several lawsuits incidental to its business, some involving substantial amounts. In those instances that the management of PREPA and legal counsel believe that the outcome of the litigation will be unfavorable to PREPA, a provision has been made to cover the estimated liability. Management of PREPA, based on discussion with legal counsel, believes that any ultimate liability, if any, will not have a material effect on PREPA's financial position.

Retained earnings at June 30, 1994 include approximately \$74.7 million which have been appropriated principally to provide a reserve for damaged or destroyed property of the electric system not fully covered by insurance as required by the 1947 Bond Indenture. Funds set aside for self insurance purposes are deposited in the General Reserve Fund held by the trustee.

Facilities and operations of PREPA are subject to regulations under numerous Federal and Commonwealth environmental laws, including the Clean Air Act, Clean Water Act, and the National Pollutant Discharge Elimination System (NPDES). In February 1992, the Environmental Protection Agency (EPA) performed an inspection of various facilities of PREPA and noted deficiencies in air opacity; water quality; spill prevention control and countermeasures; and underground storage tanks. During 1993 the EPA, the Federal Department of Justice (DOJ) and PREPA were involved in negotiations to pursue a comprehensive settlement of the case and assure future compliance with applicable regulatory provisions. Among other things, the settlement proposal considers investment in capital improvement and Supplemental Environmental Projects (SEPs) estimated at approximately \$81 million during the five fiscal years ending June 30, 1998. Also, PREPA agreed to use fuel oil not exceeding a sulfur content of 1.5%, a vanadium content of 150 PPM and asphaltene content of 8% at the generating plants with an additional annual fuel oil cost of approximately \$54 million.

On October 27, 1993, DOJ and EPA filed a complaint in the United States District Court for the District of Puerto Rico based upon the above violations notified to PREPA during 1992. At June 30, 1994, it is not possible to estimate the ultimate liability to PREPA for civil penalties. However, management will continue settlement negotiations and based on discussions with legal counsel, believes that ultimate liability, if any, will not have a material effect on the PREPA's financial position.

The Authority has construction commitments for approximately \$132.4 million.

#### **Puerto Rico Aqueduct and Sewer Authority (PRASA) (Unaudited)**

PRASA is a defendant or co-defendant in various claims for damages and lawsuits for approximately \$102 million. Most of the cases are pending trial or final judgment. Management of PRASA and legal counsel are of the opinion that any liability that may result from such claims and lawsuits would not have a material adverse effect on PRASA's financial position as of June 30, 1994.

On September 24, 1990, a contractor filed a lawsuit against PRASA in the United States District Court of Puerto Rico alleging breach of contract and seeking specific performance of certain contractual obligations, collection of monies allegedly due and payable, damages, costs and attorney's fees of approximately \$48 million. PRASA has recorded the amounts it believes are payable to the contractor. However, PRASA has a counter claim against the contractor for approximately \$39 million. Outside legal counsel has stated that it is not possible at this time to render an opinion as to the likely outcome of these claims or to reasonably estimate the amount of loss, if any. Management of PRASA is vigorously contesting this litigation and is of the opinion that any liability that may result would not have a material adverse effect on PRASA's financial position.

## **Puerto Rico Telephone Authority, Subsidiaries and Affiliate (PRTA)**

The consolidated construction program for the year 1994 amounts to approximately \$276 million.

In September 1993, the National Exchange Carrier Association (NECA) informed PRTA that they would not accept the inclusion of the additional in-lieu-of taxes payment corresponding to 1992, for interstate settlement purpose unless the Company obtains approval from the Federal Communications Commission (FCC). On November 30, 1993, the Company submitted a request for ruling by the FCC on the issue. If the FCC does not approve the inclusion of the additional payment in-lieu-of taxes, a settlement adjustment will be required to the PRTA financial statements amounting to approximately \$32 million. As of the date of the December 31, 1993 PRTA's financial statements, no decision has been issued by the FCC.

PRTA has entered into an interest rate swap agreement to reduce the impact of changes in interest rates on its variable interest rate subordinated notes. The interest rate swap agreement requires PRTA to pay a fixed rate while receiving amounts at a variable rate based on LIBOR, settled every six months, on notional principal amounts ranging from a high of \$11.3 million up to February 15, 1995, to a low of \$1.3 million from February 15, 1999 to August 15, 1999, dates of maturity of the notes and the swap agreement. As a result of this agreement, the effective rate on the variable interest rate subordinated notes of \$14.7 million was 6.77% for the year ended December 31, 1993. The obligations of the other party in the agreement have been guaranteed by its parent company. PRTA is exposed to credit loss in the event of nonperformance by the other party to the interest rate swap agreement. However, PRTA does not anticipate nonperformance by the counterparty.

PRTA is organized under the laws of the state of Delaware, USA. As such, PRTA is subject to United States federal income taxes. The United States Internal Revenue Code Section 936 allows certain income tax benefits to United States corporations deriving substantially all of their income from sources within possessions of the United States, including Puerto Rico. PRTA has exercised the corresponding election to claim these benefits and has complied with the requirements of the United States Internal Revenue Code; accordingly, liability for US federal income taxes, if any, would arise only on income from sources outside Puerto Rico. Income tax relief from this exemption approximated \$80 million for year ended December 31, 1993.

Effective January 1, 1993, PRTA adopted Statement of Financial Accounting Standards (SFAS) No. 109, *Accounting for Income Taxes*, under which deferred taxes are based on the asset and liability method. The implementation of SFAS 109 had no significant impact on PRTA's results of operations for fiscal year 1993 or prior years.

On August 10, 1993, the President of the United States signed into law The Omnibus Budget Reconciliation Act of 1993 (the Act). The Act enacts significant tax changes including a provision that the Section 936 credit allowed to a possession corporation for a taxable year against US tax on its business income would be computed as under present laws, but would be subject to one of two alternative limitations. The choice of which alternative limitation to apply would be made by the PRTA. The anticipated effect of this provision, which is effective for fiscal years commencing after December 31, 1993, has not been determined.

### **Puerto Rico Industrial Development Company (PRIDCO)**

PRIDCO is party to various claims and lawsuits relating, among other matters, to the Federal Environmental Protection Agency and the Environmental Quality Board of the Commonwealth. These claims and lawsuits include various environmental issues where PRIDCO may be held liable under the Comprehensive Environmental Response, Compensation and Liability Act of 1980 (CERCLA) and other federal legislation including the Clean Water Act and the National Pollutants Discharge Elimination (NPDES). CERCLA establishes procedures and standards for responding to releases of hazardous substances, pollutions and contaminants.

Under CERCLA and its regulations, liability for the clean-up costs from damage to natural resources and any health assessment or health effects may be imposed on the present and past owner or operator of a facility from which there was a release of hazardous substances in addition to any person who arranged for disposal or treatment of hazardous substances at a site from which there was a release.

### **Puerto Rico Ports Authority (PRPA)**

At June 30, 1994, PRPA was not in compliance with the provision of attaining net revenues at a minimum of 125% of the maximum aggregate principal and interest requirement. PRPA's management communicated this situation to its transportation consultants and is in the process of implementing a cost reduction program as required by the trust indenture agreement and recommended by the transportation consultants. In addition, effective September 1, 1994, PRPA increased the rates and fees for the maritime operations and on January 1, 1995 increased airplane landing fees.

### **Commercial and Agricultural Credit and Development Corporation**

The Corporation is the defendant in various lawsuits assumed from the former Commercial Development Company (the Company) for alleged negligence, brought by insurance companies in connection with a fire at Mercado Central Phase I in March 1981. These lawsuits involve various defendants and a series of cross claims and counter claims instituted against the Company for approximately \$32 million including legal fees and interest. Management of the Corporation, after consultation with legal counsel, recorded a provision in the Corporation's financial statements for the estimated liability that could result from these legal cases.

### **Automobile Accident Compensation Administration (AACCA)**

As of June 30, 1994, the Automobile Accident Compensation Administration is defendant in a lawsuit filed by a professional services firm for alleged-unpaid additional work related to a professional contract. The suit asks for damages totaling approximately \$10.6 million. AACCA's management and its legal advisor believe the suit is without merit and are vigorously defending its position.

### **Land Authority of Puerto Rico (LAPR)**

LAPR owns agricultural lands, mills and refinery which are operated by its subsidiary, the Sugar Corporation of Puerto Rico, a discretely presented component unit. These assets and the related debt incurred in their acquisition are recorded in the books of the subsidiary which has assumed responsibility for payment of principal and interest on the loans, as well as all other expenses incidental to ownership, including property taxes and repairs and maintenance. LAPR is contingently liable to third parties for loans which are secured by properties transferred to the Sugar Corporation of Puerto Rico and guaranteed by the Commonwealth.

LAPR is a defendant under a claim brought by a group of pineapple growers amounting to approximately \$43 million. LAPR is in the process of litigating these actions, but the ultimate outcome cannot be presently determined due to the stage of proceedings. Accordingly, no provisions for any liability that may result upon a final resolution of these actions has been made in the financial statements of LAPR.

The Pineapple Program has incurred substantial losses in recent years. The Commonwealth is negotiating with private investors the sale of the Pineapple Program. The effect, if any, that the sale of the program may have on the LAPR's financial statements has not been determined.

#### **Puerto Rico Industrial, Tourist, Educational, Medical and Environmental Control Facilities Financing Authority (AFICA)**

AFICA has sold, since inception, revenue bonds aggregating approximately \$3,432 million, of which \$2,637 million remain outstanding as of June 30, 1994. The revenue bonds do not constitute a debt or a pledge of the good faith and credit of AFICA or the Commonwealth or any political subdivision thereof (non-commitment debt). However, the Government Development Bank for Puerto Rico (GDB), an internal service fund, and one of its subsidiaries have issued a letter of credit and a guarantee totaling \$140 million in connection with two tourism related revenue bond issuances.

#### **Caribbean Basin Projects Financing Authority (CBPFA)**

Since inception and up to June 30, 1994, CBPFA has sold revenue bonds aggregating approximately \$522 million all of which were outstanding at June 30, 1994. Pursuant to the loan agreements covering the issuances of these bonds, the proceeds from the sales were borrowed from CBPFA by corporations and partnerships operating in qualified Caribbean Basin countries. The revenue bonds are special and limited obligations of the CBPFA and, except to the extent payable from bond proceeds and investments thereof, will be payable solely from and secured by a pledge and assignment of the amounts payable under the loan agreements between the CBPFA and the borrowers. Furthermore, payment of the principal and interest on the revenue bonds is unconditionally guaranteed by the borrowers, their parent companies and/or letters of credit from major United States banks or United States branches of international banks. The revenue bonds do not constitute a debt or a pledge of the good faith and credit of CBPFA or the Commonwealth or any political subdivision thereof (non-commitment debt).

#### **Corporation of Stocks and Deposit Insurance for the Savings and Loans Cooperatives (CSDISLC)**

CSDISLC is a defendant in a case where the plaintiffs claim \$10 million in damages allegedly suffered due to the imposition by CSDISLC of a special premium and request that the special premium be deemed illegal and therefore eliminated. Management, based on advice from legal counsel, believes that CSDISLC will be able to successfully defend this case. However, the amount of approximately \$5.3 million regarding the special premium assessed to the insured cooperatives has been recorded as deferred revenue in CSDISLC's balance sheet until a final determination is reached by the Superior Court of Puerto Rico.

CSDISLC and the insured cooperatives hold certain cash and cash equivalents and investments in equity in the Cooperative Bank. The Cooperative Bank incurred an operating loss of approximately \$14 million in 1993 and had a stockholders' deficiency of approximately \$7.4 million at December 31, 1993, according to its latest audited financial statements. The financial condition of CSDISLC and the insured cooperatives could be adversely affected if the Cooperative Bank is not able to continue as a going concern because these entities could potentially be unable to recover the carrying value of their deposits and investments in the Cooperative Bank. In June, 1994, the Legislative Assembly authorized the

Commonwealth to guarantee the payment of debt securities to be issued by the Cooperative Bank, up to a maximum of \$10 million. This guarantee became effective in the amount of \$8.3 million when an additional investment in common stock for the same amount was made by the Cooperative Bank's stockholders. This guarantee will be in effect for a period of 10 years. Management is of the opinion that the ultimate effect resulting from this condition will not have a material effect on CSDISLC's financial condition.

Under the terms of certain merger agreements for troubled cooperatives, CSDISLC has agreed to repurchase certain assets. At June 30, 1994, the loan portfolios sold subject to recourse had a remaining unpaid principal balance of approximately \$30.3 million, which is the amount of potential risk associated with these particular loans. Certain loans are collateralized and the recourse provisions range for periods of 1 to 3 years. CSDISLC has established a loss reserve to cover this exposure.

## 15. RETIREMENT SYSTEMS

The Commonwealth has three contributory defined benefit pension plans:

- Employees' Retirement System of the Government of Puerto Rico and Its Instrumentalities (ERS),
- Puerto Rico Judiciary Retirement System (JRS), and
- Annuity and Pension System for the Teachers of Puerto Rico (TRS).

The audited financial statements for ERS and JRS, as well as the unaudited financial statement for TRS, are presented in the fiduciary funds. Each system is independent. Assets may not be transferred from one system to another or used for any purpose other than to benefit each system's participants. In addition, the University of Puerto Rico Retirement System audited financial statements are included in the public university funds.

The pension plans engaged from time to time in securities lending transactions as authorized by local laws and regulations. Credit risk is controlled and monitored by the securities brokers and dealers contracted by the pension plans.

### Plan Descriptions

#### A. Employees' Retirement System of the Government of PR and Its Instrumentalities (ERS)

The Employees' Retirement System of the Government of Puerto Rico and Its Instrumentalities (ERS) is the administrator of a cost-sharing multiple-employer retirement system established by the Commonwealth. The System was created under Act 447, approved on May 15, 1951, as amended, and became effective on January 1, 1952. ERS covers all regular employees of the Commonwealth and its instrumentalities and of certain municipalities and components units not covered by their own retirement systems.

Employees include those in the following categories:

- Police of Puerto Rico
- Justices of the Peace of Puerto Rico
- Members and employees of the Legislature
- Officers and employees of the Government of Puerto Rico, most components units and municipalities
- Members of the Employees Association of the Commonwealth of Puerto Rico
- Irregular employees fulfilling the requirements of a regular employee

Participation is mandatory except for members of the Legislature, Government Secretaries, Heads of Agencies and Public Instrumentalities, Assistants to the Governor, the Comptroller of Puerto Rico, Gubernatorial Board and Committee appointees and Experimental Service Station employees.

The System provides retirement, death and disability benefits. Disability retirement benefits are available to members for occupational and non-occupational disabilities. Retirement benefits depend upon age at retirement and number of years of credited service. Benefits vest after ten years of plan participation.

Members who have attained an age of at least fifty-five (55) years and have completed at least twenty-five (25) years of creditable service or members who have attained an age of at least fifty-eight (58) years and have completed at least ten (10) years of creditable service, are entitled to an annual benefit, payable monthly for life.

The amount of the annuity shall be one and one-half percent of the average compensation multiplied by the number of years of creditable service up to twenty years, plus two percent of the average compensation multiplied by the number of years of creditable service in excess of twenty years. In no case will the annuity be less than \$200 per month.

Participants who have completed at least thirty years of creditable service are entitled to receive the Merit Annuity. Participants who have not attained fifty-five (55) years of age will receive 65% of the average compensation or if they have attained fifty-five (55) years of age will receive 75% of the average compensation. Disability retirement benefits are available to members for occupational and non-occupational disability. However, for non-occupational disability a member must have at least ten (10) years of service.

No benefit is payable if the participant receives a refund of his accumulated contributions.

Commonwealth legislation requires employees to contribute 5.775% for the first \$550 of their monthly gross salary and 8.275% for the salary in excess of \$550. The Commonwealth contributions are 9.275% of gross salary. Contributions requirements are established by law. Total employee and employer contributions during the year ended June 30, 1994 amounts to approximately \$150 million and approximately \$191 million, respectively. Total payroll covered for the year was approximately \$1.9 billion.

Act number 1 dated February 16, 1990, made certain amendments applicable to new participants joining the System effective on April 1, 1990. Changes mainly consisted of an increase of the retirement age to 65 years, the elimination of the Merit Annuity and a reduction of the percentage for disability and death benefits.

#### **B. Puerto Rico Judiciary Retirement System (JRS)**

The Puerto Rico Judiciary Retirement System (JRS) is a single-employer defined benefit plan which is administered by the ERS. The System was created under Act 12, approved on October 19, 1954. The membership includes all individuals holding a position as Justice of the Supreme Court, Judge of the Superior Court or the District Court or Municipal Judges of the Commonwealth of Puerto Rico. The System provides retirement as well as death and disability benefits.

Participants are entitled to a retirement pension if they have reached the age of 60 and have at least 10 years of creditable service. The retirement pension of any participant shall be equal to 25% of final average salary during the last three years of creditable service plus 25/72 of one percent of the said average salary during the last three years for each month of creditable service in excess of 10 year of service. Effective July 28, 1993, percentages increased to 5% for credited service in excess of 10 years. The retirement pension shall not exceed 75% of the final average salary for the last three years.

All participants are required to make contributions to the plan equal to 8% of gross salary. The Commonwealth must contribute 20% of the applicable payroll. For the year ended June 30, 1994, judges made contributions, amounting to approximately \$1.3 million. The amount contributed by the Commonwealth was approximately \$3 million. Payroll covered for the year was approximately \$12.6 million. Contribution requirements are established by law. Benefits vest after 10 years of credited service.

**C. Annuity and Pension System for the Teachers of Puerto Rico (TRS)**

The Annuity and Pension System for the Teachers of Puerto Rico (TRS) is a cost-sharing multiple-employer plan which was created under Act 218 approved on May 6, 1951.

TRS provides retirement benefits to all teachers of the Department of Education of the Commonwealth, those holding positions in the Retirement Board, all pensioned teachers, all teachers transferred to an administrative position in the Department of Education, teachers who work in the Teachers' Association of Puerto Rico, and those who practice in private institutions accredited by the Department of Education.

The Plan provides retirement, death and disability benefits. Members are eligible for retirement benefits upon:

- (a) completion of 30 years of credited service, or
- (b) attainment of age 52 and completion of 25 years of credited service or
- (c) attainment of age 60 and completion of 10 years of credited service.

The amount of the annuity shall be computed based on the teacher's final average salary, which is the highest salary over three years. The minimum service annuity is \$300 per month and the maximum is 75% of final average salary. Benefits vest after ten years of plan participation.

Participants must have at least five years of creditable service to be eligible for a non-occupational disability pension.

The disability retirement annuity is 1.8% of final average salary times years of credited service, but not less than the amount payable as a service retirement annuity.

A member should contribute to the plan with 7% of its total salary. The Commonwealth matches the member's contribution at a rate of 8.5% of total salary. For the year ended June 30, 1994, the unaudited employees and employer's contributions amounted to \$51.7 and \$62.8 million respectively. Total payroll covered for the year was approximately \$781 million.

### Funding Status and Progress

The pension benefit obligation is a standardized disclosure measure of the present value of defined pension benefits, adjusted for the effects of projected salary increases and step-rate benefits, estimated to be payable in the future as a result of employee service to date. The measure is the actuarial present value of credited projected benefits and is intended to help users access funding status on a going-concern basis, assess progress made in accumulating sufficient assets to pay benefits when due, and make comparisons with other public retirement systems. The measure is independent of the actuarial funding method used to determine contributions to the plans.

The following table presents the date of the most recent actuarial valuation used to determine the pension benefit obligation and significant assumptions used in the actuarial valuation:

|  | <u>ERS</u>    | <u>JRS</u>    | <u>TRS</u>    |
|--|---------------|---------------|---------------|
| Date of latest actuarial valuation                     | June 30, 1994 | June 30, 1994 | June 30, 1992 |
| Significant assumptions:                               |               |               |               |
| Investment rate of return per year                     | 8.5%          | 8.5%          | 8%            |
| Salary increases due to inflation, merit and longevity | 5%            | 5%            | 6%            |
| Mortality rates table                                  | GA'51         | GA'51         | GA'83         |

The standardized measure of the unfunded pension benefit obligation as of June 30, 1994 for the ERS, JRS and TRS is as follows (expressed in thousands):

|   | <u>ERS</u>         | <u>JRS</u>      | <u>TRS</u><br><u>(Unaudited)</u> |
|---|--------------------|-----------------|----------------------------------|
| Pension benefit obligation:   |                    |                 |                                  |
| Retirees and beneficiaries currently receiving benefits and terminated employees not yet receiving benefits | \$2,888,000        | \$ 37,000       | \$1,146,022                      |
| Current employees:  |                    |                 |                                  |
| Accumulated employee contributions, including allocated investment income                                   | 1,128,000          | 8,600           | 1,520,353                        |
| Employer-financed vested  | 1,428,000          | 11,100          | 441,825                          |
| Employer-financed nonvested   | <u>98,000</u>      | <u>2,200</u>    | <u>209,755</u>                   |
| Total pension benefit obligation  | <u>\$5,542,000</u> | <u>\$58,900</u> | <u>\$3,317,955</u>               |

|  | <u>ERS</u>         | <u>JRS</u>       | <u>TRS</u><br><u>(Unaudited)</u> |
|--|--------------------|------------------|----------------------------------|
| Total pension benefit obligation   | \$5,542,000        | \$58,900         | \$3,317,955                      |
| Net assets available for benefits, at market<br>for ERS and JRS, and at cost for TRS | <u>953,626</u>     | <u>35,607</u>    | <u>1,231,402</u>                 |
| Unfunded pension benefit obligation  | <u>\$4,588,374</u> | <u>\$ 23,293</u> | <u>\$2,086,553</u>               |

The membership at June 30, 1994 of ERS, JRS and TRS consisted of:

|  | <u>ERS</u>     | <u>JRS</u> | <u>TRS</u><br><u>(Unaudited)</u> |
|--|----------------|------------|----------------------------------|
| Retirees and beneficiaries currently<br>receiving benefits and terminated<br>employees entitled to benefits,<br>but not yet receiving benefits | 57,556         | 211        | 13,365                           |
| Active employees   | <u>151,935</u> | <u>248</u> | <u>48,734</u>                    |
| Total members  | <u>209,491</u> | <u>459</u> | <u>62,099</u>                    |

The distribution of active employees between vested and nonvested is not readily available.

#### Contributions Made and Actuarial Computation

Contributions in 1994 and prior years were made based on percentages established by the law. Such percentages have not been based on actuarial studies. An actuarial computation of the annual contribution applicable to the Commonwealth as of June 30, 1994 have not been prepared. Accordingly, the amounts by which the actual contributions are under the required actuarial contribution are not known.

#### Trend Information

Historical trend information gives an indication of the progress made in accumulating sufficient assets to pay benefits when due. An analysis of funding progress for the three latest available years is presented below:

|   | <u>ERS</u> | <u>JRS</u> | <u>TRS</u><br><u>(Unaudited)</u> |
|---|------------|------------|----------------------------------|
| Net assets available for benefits as a percentage<br>of total pension benefit obligation: |            |            |                                  |
| June 30, 1994   | 17%        | 60%        | N/A                              |
| June 30, 1993   | 18%        | 64%        | N/A                              |
| June 30, 1992   | 18%        | 61%        | 37%                              |
| Unfunded pension benefit obligation as a<br>percentage of annual covered payroll:         |            |            |                                  |
| June 30, 1994   | 245%       | 185%       | N/A                              |
| June 30, 1993   | 230%       | 158%       | N/A                              |
| June 30, 1992   | 236%       | 158%       | 267%                             |

|  | <u>ERS</u> | <u>JRS</u> | <u>TRS</u><br><u>(Unaudited)</u> |
|--|------------|------------|----------------------------------|
| Employer contributions (not actuarially determined) as a percentage of annual covered payroll: |            |            |                                  |
| June 30, 1994  | 10%        | 24%        | N/A                              |
| June 30, 1993  | 10%        | 22%        | N/A                              |
| June 30, 1992  | 10%        | 19%        | 8.5%                             |

N/A = Not Available

For a ten-year trend information, refer to the separately issued financial statements of ERS and JRS. The information for TRS is unaudited and the ten year trend information is not readily available.

On May 21 and September 4, 1992, the Legislature approved through Acts No. 10 and 62, respectively, a 3% increase in the annual pension benefit paid by the ERS and TRS, respectively. This increase was applied retroactively to January 1992 and will be in effect for the next three years. Subsequently, the annual pension benefit may be increased upon favorable recommendation by the Systems' actuaries and Board of Trustees.

The Commonwealth did not obtain an actuarial update for the TRS as required by GASB Statement 5, *Disclosure of Pension Information by Public Employee Retirement Systems and State and Local Governmental Employers*.

#### **D. University of Puerto Rico Retirement System - Plan Description**

The University of Puerto Rico (the University) contributes to the University of Puerto Rico Retirement System (the System), a single-employer defined benefit public employee retirement system that acts as a common investment and administrative agent for the University. The System is the administrator of the plan created under Act No. 135, approved on May 7, 1942, and became effective on January 1, 1945. The University's payroll for employees covered by the System for the year ended June 30, 1994 was approximately \$233 million.

All full-time employees and employees contracted for a period of 9 months by the University are eligible to participate in the System. Benefits vest after 10 years of service. University employees who retire at or after age 58 with 10 years of credited service are entitled to an annual retirement benefit, payable monthly for life, in an amount equal to 15% of their average compensation for the highest 36 months. Maximum benefits equal to 75% of average compensation generally require 30 years of service and attainment of age 55. The System also provides death and disability benefits. These benefit provisions and all other requirements are established by law.

University employees are required to contribute 4% to 8% of their annual salary to the System. The University is required to contribute 14% of applicable payroll.

Certain amendments have been made to the System's plan for which the actuaries are suggesting increasing the University's contributions to 15% and 16% for years ending June 30, 1995 and 1996, respectively, and the increase in pension benefits of 3% increase the maximum annual compensation, and in the Christmas bonus. These changes have resulted in a significant increase of the pension benefit obligation.

### Funding Status and Progress

The pension benefit obligation was computed as part of an actuarial valuation performed as of June 30, 1993. Significant actuarial assumptions used in the valuation include (a) a rate of return on the investment of present and future assets of 7.5% a year compounded annually, (b) projected salary increases of 5% a year compounded annually, (c) mortality rates based on UP-1984 Group Annuity Mortality Table. The information as of June 30, 1994 was prepared by the actuaries by projecting the results of the actuarial valuation performed by them as of June 30, 1993.

Total unfunded pension benefit obligation applicable to the University's employees at June 30, 1994 follows (expressed in thousands):

|  |                   |
|--|-------------------|
| Pension benefit obligation:  |                   |
| Retirees, beneficiaries, and terminated employees not yet receiving benefits | \$ 352,200        |
| Current employees:   |                   |
| Accumulated employee contributions including allocated investment earnings   | 127,563           |
| Employer-financed vested   | 237,145           |
| Employer-financed non-vested   | <u>54,181</u>     |
| Total pension benefit obligation   | 771,089           |
| Net assets available for benefits, at market value                           | <u>344,778</u>    |
| Unfunded pension benefit obligation  | <u>\$ 426,311</u> |

### Actuarially Determined Contribution Requirements and Contributions Made

The System's funding policy requires actuarially determined periodic contributions at rates that, for individual employees, increase gradually over time so that sufficient assets will be available to pay benefits when due. However, the contributions are made on a predetermined basis instead of the actuarially determined basis.

The actuarial valuation as of June 30, 1994 revealed an actuarially accrued liability of approximately \$771 million and an unfunded accrued liability of approximately \$426 million. During the year the University contributed approximately \$35.2 million to its retirement plan and recognized such amount as expenditure. The required contribution was approximately \$38.5 million. The difference of approximately \$3.3 million has not been accrued in the public university funds as required by generally accepted accounting principles. If such amount had been accrued together with prior years cumulative unfunded amount, the expenditures and accrued liabilities in the public university funds would have increased and the fund balance decreased by approximately \$170 million.

### Trend Information

Trend information gives an indication of the progress made in accumulating sufficient assets to pay benefits when due. For the year ended June 30, 1994 assets were sufficient to fund 44.7% of the pension benefit obligation. Unfunded pension benefit obligation represented 182.8% of the annual payroll for employees covered by the System. Showing unfunded pension benefit obligation as a percentage of annual covered payroll approximately adjusts for the effects of inflation for analysis purposes. For a five-year historical trend, refer to the separately issued System's financial statements.

An analysis of funding progress for the three latest years is presented below:

|   | 1994   | June 30<br>1993 | 1992   |
|---|--------|-----------------|--------|
| Net assets available for benefits as a percentage of total pension benefit obligation         | 44.7%  | 46.2%           | 46.2%  |
| Unfunded pension benefit obligation as a percentage of annual covered payroll                 | 182.8% | 180.1%          | 162.1% |
| Employer contributions (not actuarially determined) as a percentage of annual covered payroll | 14.6%  | 14.6%           | 13.4%  |

## 16. SEGMENT INFORMATION - Proprietary Funds

The proprietary funds are composed of the following entities which generally follow the accrual basis of accounting:

### Enterprise Funds

#### **Health Facilities and Services Administration of Puerto Rico (HFSA) (Unaudited)**

Health Facilities and Services Administration of Puerto Rico (HFSA) was created as an executive agency in 1975 to lease and operate hospitals and other health facilities and to provide for the improvement, alteration or repair of such facilities. HFSA is authorized to borrow money and issue notes or other obligations for the purpose of financing the costs of improvements and providing health services to the general public. Patients, admitted to an institution under the jurisdiction of HFSA who are indigent, receive hospital and medical services free of charge; otherwise, payments for services rendered are required.

Advances from other funds mainly consist of a loan for approximately \$326 million from the Government Development Bank for Puerto Rico (GDB), an internal service fund, to refinance an existing loan, provide additional resources for the purchase of equipment and rehabilitation of certain public hospitals, and to provide resources for the payment of outstanding debts. The loan is payable in semiannual installments commencing on July 1, 1993 and bears interest at 8%.

#### **Lottery of Puerto Rico**

The Lottery of Puerto Rico (the Lottery) was created under Law No. 465 of May of 1947. The Lottery is an operational unit of the Commonwealth of Puerto Rico Treasury Department and is engaged in the sale of tickets to authorized agents throughout the Commonwealth. It was created to help those authorized agents with an additional source of revenues and to supplement revenues for the general fund of the Commonwealth. The revenues obtained by the Lottery from the sale of tickets are distributed pursuant to the approved budget to cover the payment of prizes and general and administrative expenses. The excess of revenues over prizes and expenses must be transferred to the general fund of the Commonwealth.

## The Additional Lottery System

The Additional Lottery System was created by Law No. 10 of May 24, 1989, as amended, and commenced operations on June 1, 1990. The Additional Lottery is an operational unit of the Commonwealth of Puerto Rico Treasury Department. Presently, two games (Pick 3 and Lotto) with several betting alternatives are offered by the Additional Lottery. Also, Law No. 10 requires the Additional Lottery to remit the excess of revenues over expenses to the Commonwealth. Deficits are not allowed to be offset against the excess of revenues over expenses. Remittances are earmarked as follows: 5% of the excess of revenues over expenses (net revenues) to a Contingency fund, 35% of remaining balance to the Municipal Autonomy fund, and the rest to the Commonwealth. All prize winners have 180 days to claim their prizes. After 180 days unclaimed prizes are transferred to the Commonwealth; during 1994, such transfers approximated \$5 million.

## Puerto Rico Highway and Transportation Authority (Enterprise fund only)

The Puerto Rico Highway and Transportation Authority (PRHTA) is a blended component unit of the Commonwealth, created by Act No. 74 of June 23, 1965, as amended, to provide roads and other transportation facilities for the planning, promotion and feasibility of mass transportation systems. The powers normally exercised by a Board of Directors are vested with the Commonwealth's Secretary of the Department of Transportation and Public Works (DTPW). PRHTA is exempt from the payment of any taxes on its revenues and properties.

Segment information for the enterprise funds is as follows (expressed in thousands):

|                                | HFS<br>(Unaudited) | Lottery<br>of PR | Additional<br>Lottery | PRHTA    |
|--------------------------------|--------------------|------------------|-----------------------|----------|
| Operating revenues             | \$ 111,317         | \$457,968        | \$224,737             | \$ 2,634 |
| Depreciation and amortization  | 11,843             |                  | 22                    | 667      |
| Operating income (loss)        | (812,908)          | 65,923           | 87,666                | (2,531)  |
| Non-Operating revenues, net:   |                    |                  |                       |          |
| Operating transfers-in (out)   | 718,757            | (62,747)         | (87,666)              | 1,864    |
| Net income (loss)              | (94,151)           | 3,176            | -0-                   | (677)    |
| Current capital contribution   |                    |                  |                       | 677      |
| Property, plant and equipment: |                    |                  |                       |          |
| Additions and adjustments      | 14,639             | 209              | 48                    | 361,536  |
| Deletions and adjustments      |                    |                  |                       | 3,494    |
| Total assets                   | 302,666            | 37,602           | 109,601               | 6,322    |
| Total equity (deficit)         | (480,255)          | 8,672            | (1,365)               | 6,322    |

## Internal Service Funds

### Government Development Bank for Puerto Rico and Subsidiaries

Government Development Bank for Puerto Rico and Subsidiaries (GDB) was created as a public corporation in 1948 to act as fiscal agent for the Commonwealth and its components units and to make loans to components units and private enterprises which will further the economic development of Puerto Rico.

## Public Buildings Authority

Public Buildings Authority (PBA) was created as a public corporation in 1958 to design and construct office buildings, courts, schools, health facilities, warehouses and related facilities for lease to the Commonwealth or any of its departments, agencies, instrumentalities, components units or to the municipalities of Puerto Rico and to finance and construct schools, healthcare, jails, and social welfare facilities. The annual rent for each building leased is computed based on the amounts needed by PBA for: (1) principal, interest and other amortization requirements of the notes and bonds issued to finance the buildings; (2) operating and maintenance expenses of the buildings, including a reasonable proportional share of PBA's administrative expenses, excluding depreciation; (3) cost of equipment replacement and other noncurrent operating and maintenance costs; and (4) reserve for such purposes. Rentals for operating and maintenance expenses, together with equipment replacement, are subject to escalation to permit PBA to recover costs in these areas.

## Puerto Rico Land Administration

The Puerto Rico Land Administration (PRLA) was created to promote the welfare of the community through efforts and programs designed for the efficient utilization of the land in Puerto Rico. Among its programs, PRLA acquires, through negotiation or expropriation, parcels of land on behalf of government instrumentalities, for future development or for reserve.

Segment information for the internal service funds is as follows (expressed in thousands):

|  | Government<br>Development Bank<br>for Puerto Rico | Public<br>Buildings<br>Authority | Puerto Rico<br>Land<br>Administration |
|--|---|----------------------------------|---------------------------------------|
| Operating revenues                     | \$388,173   | \$ 175,373                       | \$15,248                              |
| Depreciation and amortization          | 2,637   | 18,984                           | 1,209                                 |
| Operating income                       | 72,382  | 6,566                            | 4,901                                 |
| Non-operating income                   | 37,747  | 15,975                           | 246                                   |
| Operating transfers-in                 |   | 479                              |                                       |
| Net income                             | 110,129   | 23,020                           | 5,147                                 |
| Transfers to contributed capital       | (125,000)   |                                  |                                       |
| Transfers from contributed capital     |   | 41,065                           |                                       |
| Property, plant and equipment:         |   |                                  |                                       |
| Additions and adjustments              |   | 67,707                           | 1,149                                 |
| Retirements and adjustments            |   | 8,779                            |                                       |
| Total assets                           | 7,451,208   | 1,372,356                        | 214,715                               |
| Bonds and other long-term liabilities: |   |                                  |                                       |
| Payable from operating revenues        | 2,538,872   | 1,189,065                        | 5,000                                 |
| Total equity                           | 956,045   | 14,256                           | 137,135                               |

Intra-fund loans from GDB to PBA and PRLA for approximately \$89 million were eliminated for financial reporting purposes in the combined balance sheet.

## 17. SUBSEQUENT EVENTS

### Primary Government

On October 31, 1994, the Commonwealth enacted Law No. 120, *Puerto Rico Internal Revenue Code of 1994* (the Code). The Code's main purpose is to compile, in a single volume, all laws and regulations governing the Commonwealth's internal revenues. As part of this change, the Commonwealth approved the *Income Tax Reform of 1994* (the Reform), included as Subtitle A of the Code, which substantially revises the Puerto Rico income tax regulations including, among others, the reduction of income tax rate to certain taxable income brackets, and modifications of certain deductions in the tax returns for the calendar year ending December 31, 1995. The Commonwealth estimates a reduction of income tax revenues in the general fund of approximately \$347 million for fiscal year 1995-96.

The Commonwealth has preliminary approved and intends to issue \$325 million of 1995 Public Improvements Bonds in May, 1995. The net proceeds of the issuance will be substantially used to finance the construction of public structure.

On July 20, 1994, the Board of Trustees of the Employees' Retirement System of the Government of Puerto Rico and its Instrumentalities (ERS), authorized the issuance of Collateralized Promissory Notes (the Notes) to generate additional funds to carry out the investment objectives and to improve the investment portfolio. The Notes cannot exceed, in an aggregate principal amount, \$200 million outstanding at any time, and a term to maturity up to 90 days so that at the end of each quarter the outstanding balance equals zero. The Notes will be secured by a pledge on ERS's securities. The Government Development Bank for Puerto Rico (GDB), an internal service fund, will act as ERS's agent for selling the Notes, effecting the pledge on the securities, securing them, investing their proceeds and acting as custodian of the securities purchased with the proceeds. GDB will issue and sell the Notes through brokers and record the transfer of and make payments of principal and interest on the Notes, all under such terms and conditions, and at such interest rates and prices, as GDB shall consider to be in the best interest of ERS. In connection with such issuance, GDB will pay a commission from the proceeds of the Notes to these brokers, in an amount to be determined. On December 14, 1994, the Board of Trustees changed the maximum principal amount from \$200 million to \$400 million. In addition, on December 14, 1994, the Board of Trustees approved the sale of the portfolio of the FNMA Guaranteed Mortgage Pass-Through securities acquired during March 1994. The net proceeds will be invested in short-term and liquid securities. GDB will also act as sales agent and will manage the investment portfolio.

On July 28, 1994, the Commonwealth approved the appropriation of \$110 million from the following four fiscal years' budget to aid the Puerto Rico Aqueduct and Sewer Authority, a discretely presented component unit, in its capital improvements program, and to subsidize its operations. On the same date, the Commonwealth enacted Law No. 45 providing guarantees for the payment of the principal and interest of the outstanding bonds payable by the Puerto Rico Aqueduct and Sewer Authority, as of July 28, 1994, which approximates \$388 million, as well as any refunding bonds or other obligations issued subsequently.

On August 11, 1994, the Government Development Bank for Puerto Rico (GDB), an internal service fund, approved a loan for the Commonwealth for approximately \$284.4 million to repay property taxes owed to the municipalities of Puerto Rico.

On August 12, 1994, the Commonwealth enacted a law authorizing the Secretary of the Treasury to take a loan of \$25 million from the Government Development Bank for Puerto Rico (GDB), an internal service fund, to comply with the requirements of Law 89, of July 12, 1979, *Uniform Compensation Law*, to pay certain back-pay to the employees of the Puerto Rico Department of Education.

On October 24, 1994, the Commonwealth, through GDB, approved a loan for the Puerto Rico Industrial Development Company for \$16 million, which will be due on September 30, 1995. The source of payment will be from legislative appropriations for fiscal year 1995-96.

On December 13, 1994 the Commonwealth enacted Law No. 134 to transfer all public housing buildings (with an unaudited book value of approximately \$1,369 million) from the liquidated Puerto Rico Urban Renewal and Housing Corporation, (a liquidated component unit), to the Puerto Rico Public Housing Administration, which is part of the primary government. As part of the transfer, the Commonwealth will assume liabilities for approximately \$238 million in bonds outstanding. In addition, the Commonwealth waived approximately \$123 million on advances made by the Commonwealth to the now liquidated entity, in compensation for the transfer of the buildings.

The Commonwealth has preliminarily approved the appropriation of approximately \$4.7 million from available resources for the Puerto Rico Ports Authority (PRPA), a discretely presented component unit, to improve its financial condition. In addition, on December 23, 1994, the Government Development Bank for Puerto Rico, an internal service fund, approved a \$20 million loan to PRPA for the payment of certain liabilities. PRPA shall repay this loan in semestral installments for six years, except for \$5 million that shall be appropriated by the Commonwealth during fiscal year 1994-95.

Effective July 1, 1994, Puerto Rico Land Administration transferred the Rio Camuy Cave Park's assets, as well as the rights, obligations and personnel, to the Trust for the Development, Operation and Conservation of National Parks. The transfer is at no cost. This transfer will result in a reduction of capital of approximately \$8.6 million. Under the agreement, the Administration will contribute, if necessary, up to \$400,000, in quarterly installments of \$100,000, to cover the Park's losses in fiscal 1994-1995. Provision has been made in the financial statements of the Puerto Rico Land Administration for the expected contributions.

### Component Units - Other

#### **Puerto Rico Aqueduct and Sewer Authority (PRASA) (Unaudited)**

On July 28, 1994, the Legislature signed Law No. 45 (the Law) and Joint Resolution No. 298 (Joint Resolution) through which the Commonwealth guarantees the principal, premium and interest payments to the bondholders of all outstanding bonds issued by PRASA at the effective date of this law (approximately \$388 million) and of all future bond issued or any other obligations incurred by PRASA to refinance all outstanding bonds covered by the guarantee. According to the Law, if PRASA's funds are not available for bond payments of principal, premium and interest, the Commonwealth will provide such funds to cover all required payments.

Also, PRASA will receive, through the Joint Resolution, a subsidy from the Commonwealth of \$20 million, \$25 million, \$30 million and \$35 million for fiscal years ending 1995, 1996, 1997 and 1998 respectively, to contribute with PRASA's financial and operational restructuring.

### **Sugar Corporation of Puerto Rico (SCPR)**

In February 1995, the Commonwealth began the process of selling through competitive bids, the Sugar Corporation of Puerto Rico to a group of private investors for approximately \$24 million. After the sale, the Commonwealth will continue indefinitely subsidizing the SCPR with annual appropriations of at least \$5 million. The Commonwealth will also guarantee loans made to tenant farmers for approximately \$15 million and make annual payments of \$564,000 through 1997 to amortize an existing loan.

### **Puerto Rico Housing Bank and Finance Agency (PRHBFA)**

In July, 1994, PRHBFA issued \$125 million in Affordable Housing Mortgage Subsidy Program Collateralized Mortgage Revenue Bonds to provide funds for a program under which PRHBFA will purchase FNMA certificates backed by pools of mortgage loans to be made by participating lending institutions to low and moderate income families to finance the purchase of qualified singled family residential housing in Puerto Rico.

In September, 1994, PRHBFA issued Loan Insurance Claim Refunding Bonds to provide funds for the advance refunding of approximately \$80.9 million of outstanding Loan Insurance Claim Bonds; and Subsidy Prepayment Refunding Bonds to provide advance refunding of approximately \$301 million of Subsidy Prepayment Bonds. The Loan Insurance Claim Bonds were issued for providing funds for the payment of certain insurance obligations of PRHBFA guaranteed by the Commonwealth related to interim construction loans. The Subsidy Prepayment Bonds were issued for the purpose of providing funds for the prepayment of certain home mortgage subsidy obligations of the Department of Housing of the Commonwealth to benefit low and moderate income families in Puerto Rico. The proceeds from the Refunding Bonds were used to purchase and deposit in escrow certain US Government securities to provide debt service payments until the maturity of the refunded bonds. The principal and interest of the Loan Insurance Claim Refunding Bonds and the Subsidy Prepayment Refunding Bonds are payable from and secured by all amounts appropriated by the Legislature of the Commonwealth for payment of the bonds principal and interest and paid by the Secretary of the Treasury for such purpose and a pledge and assignment of all rights, title and interest of the PRHBFA in and to all monies and securities in the funds and accounts established under the Loan Insurance Claims Bond Indenture.

### **Right to Employment Administration (REA)**

Beginning on July 1, 1994, REA had a reduction of Job Training Partnership Act (JTPA) funds of approximately \$54 million. REA will receive only JTPA funds for the Program Titles III, II-A 5% and II-A 3%. The funds previously provided to REA will be used directly by the municipal consortiums who now will administer such programs.

### **Office for the Liquidation of the Accounts of the Puerto Rico Urban Renewal and Housing Corporation**

On December 13, 1994, the Commonwealth approved Act No. 134, which authorized the transfer of the low income housing projects constructed by PRURHC with the Federally - Assisted Low Income Housing Program (Tittle III) to the Puerto Rico Public Housing Administration, the actual administrator of the Title III Program; and the General Obligation Bonds Payable to the Puerto Rico Treasury Department. According to the act, the value of assets and liabilities transferred was established approximately \$1.4 billion and \$238 million, respectively.

## **Commercial and Agricultural Credit and Development Corporation**

During fiscal year 1993-1994, the Corporation initiated a restructuring plan to reduce costs and increase operating efficiency. As part of such plan, management decided to eliminate the Corporation's financing activities, effective September 30, 1994. The restructuring will include the closing of the regional offices, and employee terminations and relocations. As of June 30, 1994, management provided for the estimated costs of the restructuring through a charge to income amounting to approximately \$2.2 million. The reserve considers the costs of lease cancellations, severance and other employee benefits approved by the Corporation's Board of Directors.

## **Agricultural Services Administration; and the Agricultural Development Administration**

In accordance to a Reorganization Plan, Law No. 5 was enacted by the Governor in order to reorganize the Department of Agriculture. The plan creates the *Agricultural Services and Development Administration* and transfer to this structure the power and legal functions of the Agricultural Services Administration and the Agricultural Development Administration. Also the personnel, property and funds will be transferred to the new organization. Law No. 5 is effective on July 1, 1994 and reorganization begins with the transfers mentioned above. Also, the Department of Agriculture will be responsible to coordinate, plan, supervise and evaluate all efforts, programs and public entities to develop the plan created at maximum.

## **18. SALE OF THE PUERTO RICO MARITIME SHIPPING AUTHORITY (PRMSA)**

On March 3, 1995, the Commonwealth sold the assets and operations of the Puerto Rico Maritime Shipping Authority (PRMSA) to a group of private investors.

As part of the agreement, the Commonwealth assumed debt of approximately \$300 million and the Government Development Bank for Puerto Rico, (GDB), an internal service fund, is committed to purchase from third parties approximately \$100 million of loans owed by PRMSA. Also, GDB may provide a liquidity facility for certain contingencies of PRMSA. The Commonwealth enacted a law that provides that the Commonwealth's general fund will appropriate funds from its future budgets to repay GDB for all the payments made for PRMSA's debt and the liquidity facility.

**SUMMARY OF PROVISIONS OF THE PUBLIC IMPROVEMENT BOND RESOLUTION RELATING TO ARS AND IRS AND AUCTION PROCEDURES**

The following is a summary of certain provisions of the Public Improvement Bond Resolution relating to ARS and IRS and the Auction Procedures applicable thereto. This summary is not to be regarded as a full statement of the terms of the Public Improvement Bond Resolution and, accordingly, is qualified by reference thereto and is subject to the full text thereof. Capitalized terms not previously defined in this Official Statement or defined below have the meanings set forth in the Public Improvement Bond Resolution. Copies of the Public Improvement Bond Resolution may be examined at the office of the Registrar or obtained from the Commonwealth. For purposes of this Appendix III, references below in this Appendix to the Bond Resolution refer to the Public Improvement Bond Resolution.

See also "ARS and IRS" under *The Bonds* in this Official Statement for a description of certain other provisions of the Bond Resolution relating to ARS and IRS.

**DEFINITIONS**

"All Hold Rate" means, as of any date of determination thereof, 75% of the ARS Index in effect on such date.

"ARS" means the Auction Rate Securities (ARS) issued under the Bond Resolution, as shown on the inside cover of this Official Statement.

"ARS Index" has the meaning set forth for such term under the caption "ARS Index" in this Appendix.

"ARS Multiple" means, as of any Auction Date, the percentage of the ARS Index (in effect on such Date) determined as set forth below, based on the Prevailing Rating of the ARS in effect at the close of business on the Business Day immediately preceding such Auction Date:

| <u>Prevailing Rating</u> | <u>Percentage of ARS Index</u> |
|--------------------------|--------------------------------|
| AAA/Aaa . . . . .        | 175%                           |
| AA/Aa . . . . .          | 175%                           |
| A/A . . . . .            | 175%                           |
| BBB/Baa . . . . .        | 200%                           |
| Below BBB/Baa . . . . .  | 265%                           |

"ARS Rate" means the rate of interest to be borne by the ARS for each Rate Period

which shall be the rate per annum indicated on the cover of this Official Statement (plus the Service Charge) for the Rate Period commencing on the Delivery Date and thereafter shall equal the sum of the Auction Rate for each Rate Period plus the Service Charge then in effect for such Rate Period, all as determined in accordance with the Bond Resolution; provided, however, that if the Auction Agent shall have failed to determine the Auction Rate for any Rate Period (including, without limitation, the circumstance where there is no Auction Agent or no Broker-Dealer), the ARS Rate for such Rate Period shall be the No Auction Rate determined for such Rate Period plus the Service Charge then in effect; and provided, further, that, if a failure to pay principal, interest or premium on any Bond when due shall have occurred, the ARS Rate for the Rate Period during which such failure shall have occurred and each Rate Period thereafter commencing prior to the date on which such failure shall have been cured shall be the Default Rate for such Rate Period plus the Service Charge then in effect; and provided, further, that in no event shall the ARS Rate exceed 12% per annum.

"Auction" means each periodic implementation of the Auction Procedures.

"Auction Agent" means the auction agent acting pursuant to the Bond Resolution, initially The Bank of New York, a New York banking corporation.

"Auction Agent Fee" means, with respect to any Auction Date, the fee to be paid from the interest payable on the Regular ARS and Special Linked ARS and IRS to the Auction Agent for conducting an Auction for the benefit of the Owners of Regular ARS and Special Linked ARS and IRS on such Auction Date, as determined in accordance with the Bond Resolution.

"Auction Agent Fee Rate" means, with respect to any Auction Date, the rate per annum to be used in computing the Auction Agent Fee to be paid to the Auction Agent for the services rendered by it with respect to such Auction Date, which rate shall equal .03 of 1 percent per annum until changed in accordance with the Bond Resolution, and thereafter shall equal the rate per annum most recently determined pursuant to the Bond Resolution.

"Auction Agreement" means the Auction Agreement, dated as of February 1, 1996, between the Auction Agent and the Registrar and all amendments thereto and any other agreement entered into by the Registrar and any successor Auction Agent in lieu of the original Auction Agreement and all amendments thereto.

"Auction Date" means, during any period in which the Auction Procedures are not suspended in accordance with the provisions of the Bond Resolution, the Business Day next preceding each Interest Payment Date for the ARS (whether or not an Auction shall be conducted on such date), the first Auction Date for the ARS being June 30, 1996; provided, however, that the last Auction Date shall be the Business Day next preceding the Interest Payment Date next preceding the final maturity date of the ARS.

"Auction Procedures" means the procedures for conducting Auctions for ARS set forth in the Bond Resolution.

**"Auction Rate"** means, for each Rate Period, for ARS and IRS that are not permanently linked, (i) if Sufficient Clearing Bids exist, the Winning Bid Rate; (ii) if Sufficient Clearing Bids do not exist for at least two (2) consecutive Auctions (other than because all of the ARS are either the subject of Submitted Hold Orders or were Linked ARS and IRS or Special Linked ARS and IRS at the close of business on the immediately preceding Record Date), the Maximum Rate; or (iii) if all of the ARS are the subject of Submitted Hold Orders, the All Hold Rate; or (iv) if all of the ARS were Linked ARS and IRS or Special Linked ARS and IRS at the close of business on the immediately preceding Record Date or if an Auction is not held (other than in a situation covered by clause (ii) above), the No Auction Rate.

**"Available ARS"** means, on each Auction Date, the aggregate principal amount of Regular ARS and Special ARS at the close of business on the immediately preceding Record Date that is not the subject of Submitted Hold Orders.

**"Bidder"** means each Existing Owner and Potential Owner who places an Order.

**"Broker-Dealer"** means any broker-dealer or other entity that is permitted by law to perform the functions required of a Broker-Dealer in the Bond Resolution on behalf of Existing Owners and Potential Owners of ARS that is a Direct Participant in the Securities Depository, that has been selected by the Commonwealth and that is a party to a Broker-Dealer Agreement with the Auction Agent that remains effective.

**"Broker-Dealer Agreement"** means an agreement between the Auction Agent and a Broker-Dealer pursuant to which such Broker-Dealer agrees to follow the procedures specified in the Bond Resolution, as such agreement may from time to time be amended or supplemented, and also means the Broker-Dealer Agreement, dated as of February 1, 1996, between the Auction Agent and Smith Barney Inc. and all amendments thereto.

**"Broker-Dealer Fee"** means, with respect to any Auction Date, the fee from the interest payable on the Regular ARS and the Special Linked ARS and IRS to be paid to the Broker-Dealer for its services for the benefit of the Owners of the Regular ARS and the Special Linked ARS and IRS relating to the Auction conducted on such Auction Date, as determined in accordance with the Bond Resolution.

**"Broker-Dealer Fee Rate"** means, with respect to any Auction Date, the rate per annum to be used in computing the Broker-Dealer Fee to be paid to the Broker-Dealer for the services rendered by it with respect to such Auction Date, which rate shall equal .25 of 1 percent per annum until changed in accordance with the Bond Resolution, and thereafter shall equal the rate per annum most recently determined pursuant to the Bond Resolution.

**"Business Day"** means, with respect to the ARS and IRS, any day except Saturday, Sunday or any day on which banking institutions located in the State of New York are required or authorized to close or on which the New York Stock Exchange is closed.

"Closed Period" means each period (i) commencing at 11:00 a.m, New York City time, on the Business Day immediately preceding any Record Date and ending immediately prior to the opening of business on the next succeeding Interest Payment Date, and (ii) commencing immediately prior to the opening of business on the second Business Day next preceding the date on which a lottery is held to select ARS and IRS for redemption and ending immediately prior to the opening of business on the date fixed for redemption.

"Default Rate" means, in respect of any Rate Period, 265% of the ARS Index determined on the Auction Date next preceding the first day of such Rate Period; provided, however, that in no event shall the Default Rate, when added to the Service Charge, exceed 12% per annum.

"Delivery Date" means the date of initial delivery of the ARS and IRS.

"Direct Participant" means the member of, or the participant in, DTC that will act on behalf of a Bidder.

"DTC" shall mean The Depository Trust Company or any substitute Securities Depository appointed pursuant to the Bond Resolution.

"Existing Holder" or "Existing Owner" means a person who is listed as the Owner or a Beneficial Owner of ARS (other than ARS that are Linked ARS and IRS or Permanently Linked AIRS) in the records of the Auction Agent.

"Index Rate" means, on any date of determination, the PSA Index Rate, or if such rate is not available, a rate so determined by the Auction Agent for the AIRS, which shall equal the prevailing rate for bonds rated in the highest short-term rating category by Moody's and S&P in respect of issuers most closely resembling the "high grade" component issuers included in the PSA Index Rate that are subject to tender by the holders thereof for purchase on not more than seven (7) days' notice and the interest on which is (i) variable on a weekly basis, (ii) excludable from gross income for federal income tax purposes under the Internal Revenue Code of 1986, as amended (the "Code"), and (iii) not subject to an "alternate minimum tax" or similar tax under the Code, unless all tax-exempt bonds are subject to such tax.

"Interest Payment Date" means July 1, 1996 and each January 1 and July 1 thereafter. If any such date is not a Business Day, interest shall be paid on the first Business Day thereafter.

"IRS" means the Inverse Rate Securities (IRS) issued under the Bond Resolution, as shown on the inside cover of this Official Statement.

"IRS Rate" means the rate of interest to be borne by the IRS for each Rate Period which shall be the rate per annum indicated on the cover of this Official Statement for the Rate Period commencing on the Delivery Date and, for each Rate Period thereafter, shall equal 12% per annum minus the ARS Rate for such Rate Period.

"Linkage Request" means a request to link Regular ARS and IRS or Special ARS and IRS by a person who is an Existing Owner of Regular ARS or Special ARS and who is an Owner of IRS, which request shall be delivered by such person's Broker-Dealer to the Auction Agent in substantially the form attached to the Broker-Dealer Agreement.

"Linked ARS and IRS" for all ARS and IRS other than Permanently Linked AIRS, means (i) Regular ARS and IRS of equal principal amounts which are linked pursuant to the provisions of the Bond Resolution from and after the first Auction Date succeeding the date of linkage (assuming such linkage still exists on such Auction Date) to and until the date linkage is broken pursuant to the provisions of the Bond Resolution, and (ii) Special ARS and IRS, of equal principal amounts which are linked pursuant to the provisions of the Bond Resolution from and after the date of linkage to and until the date linkage is broken pursuant to the provisions of the Bond Resolution.

"Linked Rate" means 6% per annum.

"Maximum Rate" means, as of any Auction Date, the product of the ARS Index in effect on such date multiplied by the ARS Multiple; provided, however, that in no event shall the Maximum Rate, when added to the Service Charge, exceed 12% per annum.

"Moody's" means Moody's Investors Service, Inc., a corporation organized and existing under the laws of the State of Delaware, its successors and assigns, and, for the purposes of the Auction Procedures, if such corporation shall be dissolved or liquidated or shall no longer perform the functions of a securities rating agency, "Moody's" shall be deemed to refer to any other nationally recognized securities rating agency designated by the Commonwealth by notice to the Registrar, the Auction Agent and the Broker-Dealers; provided, however, that such notice shall not be effective unless accompanied by a consent of a majority of the Broker-Dealers.

"No Auction Rate" means, as of any Auction Date, the rate determined by multiplying the percentage of the ARS Index set forth below, based on the Prevailing Rating of the ARS in effect at the close of business on the Business Day immediately preceding such Auction Date, by the ARS Index in effect on such Auction Date:

| <u>Prevailing Rating</u> | <u>Percentage of ARS Index</u> |
|--------------------------|--------------------------------|
| AAA/Aaa . . . . .        | 130%                           |
| AA/Aa . . . . .          | 135%                           |
| A/A . . . . .            | 140%                           |
| BBB/Baa . . . . .        | 150%                           |
| Below BBB/Baa . . . . .  | 170%                           |

provided, however, that in no event shall a No Auction Rate, when added to the Service Charge, exceed 12% per annum.

**"Order"** means, as the context requires, a Hold Order, a Bid or a Sell Order.

**"Owner"** means a registered owner of any of the ARS or IRS.

**"Permanent Linkage Request"** shall mean a request permanently to link existing Linked ARS and IRS in minimum denominations of \$200,000 or multiples thereof by a Person who is an Owner of Linked ARS and IRS, which request shall be delivered by such Person's Broker-Dealer to the Auction Agent in substantially the form attached to the Broker-Dealer Agreement.

**"permanently linked"**, when used with respect to: (i) ARS, shall mean ARS the beneficial ownership of which has been linked with the beneficial ownership interest in an equal aggregate principal amount of IRS, which linkage the Owner of such Linked ARS and IRS shall have irrevocably elected never to break as provided above in "Permanently Linked - Rate Lock Option" in "ARS and IRS" under *The Bonds* in this Official Statement; and (ii) IRS, shall mean IRS the beneficial ownership of which has been linked with the beneficial ownership interest in an equal aggregate principal amount of ARS, which linkage the Owner of such Linked ARS and IRS shall have irrevocably elected never to break as provided in "Permanently Linked - Rate Lock Option" in "ARS and IRS" under *The Bonds* in this Official Statement. Once permanently linked, ARS and IRS will be treated for all purposes of the Bond Resolution as Bonds that are not ARS and IRS.

**"Permanently Linked AIRS"** on any date, shall mean ARS and IRS that were permanently linked at the close of business on the first day of the then current Rate Period, and the beneficial ownership of which is recorded under a separate CUSIP number at the Securities Depository.

**"Potential Owner"** means any person, including any Existing Owner, who may be interested in acquiring ARS or, in the case of an Existing Owner, an additional principal amount of ARS.

**"Prevailing Rating"** means (i) AAA/Aaa, if the ARS shall have a rating of AAA or better by S&P and a rating of Aaa or better by Moody's, (ii) if not AAA/Aaa, then AA/Aa if the ARS shall have a rating of AA- or better by S&P and a rating of Aa3 or better by Moody's, (iii) if not AAA/Aaa or AA/Aa, then A/A if the ARS shall have a rating of A- or better by S&P and a rating of A3 or better by Moody's, (iv) if not AAA/Aaa, AA/Aa or A/A, then BBB/Baa if the ARS shall have a rating of BBB- or better by S&P and a rating of Baa3 or better by Moody's, and (v) if not AAA/Aaa, AA/Aa, A/A or BBB/Baa, then below BBB/Baa, whether or not the ARS are rated by any securities rating agency. For purposes of this definition, S&P's rating categories of AAA, AA-, A- and BBB-, and Moody's rating categories of Aaa, Aa3, A3 and Baa3, shall be deemed to refer to and include the respective rating categories correlative thereto in the event that either or both of such Rating Agencies shall have changed or modified their generic rating categories or if any successor thereto appointed in accordance with the definitions thereof shall use different rating categories.

"PSA Index Rate" means on any date, a rate determined on the basis of the seven-day high grade market index of tax-exempt variable rate demand obligations, as produced by Municipal Market Data and published or made available by the Public Securities Association ("PSA") or any person acting in cooperation with or under the sponsorship of PSA and acceptable to the Auction Agent for the ARS, and effective from such date.

"Rate Period" means the period from and including each Interest Payment Date for the ARS and IRS to and including the day (whether or not a Business Day) preceding the next succeeding Interest Payment Date; provided, however, that the first Rate Period shall be the period from and including the Delivery Date to and including the day next preceding the first Interest Payment Date.

"Rating Agency" means Moody's or Standard & Poor's and their respective successors and assigns.

"Record Date" means the 15th day of the month next preceding an Interest Payment Date.

"Regular ARS" means ARS which are not Special ARS, Linked ARS and IRS, Permanently Linked AIRS or Special Linked ARS and IRS.

"Request to Break Linkage" means an Owner's request to break linkage of Linked ARS and IRS or Special Linked ARS and IRS, which shall be delivered by such Owner's Broker-Dealer to the Auction Agent in substantially the form attached to the Broker-Dealer Agreement.

"Securities Depository" means DTC or any other securities depository selected by the Commonwealth which agrees to follow the procedures required to be followed by such securities depository in connection with the ARS and IRS.

"Service Charge" means, with respect to any Auction Date, the sum of the Auction Agent Fee and the Broker-Dealer Fee payable out of the interest payable on the Regular ARS and Special Linked ARS and IRS with respect to such Auction Date.

"Special ARS" means ARS which become unlinked from Linked ARS and IRS pursuant to the provisions of the Bond Resolution from the date linkage is broken until the earlier of (i) the first Auction Date succeeding the date linkage is broken, and (ii) the date linkage is reestablished with an IRS pursuant to the provisions of the Bond Resolution.

"Special Linked ARS and IRS" means Regular ARS and IRS of equal principal amounts which are linked pursuant to the provisions of the Bond Resolution from the date of linkage until the earlier of (i) the first Auction Date succeeding the date of linkage, and (ii) the date linkage is broken pursuant to the provisions of the Bond Resolution.

"Standard & Poor's" or "S&P" means Standard & Poor's Corporation Ratings Group, a division of The McGraw-Hill Companies, a corporation organized and existing under the laws of the State of New York, its successors and assigns and, for purposes of the Auction Procedures, if such corporation shall be dissolved or liquidated or shall no longer perform the functions of a securities rating agency, "Standard & Poor's" and "S&P" shall be deemed to refer to any other nationally recognized securities rating agency designated by the Commonwealth by notice to the Registrar, the Auction Agent and the Broker-Dealers; provided, however, that such notice shall not be effective unless accompanied by a consent of a majority of the Broker-Dealers.

"Submission Deadline" means 12:30 p.m., New York City time, on any Auction Date or such other time as shall be specified from time to time by the Auction Agent pursuant to the Auction Agreement as the time by which Broker-Dealers are required to submit Orders to the Auction Agent.

"Sufficient Clearing Bids" means, with respect to any Auction, the condition in which the aggregate principal amount of ARS 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 sum of (i) the aggregate principal amount of ARS that are the subject of Submitted Bids by Existing Owners specifying rates higher than the Maximum Rate, and (ii) the aggregate principal amount of ARS that are the subject of Submitted Sell Orders (other than because all ARS are either subject to Submitted Hold Orders or were Linked ARS and IRS, Permanently Linked AIRS or Special Linked ARS and IRS at the close of business on the immediately preceding Record Date). For definitions of "Submitted Bids," "Submitted Sell Orders" and "Submitted Hold Orders," see "Auction Procedures—Determination of ARS Rate" below.

"Winning Bid Rate" means the lowest rate specified in any Submitted Bid which if selected by the Auction Agent as the Auction Rate would cause the aggregate principal amount of ARS that are the subject of Submitted Bids specifying a rate not greater than such rate to be not less than the aggregate principal amount of Available ARS.

## **AUCTION PROCEDURES**

The following is a summary of the procedures to be used in conducting Auctions. As a summary, it does not purport to be complete and is qualified in its entirety by reference to the Auction Procedures set forth in the Bond Resolution, the Auction Agreement and the Broker-Dealer Agreements.

**Orders by Existing Owners and Potential Owners.** Prior to the Submission Deadline 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, information as to:

(A) the principal amount of ARS, if any, held by such Existing Owner which such Existing Owner desires to continue to hold for the next succeeding Rate Period without regard to the rate determined by the Auction Procedures for such Rate Period;

(B) the principal amount of ARS, if any, held by such Existing Owner which such Existing Owner desires to continue to hold for the next succeeding Rate Period if the rate determined by the Auction Procedures for such Rate Period shall not be less than the rate per annum then specified by such Existing Owner (and which such Existing Owner desires to sell on the next succeeding Interest Payment Date if the rate determined by the Auction Procedures shall be less than the rate per annum then specified by such Existing Owner); and/or

(C) the principal amount of ARS, if any, held by such Existing Owner which such Existing Owner offers to sell on the next succeeding Interest Payment Date without regard to the rate determined by the Auction Procedures for the next succeeding Rate Period; and

(ii) for the purpose of implementing the Auctions and thereby to achieve the lowest possible interest rate on the ARS, the Broker-Dealers will contact Potential Owners (including persons who are Existing Owners), by telephone or otherwise, to determine the principal amount of ARS, if any, which each such Potential Owner offers to purchase if the rate determined by the Auction Procedures for the next succeeding Rate Period is not less than the rate per annum specified by such Potential Owner.

For the purposes hereof, 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."

A Bid by an Existing Owner shall constitute an irrevocable offer to sell:

(A) the principal amount of ARS specified in such Bid if the rate determined by the Auction Procedures on such Auction Date shall be less than the rate specified therein; or

(B) such principal amount or a lesser principal amount of ARS to be determined as set forth in clause (v) of the first paragraph of the section below entitled "Allocation of ARS" (the "Allocation Provisions") if the rate determined by the Auction Procedures on such Auction Date shall be equal to such specified rate; or

(C) a lesser principal amount of ARS to be determined as set forth in clause (iv) of the second paragraph of the Allocation Provisions if such specified rate shall be higher than the Maximum Rate and Sufficient Clearing Bids do not exist.

A Sell Order by an Existing Owner shall constitute an irrevocable offer to sell:

(A) the principal amount of ARS specified in such Sell Order; or

(B) such principal amount or a lesser principal amount of ARS as set forth in clause (iv) of the second paragraph of the Allocation Provisions if Sufficient Clearing Bids do not exist.

A Bid by a Potential Owner shall constitute an irrevocable offer to purchase:

(A) the principal amount of ARS specified in such Bid if the rate determined by the Auction Procedures on such Auction Date shall be higher than the rate specified therein; or

(B) such principal amount or a lesser principal amount of ARS as set forth in clause (vi) of the first paragraph of the Allocation Provisions if the rate determined by the Auction Procedures on such Auction Date shall be equal to such specified rate.

Anything contained herein to the contrary notwithstanding:

(i) for purposes of any Auction, any Order which specifies ARS to be held, purchased or sold in a principal amount which is not \$100,000 or a multiple thereof shall be rounded down to the nearest \$100,000, and the Auction Agent shall conduct the Auction Procedures as if such Order had been submitted in such lower amount;

(ii) for purposes of any Auction, any portion of an Order of an Existing Owner which relates to a ARS which has been called for redemption on or prior to the Interest Payment Date next succeeding such Auction 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;

(iii) for purposes of any Auction, no portion of a ARS which 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 ARS;

(iv) the Auction Procedures shall be suspended during the period commencing on the date of the Auction Agent's receipt of notice from the Registrar of the failure to pay principal, interest or premium on any Public Improvement Bond when due, but shall resume with the next Auction to occur on the next regularly scheduled Auction Date which occurs at least two Business Days after the Auction Agent receives a notice from the Registrar that such failure has been cured; and

(v) Owners of Linked ARS and IRS, Permanently Linked AIRS and Special Linked ARS and IRS at the close of business on the Record Date immediately preceding

any Auction Date are not Existing Owners for purposes of the Auction Procedures and may not participate in the Auction held on such Auction Date with respect to such ARS. An Existing Owner of Regular ARS or Special ARS who is also the Owner of Linked ARS and IRS, Permanently Linked AIRS or Special Linked ARS and IRS at the close of business on the immediately preceding Record Date may not submit Orders in an Auction with respect to such Linked ARS and IRS, Permanently Linked AIRS or Special Linked ARS and IRS, and such Linked ARS and IRS, Permanently Linked AIRS or Special Linked ARS and IRS will not be included in the principal amount of ARS held by such Existing Owner for the purposes of the Auction Procedures. If any Owner of Linked ARS and IRS, Permanently Linked AIRS or Special Linked ARS and IRS at the close of business on the immediately preceding Record Date submits a Bid with respect to such Linked ARS and IRS, Permanently Linked AIRS or Special Linked ARS and IRS, such Bid will be invalid, and the Auction Agent shall conduct the Auction Procedures as if such Order had not been submitted.

**Submission of Orders by Broker-Dealers to Auction Agent.** Each Broker-Dealer will submit to the Auction Agent, in writing or by such other method as shall be reasonably acceptable to the Auction Agent, prior to the Submission Deadline on each Auction Date, all Orders obtained by such Broker-Dealer and specifying with respect to each Order:

- (i) the name of the Bidder placing such Order;
- (ii) the aggregate principal amount of ARS that are the subject of such Order;
- (iii) to the extent that such Bidder is an Existing Owner:
  - (A) the principal amount of ARS, if any, subject to any Hold Order placed by such Existing Owner;
  - (B) the principal amount of ARS, if any, subject to any Bid placed by such Existing Owner and the rate specified in such Bid; and
  - (C) the principal amount of ARS, if any, subject to any Sell Order placed by such Existing Owner; and
- (iv) to the extent such Bidder is a Potential Owner, the rate specified in such Bid.

The Auction Agent shall be entitled to rely upon the terms of any Order submitted to it by a Broker-Dealer.

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 %).

If an Order or Orders covering all of the ARS held by an Existing Owner is not submitted to the Auction Agent prior to the Submission Deadline, the Auction Agent shall deem a Hold Order to have been submitted on behalf of such Existing Owner covering the principal amount of ARS held by such Existing Owner and not subject to Orders submitted to the Auction Agent.

If one or more Orders covering in the aggregate more than the principal amount of ARS held by any Existing Owner are submitted to the Auction Agent, such Orders shall be considered valid as follows and in the following order of priority:

(i) all Hold Orders shall be considered valid, but only up to and including in the aggregate the principal amount of ARS held by such Existing Owner:

(ii) (A) any Bid of an Existing Owner shall be considered valid as a Bid of an Existing Owner up to and including the excess of the principal amount of ARS held by such Existing Owner over the principal amount of ARS subject to Hold Orders referred to in paragraph (i) above;

(B) subject to clause (A), if more than one Bid with the same rate is submitted on behalf of such Existing Owner and the principal amount of ARS subject to such Bids is greater than such excess of the principal amount of ARS held by such Existing Owner over the principal amount of ARS subject to Hold Orders referred to in paragraph (i) above, such Bids shall be considered valid up to the amount of such excess;

(C) subject to clause (A), if more than one Bid with different rates is submitted on behalf of such Existing Owner, 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 principal amount of ARS held by such Existing Owner over the principal amount of ARS held by such Existing Owner subject to Hold Orders referred to in paragraph (i) above; and

(D) the principal amount, if any, of such ARS subject to Bids not considered to be Bids of an Existing Owner under this paragraph (ii) shall be treated as the subject of a Bid by a Potential Owner; and

(iii) all Sell Orders shall be considered Sell Orders, but only up to and including a principal amount of ARS equal to the excess of the principal amount of ARS held by such Existing Owner over the sum of the principal amount of the ARS considered to be subject to Hold Orders pursuant to paragraph (i) above and the principal amount of ARS considered to be subject to Bids of such Existing Owner pursuant to paragraph (ii) above.

If more than one Bid is submitted on behalf of any Potential Owner, each Bid shall be

considered a separate Bid with the rate and the principal amount of ARS specified therein.

None of the Commonwealth, the Registrar 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.

**Determination of ARS Rate.** Not later than 9:30 a.m., New York City time, on each Auction Date the Auction Agent shall advise the Broker-Dealers and the Registrar by telephone (promptly confirmed in writing) or facsimile transmission of the All Hold Rate, the Maximum Rate and the ARS Index.

Promptly after the Submission Deadline on each Auction Date, the Auction Agent shall assemble all valid 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 "Submitted Orders") and shall determine: (i) the Available ARS; (ii) whether there are Sufficient Clearing Bids; (iii) the Auction Rate; and (iv) the Service Charge.

Promptly after the Auction Agent has made the determinations set forth in the preceding paragraph, the Auction Agent shall advise the Commonwealth and the Registrar by telephone (promptly confirmed in writing) or facsimile transmission of the Auction Rate and the Service Charge for the next succeeding Rate Period.

**Allocation of ARS.** In the event of Sufficient Clearing Bids, subject to the further provisions described below, Submitted Orders 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 ARS 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 ARS 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 ARS 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 ARS 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 ARS that are the subject of such Submitted Bid, but only up to and including the principal amount of ARS obtained by multiplying (A) the aggregate principal amount of ARS which are not the subject of Submitted Hold Orders described in paragraph (i) above or of Submitted Bids described in paragraphs (iii) or (iv) above by (B) a fraction, the numerator of which shall be the principal amount of ARS held by such Existing Owner subject to such Submitted Bid and the denominator of which shall be the aggregate principal amount of ARS 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 ARS;

(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 ARS that are the subject of such Submitted Bid, but only in an amount equal to the principal amount of ARS obtained by multiplying (A) the aggregate principal amount of ARS which are not the subject of Submitted Hold Orders described in paragraph (i) above or Submitted Bids described in paragraphs (iii), (iv) or (v) above by (B) a fraction, the numerator of which shall be the principal amount of ARS subject to such Submitted Bid and the denominator of which shall be the sum of the aggregate principal amount of ARS subject to such Submitted Bids made by all such Potential Owners that specified a rate equal to the Winning Bid Rate, and the remainder, if any, 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.

If Sufficient Clearing Bids have not been made (other than because all of the ARS are either subject to Submitted Hold Orders or were Linked ARS and IRS, Permanently Linked AIRS or Special Linked ARS and IRS at the close of business on the immediately preceding Record Date), subject to the further provisions described below, Submitted Orders shall be accepted or rejected as follows and 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 ARS 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 ARS 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 ARS 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 principal amount of ARS obtained by multiplying (A) the aggregate principal amount of ARS subject to Submitted Bids described in paragraph (iii) above by (B) a fraction, the numerator of which shall be the principal amount of ARS 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 principal amount of ARS 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 ARS; and

(v) the Submitted Bid of each Potential Owner specifying any rate that is higher than the Maximum Rate shall be rejected.

If, as a result of the procedures described above, any Existing Owner or Potential Owner would be required to purchase or sell an aggregate principal amount of ARS which is not a multiple of \$100,000 on any Auction Date, the Auction Agent shall, in such manner as it shall determine in its sole discretion, round up or down the principal amount of ARS to be purchased or sold by any Existing Owner or Potential Owner on such Auction Date so that the aggregate principal amount of ARS to be purchased or sold by each Existing Owner or Potential Owner on such Auction Date shall be a multiple of \$100,000, even if such allocation results in one or more of such Existing Owners or Potential Owners not purchasing or selling any ARS on such Auction Date.

If, as a result of the procedures described above, any Potential Owner would be required to purchase less than \$100,000 in principal amount of ARS on any Auction Date, the Auction Agent shall, in such manner as it shall determine in its sole discretion, allocate ARS for purchase among Potential Owners so that the principal amount of ARS purchased on such Auction Date by any Potential Owner shall be a multiple of \$100,000, even if such allocation results in one or more of such Potential Owners not purchasing ARS on such Auction Date.

**Notice of ARS Rate.** On each Auction Date, the Auction Agent shall notify by telephone or other telecommunication device or in writing each Broker-Dealer that participated in the Auction held on such Auction Date of the following:

(i) the ARS Rate determined on such Auction Date for the succeeding Rate 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, in whole or in part, and the principal amount of ARS, 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, in whole or in part, and the principal amount of ARS, if any, to be purchased by such Potential Owner;

(v) if the aggregate principal amount of ARS to be sold by all Existing Owners on whose behalf such Broker-Dealer submitted Bids or Sell Orders is different from the aggregate principal amount of ARS 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 Direct Participant, if any, of each such other Broker-Dealer) and the principal amount of ARS 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 other Broker-Dealers submitted Bids; and

(v) the immediately succeeding Auction Date.

On each Auction Date, each Broker-Dealer that submitted an Order on behalf of any Existing Owner or Potential Owner shall (i) advise each Existing Owner and Potential Owner on whose behalf such Broker-Dealer submitted an Order as to: (A) the ARS Rate determined on such Auction Date; (B) whether any Bid or Sell Order submitted on behalf of each such Existing Owner or Potential 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 Direct Participant to pay to such Broker-Dealer (or its Direct Participant) through the Securities Depository the amount necessary to purchase the principal amount of ARS to be purchased pursuant to such Bid against receipt of such ARS; 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 Direct Participant to deliver to such Broker-Dealer (or its Direct Participant) through the Securities Depository the principal amount of ARS to be sold pursuant to such Bid or Sell Order against payment therefor.

**The Auction Agent.** The Auction Agent will enter into an Auction Agreement with the Registrar. The Auction Agent shall be (a) a bank or trust company organized under the laws of the United States or any state or territory thereof having a combined capital stock, surplus and undivided profits of at least \$30,000,000 (or whose obligations in respect of the ARS and IRS are guaranteed by a bank or trust company duly authorized to exercise corporate trust powers and subject to examination by federal or state authority, of good standing, and having at the time of the appointment of such Auction Agent, a combined capital and surplus of at least

such amount), or (b) a member of the National Association of Securities Dealers Inc., or any successor self-regulatory organization, having a capitalization of at least \$30,000,000 and, in either case, (y) authorized by law to perform all the duties imposed upon it by the provisions of the Bond Resolution providing for the issuance of the ARS and IRS and (z) a Direct Participant in the Securities Depository. The Auction Agent may at any time resign and be discharged of the duties and obligations created by the Bond Resolution or resign as a Direct Participant in the Securities Depository by giving at least 90 days' notice to the Registrar who shall give notice of the same to the Commonwealth, each Broker Dealer and the Securities Depository. The Auction Agent may be removed at any time by the Registrar, at the direction of the Commonwealth, by written notice delivered to the Auction Agent, each Broker-Dealer and the Commonwealth. The Auction Agent shall be removed by the Registrar if it ceases to be a Direct Participant in the Securities Depository. Upon any such resignation or removal, the Registrar, at the direction of the Commonwealth, shall appoint a successor Auction Agent meeting the requirements of the Bond Resolution. If no successor Auction Agent meeting the requirements referred to above is appointed, the Registrar, at the direction of the Commonwealth, shall petition a court of competent jurisdiction to appoint a successor Auction Agent having such qualifications as such court shall prescribe. In the event of the resignation or removal of the Auction Agent, the Auction Agent shall pay over, assign and deliver any moneys and Series 1995 Bonds held by it in such capacity to its successor or to the Registrar if no successor has been appointed.

**Broker-Dealers.** At the time of the issuance of the ARS, Smith Barney, Inc. will be the sole Broker-Dealer. The Commonwealth may stipulate at any time that additional firms must be allowed to participate as Broker-Dealers in Auctions for the ARS.

The Broker-Dealer Agreements provide that a Broker-Dealer may submit Orders in Auctions for its own account. If a Broker-Dealer submits an Order for its own account in any Auction, it might have an advantage over other Bidders in that it would have knowledge of Orders placed through it in that Auction; such Broker-Dealer, however, would not have knowledge of Orders submitted by other Broker-Dealers (if any) in that Auction. In the Broker-Dealer Agreements, Broker-Dealers agree to handle customer orders in accordance with their respective duties under applicable securities laws and rules.

### **ARS Index**

The "ARS Index" equals the greater of the Index Rate and the 6-Month After-Tax Equivalent Rate.

As used herein, "6-Month After-Tax Rate," on any date of determination, means the interest rate per annum equal to:

6-Month "AA" Composite Commercial Paper Rate on such date times (1.00 minus the Statutory Corporate Tax Rate on such date).

For the purposes of the definition of 6-Month After-Tax Equivalent Rate,

(i) "Statutory Corporate Tax Rate," on any date of determination, means the highest tax rate bracket (expressed as a decimal) now or hereafter applicable in each taxable year on the taxable income of every corporation as set forth in Section 11 of the Internal Revenue Code of 1986, as amended (the "Code"), or any successor section, without regard to any minimum additional tax provision or provisions regarding changes in rates during a taxable year. The Statutory Corporate Tax Rate is currently 35%; and

(ii) "6-Month 'AA' Composite Commercial Paper Rate" on any date of determination, means (A) the interest equivalent of the 180-day rate on commercial paper placed on behalf of issuers whose corporate bonds are rated AA by S&P, or the equivalent of such rating by S&P, as made available on a discount basis or otherwise by the Federal Reserve Bank of New York for the Business Day immediately preceding such date of determination, or (B) if the Federal Reserve Bank of New York does not make available any such rate, then the arithmetic average of such rates, as quoted on a discount basis or otherwise, by the Commercial Paper Dealers to the Auction Agent for the close of business on the Business Day immediately preceding such date of determination.

For purposes of the definition of 6-Month "AA" Composite Commercial Paper Rate, the "interest equivalent" means the equivalent yield on a 360 day basis of a discount-basis security to an interest-bearing security. If any Commercial Paper Dealer does not quote a commercial paper rate required to determine the 6-Month "AA" Composite Commercial Paper Rate, the 6-Month "AA" Composite Commercial Paper Rate shall be determined on the basis of the quotation or quotations furnished by the remaining Commercial Paper Dealer or Commercial Paper Dealers and any substitute commercial paper dealer not included within the definition of Commercial Paper Dealer above, which may be The First Boston Corporation or Morgan Stanley & Co., Incorporated, or their respective affiliates or successors which are commercial paper dealers (a "Substitute Commercial Paper Dealer") selected by the Registrar, at the direction of the Commonwealth, to provide such commercial paper rate or rates not being supplied by any Commercial Paper Dealer or Commercial Paper Dealers, as the case may be, or if the Registrar, at the direction of the Commonwealth, does not select any such Substitute Commercial Paper Dealer or Substitute Commercial Paper Dealers, by the remaining Commercial Paper Dealer or Commercial Paper Dealers.

If for any reason on any Auction Date the ARS Index shall not be determined as hereinabove provided, the ARS Index shall be the ARS Rate for the Rate Period ending on such Auction Date.

The determination of the ARS Index as provided in the Bond Resolution shall be conclusive and binding upon the Owners of the ARS and IRS.

**Amendment of Auction Procedures.** The provisions of the Bond Resolution concerning the Auction Procedures including the mandatory tender provisions and the definitions applicable

thereto and the definitions contained in the Bond Resolution including, without limitation, Default Rate, Maximum Rate, All Hold Rate, No Auction Rate, ARS Index, ARS Multiple and Auction Rate, may be amended by the Commonwealth but only upon obtaining (i) an opinion of counsel (who may be counsel to the Commonwealth) to the effect that the same does not materially adversely affect the rights of any Owners of ARS or IRS or (ii) the written consent of the Owners of all ARS and IRS or, in the event that all of the ARS and IRS are Linked ARS and IRS, with the consent of the Owners of at least 51% in aggregate principal amount of the Linked ARS and IRS. In the second event, if on the first Auction Date occurring at least 40 days after the date on which the Registrar mailed notice to the Owners of the ARS and IRS as required by the Bond Resolution, Sufficient Clearing Bids have been received or all of the ARS are subject to Submitted Hold Orders, the proposed amendment shall be deemed to have been consented to by the Owners of all ARS. As an additional condition precedent to any amendment of the Bond Resolution referred to in this paragraph, there shall be delivered to the Registrar and the Commonwealth an opinion of nationally recognized bond counsel to the effect that such amendment will not adversely affect the validity of the ARS or IRS or any exemption from gross income for federal income tax purposes to which the interest on the ARS and IRS would otherwise be entitled. Written notice of each such amendment shall be delivered by the Commonwealth to the Registrar, the Auction Agent and each Broker-Dealer.

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[FORM OF OPINIONS OF BOND COUNSEL]

[Letterhead]

February , 1996

Hon. Manuel Díaz Saldaña  
Secretary of the Treasury of Puerto Rico  
San Juan, Puerto Rico

Dear Sir:

We have examined Act No. 2 of the Legislature of Puerto Rico, approved October 10, 1985 (the "Act"), and certified copies of the legal proceedings, including a resolution adopted by the Secretary of the Treasury of the Commonwealth of Puerto Rico and approved by the Governor of the Commonwealth of Puerto Rico (the "Resolution"), and other proofs submitted relative to the issuance and sale of the following described bonds (the "Bonds"):

**\$57,155,000**  
**COMMONWEALTH OF PUERTO RICO**  
**PUBLIC IMPROVEMENT REFUNDING BONDS, SERIES 1996**  
**(General Obligation Bonds)**  
**Dated: January 1, 1996.**

Maturing on July 1 of the years and in such principal amounts, subject to redemption and bearing interest at the rates, all as set forth in the Resolution. The Bonds are issuable as registered Bonds without coupons in the manner and in accordance with the terms and conditions of the Resolution.

We have also examined one of the Bonds as 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 and proofs 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 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. Under the provisions of the Acts of Congress now in force and under existing regulations, rulings and court decisions, (i) subject to compliance with the covenant referred to below and requirements of the Internal Revenue Code of 1986, as amended (the "Code"), and the Resolution regarding the use, expenditure and investment of Bond proceeds and the timely payment of certain investment earnings to the Treasury of the United States, if required, interest on the Bonds is not includable in gross income for federal income tax purposes; and (ii) the Bonds and the interest thereon are exempt from state, Commonwealth of Puerto Rico and local income taxation.

Interest on the Bonds is not an item of tax preference for the purpose of computing the alternative minimum tax on individuals and corporations imposed by the Code. Such interest will, however, be includable in determining

adjusted current earnings for purposes of the computation of the alternative minimum tax and the environmental tax on corporations imposed by the Code. The Code contains other provisions that could result in tax consequences, upon which we express no opinion, as a result of (a) ownership of Bonds or (b) the inclusion in certain computations (including, without limitation, those related to the corporate alternate minimum tax and environmental tax) of interest that is excluded from gross income.

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, so that interest on the Bonds will remain exempt from federal income taxes to which it is not subject on the date of issuance of the Bonds. We are not aware of any provisions of the Constitution or laws of the Commonwealth of Puerto Rico which would prevent the Commonwealth of Puerto Rico from complying with the requirements of the Code.

Respectfully submitted,

[To be signed "Greenberg,  
Traurig, Hoffman, Lipoff,  
Rosen & Quentel"]

[LETTERHEAD]

February , 1996

Hon. Manuel Díaz Saldaña  
Secretary of the Treasury of Puerto Rico  
San Juan, Puerto Rico

Dear Sir:

We have examined Act No. 119 of the Legislature of Puerto Rico, approved August 9, 1995 (the "Act"), and certified copies of the legal proceedings, including a resolution adopted by the Secretary of the Treasury of the Commonwealth of Puerto Rico and approved by the Governor of the Commonwealth of Puerto Rico (the "Resolution"), and other proofs submitted relative to the issuance and sale of the following described bonds (the "Bonds"):

**\$350,440,000**  
**COMMONWEALTH OF PUERTO RICO**  
**PUBLIC IMPROVEMENT BONDS OF 1996**  
**(General Obligation Bonds)**  
**Dated: January 1, 1996.**

Maturing on July 1 of the years and in such principal amounts, subject to redemption and bearing interest at the rates, all as set forth in the Resolution. The Bonds are issuable as registered Bonds without coupons in the manner and in accordance with the terms and conditions of the Resolution.

We have also examined one of the Bonds as 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 and proofs 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 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. Under the provisions of the Acts of Congress now in force and under existing regulations, rulings and court decisions, (i) subject to compliance with the covenant referred to below and requirements of the Internal Revenue Code of 1986, as amended (the "Code"), and the Resolution regarding the use, expenditure and investment of Bond proceeds and the timely payment of certain investment earnings to the Treasury of the United States, if required, interest on the Bonds is not includable in gross income for federal income tax purposes; and (ii) the Bonds and the interest thereon are exempt from state, Commonwealth of Puerto Rico and local income taxation.

Interest on the Bonds is not an item of tax preference for the purpose of computing the alternative minimum tax on individuals and corporations imposed by the Code. Such interest will, however, be includable in determining adjusted current earnings for purposes of the computation of the alternative minimum tax and the environmental tax

on corporations imposed by the Code. The Code contains other provisions that could result in tax consequences, upon which we express no opinion, as a result of (a) ownership of Bonds or (b) the inclusion in certain computations (including, without limitation, those related to the corporate alternate minimum tax and environmental tax) of interest that is excluded from gross income.

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, so that interest on the Bonds will remain exempt from federal income taxes to which it is not subject on the date of issuance of the Bonds. We are not aware of any provisions of the Constitution or laws of the Commonwealth of Puerto Rico which would prevent the Commonwealth of Puerto Rico from complying with the requirements of the Code.

Respectfully submitted,

[To be signed "Greenberg,  
Traurig, Hoffman, Lipoff,  
Rosen & Quentel"]

# MBIA

## FINANCIAL GUARANTY INSURANCE POLICY

**MBIA Insurance Corporation**  
**Armonk, New York 10504**

Policy No. [NUMBER]

MBIA Insurance Corporation (the "Insurer"), in consideration of the payment of the premium and subject to the terms of this policy, hereby unconditionally and irrevocably guarantees to any owner, as hereinafter defined, of the following described obligations, the full and complete payment required to be made by or on behalf of the Issuer to [PAYING AGENT/TRUSTEE] or its successor (the "Paying Agent") of an amount equal to (i) the principal of (either at the stated maturity or by any advancement of maturity pursuant to a mandatory sinking fund payment) and interest on, the Obligations (as that term is defined below) as such payments shall become due but shall not be so paid (except that in the event of any acceleration of the due date of such principal by reason of mandatory or optional redemption or acceleration resulting from default or, otherwise, other than any advancement of maturity pursuant to a mandatory sinking fund payment, the payments guaranteed hereby shall be made in such amounts and at such times as such payments of principal would have been due had there not been any such acceleration); 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 State Street Bank and Trust Company, N.A., 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 State Street Bank and Trust Company, N.A., State Street Bank and Trust Company, N.A. 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 of \_\_\_\_\_

COUNTERSIGNED:

\_\_\_\_\_  
 Resident Licensed Agent

\_\_\_\_\_  
 City, State

STD-RCS-6  
 495

MBIA Insurance Corporation

\_\_\_\_\_  
 President

Attest:

\_\_\_\_\_  
 Assistant Secretary

SPECIMEN

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