

In the opinion of Bond Counsel, subject to compliance with certain tax covenants, interest on the Bonds is not includable in gross income for federal income tax purposes under existing statutes, regulations, rulings and court decisions. However, see "Tax Exemption" for a description of the alternative minimum tax on corporations and certain other federal tax consequences of ownership of the Bonds. Bond Counsel is further of the opinion that the Bonds and the interest thereon are exempt from state, Commonwealth of Puerto Rico and local income taxation.

NEW ISSUE—BOOK-ENTRY ONLY

\$565,590,000
Puerto Rico Electric Power Authority
\$464,840,000 Power Revenue Bonds, Series AA
\$100,750,000 Power Revenue Refunding Bonds, Series BB

Dated: May 1, 1997

Due: July 1, as shown on the inside front cover

The Bonds will be issued in fully registered form and will be initially registered in the name of Cede & Co., as nominee of the Depository Trust Company, New York, New York ("DTC"), which will act as securities depository for the Bonds. The Bonds will be available to purchasers in denominations of \$5,000 and any multiple thereof only under the book-entry system maintained by DTC through brokers and dealers who are, or act through, DTC Participants. **Purchasers will not receive delivery of the Bonds. So long as any purchaser is the beneficial owner of a Bond, such purchaser must maintain an account with a broker or dealer who is, or acts through, a DTC Participant to receive payment of principal of and interest on such Bond.** See "Book-Entry Only System" under *Description of the Bonds*.

Interest on the Bonds will be payable January 1, 1998 (representing eight months' interest) and each July 1 and January 1 thereafter. The Bonds maturing after July 1, 2012 will be subject to redemption as described herein, the earliest possible date of redemption being July 1, 2007.

The Bonds will be issued pursuant to the Trust Agreement, dated as of January 1, 1974, as amended, with State Street Bank and Trust Company, N.A., New York, New York, successor trustee, and, together with the Authority's outstanding Power Revenue Bonds, will be payable solely from the net revenues of the Authority's electric system.

Payment of principal of and interest on the Bonds maturing on July 1 of the years 2005 through 2017, inclusive, and 2022, 2023 and 2027, when due will be guaranteed by a municipal bond insurance policy issued simultaneously with the delivery of the Bonds by MBIA Insurance Corporation.

Neither the credit of the Commonwealth of Puerto Rico nor that of any of its political subdivisions is pledged for the payment of the Bonds.

The Bonds are offered when, as and if issued and accepted by the Underwriters, subject to the approval of legality by Brown & Wood LLP, New York, New York, Bond Counsel, and certain other conditions. Certain legal matters will be passed upon for the Underwriters by Pietrantonio Méndez & Alvarez, San Juan, Puerto Rico. It is expected that settlement for the Bonds will occur in New York, New York, on or about May 15, 1997.

BEAR, STEARNS & CO. INC.

GOLDMAN, SACHS & CO.

MERRILL LYNCH & CO.

PAINEWEBBER INCORPORATED

CITICORP SECURITIES, INC.

CLARK MELVIN SECURITIES
CORPORATION

LEHMAN BROTHERS

MORGAN STANLEY & CO.
Incorporated

ORIENTAL FINANCIAL SERVICES CORP.

PRUDENTIAL SECURITIES INCORPORATED

SMITH BARNEY INC.

DEAN WITTER REYNOLDS, INC.

May 8, 1997

\$565,590,000

Puerto Rico Electric Power Authority

\$464,840,000 Power Revenue Bonds, Series AA

<u>Year</u> <u>(July 1)</u>	<u>Amount</u>	<u>Interest</u> <u>Rate</u>	<u>Price or Yield</u>	<u>Year</u> <u>(July 1)</u>	<u>Amount</u>	<u>Interest Rate</u>	<u>Price or Yield</u>
1999	\$7,080,000	4.50%	100%	2009*	\$11,585,000	5.50%	5.20%
2000	7,400,000	4.75	100	2010*	12,220,000	6.25	5.25
2001	7,750,000	4.80	4.85	2011*	12,985,000	6.00	5.30
2002	8,125,000	5.50	4.95	2012*	13,765,000	6.00	5.34
2003	8,570,000	5.00	100	2013*	14,590,000	5.40	5.50
2004	9,000,000	5.00	5.10	2014*	15,380,000	5.375	5.55
2005*	9,450,000	4.90	4.95	2015*	16,205,000	5.25	5.55
2006*	9,915,000	6.00	5.00	2016*	17,055,000	5.25	5.60
2007*	10,510,000	5.00	5.05	2017*	17,950,000	5.25	5.60
2008*	11,035,000	5.00	5.10				

\$24,840,000 5.625% Bonds due July 1, 2023*—Price NRO†

\$105,710,000 5.625% Term Bonds due July 1, 2022* — Price NRO†

\$113,720,000 5.375% Term Bonds due July 1, 2027* — Yield 5.68%

(plus accrued interest from May 1, 1997)

\$100,750,000 Power Revenue Refunding Bonds, Series BB

<u>Year</u> <u>(July 1)</u>	<u>Amount</u>	<u>Interest Rate</u>	<u>Price or Yield</u>	<u>Year</u> <u>(July 1)</u>	<u>Amount</u>	<u>Interest Rate</u>	<u>Price or Yield</u>
1999	\$100,000	4.50%	100%	2007*	\$7,145,000	5.00%	5.05%
2000	105,000	4.75	100	2008*	11,085,000	5.00	5.10
2001	110,000	4.80	4.85	2009*	11,730,000	5.50	5.20
2002	115,000	5.50	4.95	2010*	12,420,000	6.25	5.25
2003	120,000	5.00	100	2011*	13,195,000	6.00	5.30
2004	125,000	5.00	5.10	2012*	13,940,000	6.00	5.34
2005*	135,000	4.90	4.95	2013*	14,690,000	5.40	5.50
2006*	140,000	6.00	5.00	2014*	15,595,000	5.375	5.55

(plus accrued interest from May 1, 1997)

* Insured by MBIA Insurance Corporation.

† Not reoffered.

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

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

TABLE OF CONTENTS

	<u>Page</u>	<u>Page</u>	
OVERVIEW	1	Principal and Interest Requirements	29
Operating Results	1	NET REVENUES AND COVERAGE	30
System Improvements and Additional Capacity	4	Management's Discussion and Analysis	
PLAN OF FINANCING	5	of Operating Results	30
Series AA Power Revenue Bonds	5	Factors Affecting the Utility Industry Generally	34
Series BB Power Revenue Refunding Bonds	5	Projected Net Revenues	34
Estimated Sources and Uses of Funds	5	Proposed Budget for Fiscal Year 1998	36
SECURITY	6	ENVIRONMENTAL MATTERS	37
Source of Payment	6	Litigation	37
Flow of Funds Under 1974 Agreement	6	Compliance Programs	37
Rate Covenants	8	Environmental Compliance Costs	39
Reserve Account	8	INSURANCE	39
Additional Bonds	8	Coverage	39
Bond Insurance	9	Self-insurance Fund	40
Concerning the Policy	10	LABOR RELATIONS	40
PROPOSED SUPPLEMENTAL AGREEMENTS	10	PENSION PLAN	40
DESCRIPTION OF THE BONDS	11	LITIGATION	41
General	11	TAX EXEMPTION	41
Book-Entry Only System	11	DISCOUNT BONDS	41
Redemption Provisions	12	PREMIUM BONDS	42
THE AUTHORITY	13	VERIFICATION OF MATHEMATICAL	
Powers	14	COMPUTATIONS	42
Management	14	UNDERWRITING	42
THE SYSTEM	17	MATERIAL RELATIONSHIPS	43
Generating Facilities	17	LEGAL MATTERS	43
Transmission and Distribution Facilities	17	LEGAL INVESTMENT	43
Adequacy of Capacity	18	GOVERNMENT DEVELOPMENT BANK	
Energy Management Programs	21	FOR PUERTO RICO	43
Statistical Information	21	INDEPENDENT ACCOUNTANTS	44
Historical Capital Improvement		RATINGS	44
and Financing Program	23	CONTINUING DISCLOSURE	44
Projected Five-Year Capital Improvement		MISCELLANEOUS	46
and Financing Program	23	APPENDIX I - Definitions of Certain Terms	I-1
Rates	24	Summary of Certain Provisions of	
Major Clients	25	the 1974 Agreement Excluding Proposed	
Residential Service Comparison of the Authority		Supplemental Agreements	I-11
with United States Electric Utilities	26	Summary of Certain Provisions of	
Fuel	27	the Proposed Supplemental Agreements	I-21
Subsidies, Contributions in Lieu		APPENDIX II - Audited Financial Statements	II-1
of Taxes and Set Asides	28	APPENDIX III - Letter of the Consulting	
DEBT	29	Engineers	III-1
Rural Electrification Bonds	29	APPENDIX IV - Proposed Form of Bond	
General Obligation Notes	29	Counsel Opinions	IV-1
Bond Anticipation Notes	29	APPENDIX V - Specimen of the Policy	V-1

[This page intentionally left blank]

\$565,590,000
Puerto Rico Electric Power Authority
\$464,840,000 Power Revenue Bonds, Series AA
\$100,750,000 Power Revenue Refunding Bonds, Series BB

The purpose of this Official Statement of Puerto Rico Electric Power Authority (the "Authority"), which includes the front and inside front cover pages, the Appendices hereto and the information relating to the Commonwealth, referred to in *Miscellaneous* and incorporated herein by reference, is to furnish information with respect to \$464,840,000 Puerto Rico Electric Power Authority Power Revenue Bonds, Series AA (the "Series AA Power Revenue Bonds") and \$100,750,000 Puerto Rico Electric Power Authority Power Revenue Refunding Bonds, Series BB (the "Series BB Power Revenue Refunding Bonds;" and collectively with the Series AA Power Revenue Bonds, the "Bonds"). The Authority was formerly known as Puerto Rico Water Resources Authority.

The Bonds will be issued under and secured by a Trust Agreement, dated as of January 1, 1974, as amended (the "1974 Agreement"), between the Authority and State Street Bank and Trust Company, N.A., successor trustee (the "1974 Trustee"). The Bonds, the \$3,248,915,000 Puerto Rico Electric Power Authority Power Revenue Bonds currently outstanding and such additional bonds as may be issued under the 1974 Agreement are herein collectively called the "Power Revenue Bonds".

The Authority had previously issued bonds pursuant to a Trust Indenture, dated January 1, 1947, as amended (the "1947 Indenture"), with The Chase Manhattan Bank (National Association), as successor trustee. All of the bonds issued under the 1947 Indenture have been defeased and are no longer outstanding. On June 9, 1996, the 1947 Indenture was defeased, released and terminated and all remaining moneys on deposit thereunder were transferred to the 1974 Trustee as required by the 1974 Agreement.

The Bonds maturing on July 1 of the years 2005 through 2027, inclusive (collectively, the "Insured Bonds") are insured by MBIA Insurance Corporation (the "Insurer") pursuant to a municipal bond insurance policy on such Insured Bonds (the "Policy").

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

OVERVIEW

The Authority, which supplies virtually all of the electric power consumed in Puerto Rico, is one of the largest municipal utilities in the United States. The Authority was created in 1941 as a public corporation and governmental instrumentality of the Commonwealth of Puerto Rico ("Puerto Rico" or the "Commonwealth"). As of January 31, 1997, it served 1,287,589 clients and had utility plant totalling approximately \$4.9 billion. Also as of that date, production plant in service totaled approximately \$1.6 billion with a dependable generating capacity of 4,149 megawatts ("MW"). In August 1996, the Authority realized a historical peak load of 2,814 MW. Ninety-eight percent of the Authority's generating capacity is provided by oil-fired units, and two percent is provided by hydroelectric units.

In order to meet expected growth in demand, diversify its fuel sources and improve the reliability of its service, the Authority is in the process of increasing its own generating capacity and has entered into agreements to purchase electricity from cogeneration facilities fueled by sources other than oil. The Authority's capital improvement program includes the installation of approximately 249 MW of additional System capacity by mid calendar year 1997 and the site repowering of two 44 MW steam units, increasing their generating capacity by approximately 376 MW by fiscal year 2000. The Authority has executed agreements for two cogeneration facilities, one of which is to be fueled by liquified natural gas and the other fueled by coal. The Authority expects that 874 MW of additional System capacity will be available from such cogeneration facilities by fiscal year 2000. See "System Improvements and Additional Capacity" below and "Adequacy of Capacity—Additional Generating Facilities" under *The System*.

Operating Results

During the period from fiscal year 1992 through fiscal year 1996, the number of clients served by the Authority increased in each fiscal year and electric energy sales grew at an average annual rate of approximately 4.0%. During this period, Current Expenses increased 6.8% due to higher energy production and higher maintenance and administrative and general expenses. During the first seven months of fiscal year 1997, energy demand decreased by 0.2% mainly due to the effects of Hurricane

Hortense and cooler temperatures. Current Expenses increased 11.2% mainly due to a \$3.14 per barrel increase in the cost of fuel oil.

Net Revenues increased by 2.3% in fiscal year 1992, 0.9% in fiscal year 1993, 12.7% in fiscal year 1994, 5.9% in fiscal year 1995 and 0.2% in fiscal year 1996. For the first seven months of fiscal year 1997, Net Revenues decreased by 1.0%.

Demand for energy is related to the level of economic and business activity in the Commonwealth, as well as oil prices and climatological factors. According to Puerto Rico Planning Board statistics, real gross product increased 3.1% in fiscal year 1996 compared to 3.4% in fiscal year 1995, 2.5% in fiscal year 1994 and 3.3% in fiscal year 1993. The Planning Board's most recent gross product forecast for fiscal year 1997, made in February 1997, projects an increase of 2.8% over fiscal 1996. Projections of future peak energy demand (for capacity planning purposes) for the five fiscal year period ending June 30, 2001 prepared by the Authority show an average annual increase of 3.8%.

The following table summarizes the operating results of the Authority for the five fiscal years ended June 30, 1996 and for the seven month periods ended January 31, 1996 and 1997, and also includes projections for the fiscal year ending June 30, 2001. This table presents Net Revenues (exclusive of certain investment income) of the Authority under the provisions of the 1947 Indenture and the 1974 Agreement. These calculations of Net Revenues differ in several important respects from the Authority's calculations of net income prepared in accordance with generally accepted accounting principles. See Schedule II to the Financial Statements in Appendix II for a reconciliation of the Authority's net income under generally accepted accounting principles with its Net Revenues under the 1947 Indenture and the 1974 Agreement. See "Proposed Budget for Fiscal Year 1998" under *Net Revenues and Coverage* for modifications in the projections for operating results for the fiscal years 1998 through 2001 that would result from the proposed budget of current expenses and capital expenditures for the fiscal year ending June 30, 1998, which budget was adopted by the Governing Board of the Authority on April 29, 1997 (the "1998 Proposed Budget").

Operating Results

	Years Ended June 30,					Seven Months Ended January 31,		Projected Year Ending June 30,
	1992	1993	1994	1995	1996	1996	1997	2001
	(dollars in thousands)							
Total Revenues	\$1,249,649	\$1,355,052	\$1,378,410	\$1,478,891	\$1,591,747	\$917,818	\$ 987,986	\$2,240,528
Less: Current Expenses ..	879,522	981,666	957,550	1,033,348	1,145,135	649,683	722,433	1,627,930
Net Revenues	<u>\$ 370,127</u>	<u>\$ 373,386</u>	<u>\$ 420,860</u>	<u>\$ 445,543</u>	<u>\$ 446,612</u>	<u>\$268,135</u>	<u>\$ 265,553</u>	<u>\$ 612,598</u>
Principal and Interest Requirements Electric Revenue Bonds ⁽¹⁾	\$ 69,174	\$ 66,072	\$ 68,295	\$ 68,102	--	--	--	--
Power Revenue Bonds	151,163	161,809	170,088	193,097	277,387 ⁽²⁾	161,809 ⁽²⁾	167,596	389,476
Total	<u>\$ 220,337</u>	<u>\$ 227,881</u>	<u>\$ 238,383</u>	<u>\$ 261,199</u>	<u>\$ 277,387</u>	<u>\$161,809</u>	<u>\$167,596</u>	<u>\$ 389,476</u>
Ratio of Net Revenues to Principal and Interest Requirements Electric Revenue Bonds	5.35	5.65	6.16	6.54	--	--	--	--
Electric Revenue and Power Revenue Bonds ⁽²⁾	1.68	1.64	1.77	1.71	1.61	1.66	1.58	1.57
Electric energy sales (in millions of kilowatt hours ("kWh"))	13,615	13,939	14,816	15,259	15,945	9,401	9,378	18,090
Percentage change from year before	4.0	2.4	6.3	3.0	4.5	4.9	(0.2)	1.1
Peak load (in MW)	2,437	2,543	2,621	2,748	2,741	2,731	2,814	3,300
Percentage change from year before	3.0	4.3	3.1	4.8	(0.3)	4.0	3.0	3.2

- (1) In fiscal year 1996, all outstanding Electric Revenue Bonds were retired and the 1947 Indenture was released and terminated.
- (2) Fiscal year 1996 includes two months debt service payments on the Electric Revenue Bonds.

System Improvements and Additional Capacity

To meet the expected growth in demand and enhance reliability of electric service to its clients, the Authority is in the process of implementing a system improvement and generating capacity expansion plan.

A substantial portion of the capital expenditures for production plant for the five fiscal years ended June 30, 1996 was spent on the rehabilitation and life extension of generating plants in order to help achieve higher levels of availability, reliability and efficiency. For the twelve months ended January 31, 1997, the Authority achieved an average availability of 78%. Its capacity expansion plan is based on an availability factor of 68%. Since every 1% increase in availability provides the Authority with the equivalent of approximately 60MW of additional capacity, improving availability from 68% to 78% is equivalent to adding approximately 600MW of additional capacity.

The Authority has completed the licensing process for a three unit, 249MW (total capacity) combustion turbine plant at Arecibo. One unit is completed and is being tested for acceptance by the Authority. The Authority expects the entire plant to be in commercial operation by the beginning of fiscal year 1998.

The Authority has included in its capital improvement program the site repowering of units 5 and 6 of the San Juan Steam Plant to provide additional generating capacity. The site repowering project replaces two 44MW steam generating units with 464MW of combined cycle capacity. It is expected to be in service in fiscal year 2000.

The Authority has entered into an agreement with EcoElectrica, L.P. ("EcoElectrica"), a joint venture between subsidiaries of Kenetech Corporation and Enron Corp. ("Enron"), for the supply of about 461MW of capacity. The EcoElectrica project is comprised of a liquefied natural gas ("LNG") terminal and a combined cycle unit. The project has received all major permits and is expected to be in service in fiscal year 1999.

The Authority has also entered into an agreement with AES Corporation ("AES") to purchase power. The agreement with AES contemplates a facility using two identical fluidized bed boilers and two steam turbines that will utilize clean burning coal technology and will add 413MW of capacity. The facility is expected to be in service by the end of fiscal year 2000. The issuance of the environmental and site permits for this project is being challenged by an environmental group in a case which is currently pending resolution in the Puerto Rico Supreme Court. See "Adequacy of Capacity—Additional Generating Facilities" under *The System*.

The Authority also continues to rehabilitate and expand its transmission and distribution system, including the construction of new 230kV transmission lines.

Set forth below is a summary of the Authority's historical total capital improvement program and financing sources therefor for the five fiscal years ended June 30, 1996 and the projected capital improvement program and financing sources for the five fiscal years ending June 30, 2001. The projected capital improvement program for fiscal years 1998 through 2001 may be modified in accordance with the 1998 Proposed Budget. See "Proposed Budget for Fiscal Year 1998" under *Net Revenues and Coverage*.

Capital Improvements	Fiscal Years			
	1992-1996 Total	% of Total	1997-2001 Total	% of Total
	(dollars in thousands)			
Production Plant	\$ 588,709	39.9%	\$ 577,617	34.8%
Transmission facilities	276,259	18.7	404,747	24.4
Distribution facilities	449,243	30.5	417,633	25.2
Other	159,717	10.9	258,413	15.6
	<u>\$1,473,928</u>	<u>100.0%</u>	<u>\$1,658,410</u>	<u>100.0%</u>
Financing Sources				
Internally generated funds	\$ 258,604	17.5	\$ 338,004	20.4
Borrowed funds	1,071,366	72.7	1,305,224	78.7
Amounts provided from unexpended financing or other funds	143,958	9.8	15,182	0.9
	<u>\$1,473,928</u>	<u>100.0%</u>	<u>\$1,658,410</u>	<u>100.0%</u>

PLAN OF FINANCING

Series AA Power Revenue Bonds

The Authority is issuing the Series AA Power Revenue Bonds pursuant to Section 208 of the 1974 Agreement to finance a portion of the cost of various projects under its capital improvement program and to refinance bond anticipation notes of the Authority issued for that purpose.

Series BB Power Revenue Refunding Bonds

The Authority is issuing the Series BB Power Revenue Refunding Bonds pursuant to Section 210 of the 1974 Agreement to refund the following Power Revenue Bonds (the "Refunded Power Revenue Bonds") on the redemption date and at the redemption price set forth below plus accrued interest to the date fixed for redemption:

Power Revenue Bonds	Maturity Date	Principal Amount to be Refunded	Interest Rate	Redemption Date	Redemption Price
Series A	July 1, 2014	\$100,000,000	6%	July 1, 1997	101%

The refunding will permit the Authority to realize savings on its debt service requirements on bonds outstanding under the 1974 Agreement. The Authority will deposit the net proceeds of the Series BB Power Revenue Refunding Bonds, together with certain other available moneys, with the 1974 Trustee, as escrow agent, under the terms of an Escrow Deposit Agreement. The net proceeds, together with such other available moneys, will be invested in Government Obligations the principal of and interest on which when due, together with any moneys deposited with the 1974 Trustee remaining uninvested, will provide moneys sufficient to pay the principal of and redemption premium and interest on the Refunded Power Revenue Bonds on their date of redemption.

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

Estimated Sources and Uses of Funds

Sources:

Principal amount of Series AA Power Revenue Bonds	\$464,840,000.00
Principal amount of Series BB Power Revenue Bonds	100,750,000.00
Net original issue discount	(759,358.10)
Accrued Interest	1,201,993.19
Deposit from 1974 Bond Service Account	<u>2,000,000.00</u>
 Total Sources	 <u>\$568,032,635.09</u>

Uses:

Deposit to the Escrow Fund for Refunded Power Revenue Bonds	\$103,333,290.34
Payment of bond anticipation notes issued to Government	
Development Bank for Puerto Rico for capital improvements	230,000,000.00
Deposit to 1974 Construction Fund	220,000,000.00
Deposit to 1974 Bond Service Account	1,201,993.19
Underwriting discount, municipal bond insurance premium, and estimated legal, printing and other financing expenses	<u>13,497,351.56</u>
 Total Uses	 <u>\$568,032,635.09</u>

SECURITY

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

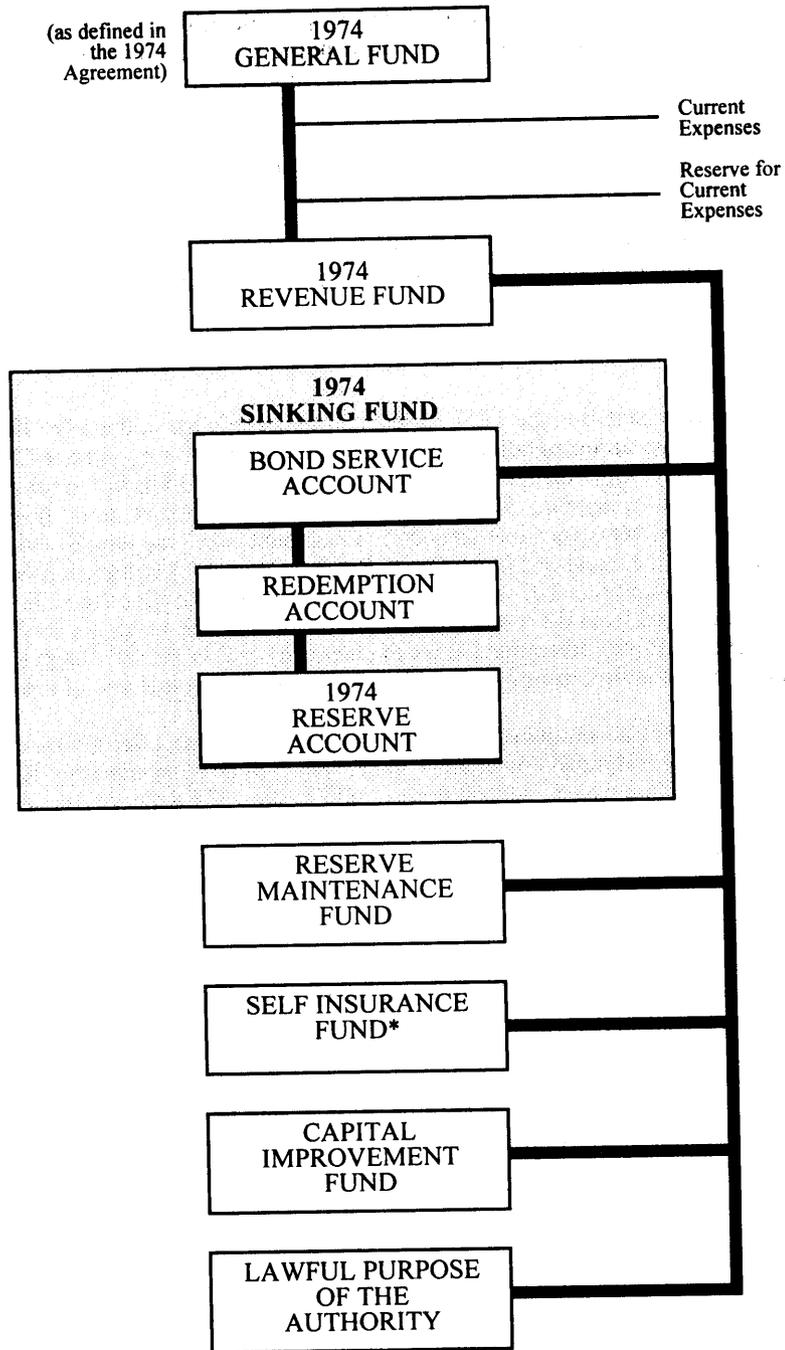
Source of Payment

The Power Revenue Bonds will be payable solely from the Revenues (as defined under the 1974 Agreement) of the System after payment of the Current Expenses (as defined in the 1974 Agreement) of the Authority and any reserve therefor, and the Authority has covenanted to deposit in the 1974 Sinking Fund a sufficient amount of such Revenues after such payment to pay the principal of and the interest on all of the Power Revenue Bonds and to provide a reserve therefor. See Appendix I, *Summary of Certain Provisions of the 1974 Agreement Excluding Proposed Supplemental Agreements*, which should be read in conjunction herewith.

Flow of Funds Under 1974 Agreement

The following schematic representation is provided only to guide readers and does not purport to be complete. Reference is hereby made to Appendix I, *Summary of Certain Provisions of the 1974 Agreement Excluding Proposed Supplemental Agreements* which should be read in conjunction herewith.

REVENUES



* Subject to replenishment at the option of the Authority.

Rate Covenants

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

Reserve Account

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

The amount required to be accumulated in the 1974 Reserve Account, after giving effect to the issuance of the Bonds, and the refunding of the Refunded Power Revenue Bonds, will be approximately \$213 million. As of April 1, 1997, approximately \$222 million was on deposit to the credit of the 1974 Reserve Account. In accordance with the provisions of the 1974 Agreement, any excess moneys on deposit in the 1974 Reserve Account will be transferred to the 1974 Bond Service Account.

Additional Bonds

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

Power Revenue Refunding Bonds may also be issued under the 1974 Agreement for the purpose of refunding all or any part of the outstanding Power Revenue Bonds of any series, subject to certain conditions as described herein in "Issuance of Power Revenue Bonds—Sections 208, 209 and 210 of the 1974 Agreement" under Appendix I, *Summary of Certain Provisions of the 1974 Agreement Excluding Proposed Supplemental Agreements*.

Under the earnings coverage tests of the 1974 Agreement, Net Revenues for the twelve months ended January 31, 1997 of \$444.0 million were 154% of the maximum aggregate annual Principal and Interest Requirements of \$287.9 million on all outstanding Power Revenue Bonds. Estimated average annual Net Revenues for the five fiscal years ending June 30, 2002 of \$552.3 million will be 173% of the maximum aggregate annual Principal and Interest Requirements of \$319.6 million on all outstanding Power Revenue Bonds (including the Bonds, but excluding the Refunded Power Revenue Bonds).

Bond Insurance

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 Policy.

The Policy unconditionally and irrevocably guarantees the full and complete payment required to be made by or on behalf of the Authority to the 1974 Trustee or its successor of an amount equal to (i) the principal of (either at the stated maturity or by an advancement of maturity pursuant to a mandatory sinking fund payment) and interest on the Insured Bonds as such payments shall become due but shall not be so paid (except that in the event of any acceleration of the due date of such principal by reason of mandatory or optional redemption or acceleration resulting from default or otherwise, other than any advancement of maturity pursuant to a mandatory sinking fund payment, the payments guaranteed by the Policy shall be made in such amounts and at such times as such payments of principal would have been due had there not been any such acceleration); 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 Policy does not insure against loss of any prepayment premium which may at any time be payable with respect to any Insured Bond. The 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 Policy also does not insure against nonpayment of principal or of interest on the Insured Bonds resulting from the insolvency, negligence or any other act or omission of the 1974 Trustee 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 1974 Trustee 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 the 1974 Trustee payment of the insured amounts due on such Insured Bonds, less any amount held by the 1974 Trustee for the payment of such insured amounts and legally available therefor.

The Insurer 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, and subject to regulation under the laws of, all 50 states, the District of Columbia, the Commonwealth of Puerto Rico, the Commonwealth of the Northern Mariana Islands, the Virgin Islands of the United States and the Territory of Guam. The Insurer has two European branches, one in the Republic of France and the other in the Kingdom of Spain. New York has laws prescribing minimum capital requirements, limiting classes and concentrations of investments and requiring the approval of policy rates and forms. State laws also regulate the amount of both the aggregate and individual risks that may be insured, the payment of dividends by the Insurer, changes in control and transactions among affiliates. Additionally, the Insurer is required to maintain contingency reserves on its liabilities in certain amounts and for certain periods of time.

As of December 31, 1996 the Insurer had admitted assets of \$4.4 billion (audited), total liabilities of \$3.0 billion (audited), and total capital and surplus of \$1.4 billion (audited) determined in accordance with statutory accounting practices prescribed or permitted by insurance regulatory authorities. As of December 31, 1995, the Insurer had admitted assets of \$3.8 billion (audited), total liabilities of \$2.5 billion (audited), and total capital and surplus of \$1.3 billion (audited) determined in accordance with statutory accounting practices prescribed or permitted by insurance regulatory authorities.

Furthermore, copies of the Insurer's year end financial statements prepared in accordance with statutory accounting practices are available without charge 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. The telephone number of the Insurer is (914) 273-4545.

Moody's Investors Service ("Moody's") rates the claims paying ability of the Insurer "Aaa".

Standard & Poor's Rating Services, a division of The McGraw Hill Companies, Inc. ("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 prices 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 Policy

As provided in the Resolution of the Board authorizing the issuance of the Bonds (the "Resolution"), the Insurer shall be deemed to be the owner of the Insured Bonds for purposes of (1) taking remedial actions under the 1974 Agreement and (2) as long as the Insurer shall not then be in default on its obligations under the Policy, the giving of consents to the adoption of any supplemental agreement to the 1974 Agreement.

PROPOSED SUPPLEMENTAL AGREEMENTS

The Authority has proposed to execute two supplemental agreements (the "Supplemental Agreements") to the 1974 Agreement. Purchasers of the Bonds will have consented by their purchase to the terms of the Supplemental Agreements.

The Third Supplemental Agreement will permit the Authority to secure its obligations to providers of credit or liquidity facilities securing Power Revenue Bonds by granting liens on Revenues on a parity with Power Revenue Bonds. The Third Supplemental Agreement will be executed when owners of 100% of the outstanding Power Revenue Bonds consent thereto. Upon the issuance of the Bonds, the owners of 92.5% of the outstanding Power Revenue Bonds will have consented to the execution of the Third Supplemental Agreement.

The Eighth Supplemental Agreement would permit the 1974 Trustee to treat variable rate bonds as having an effective fixed rate of interest if a qualifying swap agreement has been entered into by the Authority with respect thereto for purposes of calculating the amount required to be deposited to the credit of the 1974 Reserve Account and for calculating Principal and Interest Requirements in connection with the issuance of additional or refunding Power Revenue Bonds and the disposition of assets. It would also amend the definition of Principal and Interest Requirements to include in a fiscal year principal payments on serial bonds after July 31 in such fiscal year and on or before July 31 in the following fiscal year. The Eighth Supplemental Agreement will be executed when the owners of not less than 60% of the aggregate principal amount of the Power Revenue Bonds shall have consented thereto. Upon the issuance of the Bonds, the owners of 60.2% of the outstanding Power Revenue Bonds will have consented to the execution of the Eighth Supplemental Agreement. The Eighth Supplemental Agreement will be executed promptly after the issuance of the Bonds.

For a description of the foregoing Supplemental Agreements see Appendix I, *Summary of Certain Provisions of Proposed Supplemental Agreements*. Copies of the Supplemental Agreements in substantially final form are on file for inspection with the 1974 Trustee.

DESCRIPTION OF THE BONDS

General

The Bonds will be dated May 1, 1997 and will bear interest at such rates and will mature on the dates and in the principal amounts set forth on the inside cover page of this Official Statement. Interest on the Bonds is payable on each January 1 and July 1, commencing January 1, 1998 (representing eight months' interest). Principal of and premium, if any, and interest on the Bonds will be payable in the manner described below under "Book-Entry Only System." The Bonds are being issued in fully registered form and, when issued, are to be registered in the name of Cede & Co., as nominee of The Depository Trust Company, New York, New York ("DTC"). DTC is to act as securities depository for the Bonds. Individual purchases of interests in the Bonds will be made in book-entry form only, in denominations of \$5,000 or any multiple thereof. Purchasers of such interests will not receive definitive Bonds. Principal, redemption premium, if any, and interest are payable directly to DTC by the 1974 Trustee. Upon receipt of such payments, DTC is in turn to remit such principal and interest to the DTC Participants (as such term is hereinafter defined) for subsequent disbursement to the purchasers of interests in the Bonds. See "Book-Entry Only System" below. The Bonds are subject to redemption as described below under "Redemption Provisions."

Book-Entry Only System

The following information concerning DTC and DTC's book-entry system has been obtained from DTC, and the Authority, the 1974 Trustee and the Underwriters take no 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 will be issued for each maturity of the Bonds, each in the aggregate principal amount of such maturity, and will be deposited with DTC.

DTC 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. Direct Participants include securities brokers and dealers, banks, trust companies, clearing corporations, and certain other organizations ("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 Direct Participant, either directly or indirectly ("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 confirmation 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, except in the event that use of the book-entry system for the Bonds is discontinued as described below.

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 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 Authority as soon as possible after the record date. The Omnibus Proxy assigns Cede & Co.'s consenting or voting rights to those Direct Participants to whose accounts the Bonds are credited on the record date (identified in a listing attached to the Omnibus Proxy).

Principal, redemption premium, if any, and interest payments on the Bonds will be made to DTC. DTC's practice is to credit Direct Participants' accounts on each payment 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 Authority or the 1974 Trustee, 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 Authority or the 1974 Trustee, 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 Authority or the 1974 Trustee. Under such circumstances, in the event that a successor securities depository is not obtained, definitive Bonds are required to be printed and delivered.

The Authority 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.

The Authority and the 1974 Trustee will have no responsibility or obligation to such Direct or Indirect Participants, or the persons for whom they act as nominees with respect to the payments to or the providing of notice for the Direct Participants, the Indirect Participants, or the Beneficial Owners. Payments made to DTC or its nominees shall satisfy the obligations of the Authority to the extent of such payments.

In the event that such book-entry only system is discontinued, the following provisions will apply: principal of the Bonds and the redemption premium, if any, thereon will be payable in lawful money of the United States of America at the corporate trust office of the 1974 Trustee in New York, New York. Interest on the Bonds will be payable on each January 1 and July 1 by check mailed to the respective addresses of the registered owners thereof as shown on the registration books of the Authority maintained by the 1974 Trustee as of the close of business on the record date therefor (June 15 and December 15) as set forth in the 1974 Agreement. The Bonds will be issued only as registered bonds without coupons in authorized denominations. The transfer of the Bonds will be registerable and the Bonds may be exchanged at the corporate trust office of the 1974 Trustee in New York, New York upon the payment of any taxes or other governmental charges required to be paid with respect to such transfer or exchange.

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

Redemption Provisions

Optional Redemption

The Bonds maturing after July 1, 2012 may be redeemed at the option of the Authority prior to maturity, from any available moneys (other than moneys deposited in the 1974 Sinking Fund in respect of an amortization requirement), upon not less than 30 days' prior notice by mail, either in whole or in part, and if in part, in such order of maturity, as directed by the Authority, on any date not earlier than July 1, 2007, at the following prices expressed as percentages of the principal amount plus accrued interest to the date fixed for redemption:

<u>Period During Which Redeemed</u>	<u>Redemption Price</u>
July 1, 2007 through June 30, 2008	101½%
July 1, 2008 through June 30, 2009	100¾
July 1, 2009 and thereafter	100

Amortization Requirements

The Series AA Power Revenue Bonds maturing July 1, 2022, and 2027 will be redeemed in part on July 1, 2018 and 2024, respectively, and on each July 1 thereafter for which there is an Amortization Requirement in the principal amounts equal to the Amortization Requirements for said Bonds (less the principal amount of any Series AA Power Revenue Bonds retired by purchase and otherwise subject to adjustment as provided in the 1974 Agreement) from moneys in the 1974 Sinking Fund at par plus accrued interest in the years and amounts set forth below:

<u>Fiscal Year Ending</u>	<u>Amortization Requirements</u>	
	<u>Due July 1, 2022</u>	<u>Due July 1, 2027</u>
2018	\$ 18,895,000	
2019	19,955,000	
2020	21,080,000	
2021	22,265,000	
2022	23,515,000*	
2024		\$ 26,235,000
2025		27,650,000
2026		29,135,000
2027		30,700,000*
Totals	<u>\$105,710,000</u>	<u>\$113,720,000</u>
Average life (years)	23.2	28.7

* Maturity.

THE AUTHORITY

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

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

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

Powers

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

Management

The Act provides that the Governing Board of the Authority (the "Board") shall be composed of nine members. The Secretary of Transportation and Public Works serves ex officio as a member of the Board, and six other members are appointed by the Governor with the advice and consent of the Senate of Puerto Rico. The remaining two members are consumer representatives elected directly by the Authority's clients. Members of the Board serve for a term of four years and members who are not ex officio can be reappointed and reelected. The members of the Board are set forth below.

<u>Name</u>	<u>Principal Occupation</u>	<u>Term Ends</u>
Luis M. García Passalacqua, Chairman	Engineer	February 2001
Carlos I. Pesquera, Vice Chairman	Secretary of Transportation and Public Works	Ex Officio
José A. Bechara Bravo	Lawyer	February 1999
José A. Fernández Polo	Engineer	February 1999
Roberto Fuertes Thillet	Lawyer	February 1998
Modesto Iriarte, Jr.	Consultant	February 1999
Donald Kevane	Certified Public Accountant	February 1999
Julio César Laracuente*	Chemist	March 1999
Héctor Vázquez Muñiz*	Certified Public Accountant	February 2000

* Consumer representative

The Board appoints an Executive Director who is the principal operating officer of the Authority and is responsible for the general operation of the Authority.

Miguel A. Cordero was appointed Executive Director effective January 24, 1993. Mr. Cordero is a licensed professional electrical engineer and during his 28 years of service with the Authority has occupied various executive level positions, such as San Juan Regional Director, Head, Distribution Division, Director of Electric Distribution, and Director of Transmission and Distribution.

Other principal officers of the Authority include the following:

Roberto A. Volckers, Director of the Electric System, is a licensed professional electrical engineer with 30 years of service with the Authority. Among the positions he has held are Head, Electric System Operation Division; Senior Assistant Head, Electric System Operation Division; Assistant Head, (Operation) Electric System Operation Division; and Electric System Protection Engineer.

Jorge L. Bauzó, Director of Transmission and Distribution, is a licensed professional electrical engineer with 25 years of service with the Authority. Among the positions he has held are Director of Administrative Services, Fajardo District Engineer; San Juan District Engineer; San Juan Regional Director; Technical Auditor; and General Superintendent.

Héctor Bezares, Director of Customer Service; holds a Bachelor's Degree in Business Administration and has 24 years of service with the Authority. Among the positions he has held are Customer Service Trainee Supervisor; Internal Auditor; District Manager - Caguas Commercial Office; Member, Committee of Awards; Head, Personnel Division; and Fuel Office Manager.

Martín V. Arroyo, Director of Finance, holds a Master Degree in Business Administration, and has been with the Authority since September, 1995. He was the Budget Manager of the University of Puerto Rico System, and a Professor of Finance and Accounting at the Department of Business Administration for the preceding 14 years. He was also active as a private business consultant during his tenure at the University of Puerto Rico.

Ronald A. Hopgood, Director of Engineering, is a licensed professional electrical engineer with 28 years of service with the Authority. Among the positions he has held are Director of Transmission and Distribution; Technical Auditor; Assistant Head, Materials Division; Bayamón Area Engineer; District Engineer; and Electric Engineer Supervisor.

Angel Luis Rivera Santana, Director of Planning and Environmental Protection, is a licensed professional electrical engineer with 27 years of service with the Authority. During that time he has occupied the positions of Head, Planning and Research Division; Supervisor, Forecasting, Rate Studies and Statistics Department; Supervisor, Forecasting and Cost of Service Section; Technical Analysis Engineer; and Electrical System Engineer.

Brunilda Marrero, Director of Corporate Information Systems, has a Doctorate in Business Administration, and has 13 years of service with the Authority. She has also occupied the positions of Director of Administrative Services, Advisor in Programming Matters and Head of the Information System Division.

Nydia Vergé, Director of Human Resources, holds a Bachelor's degree in Business Administration, with concentration in Management, and has 31 years of service with the Authority. She has occupied the positions of General Administrator Occupational Health and Safety; Supervisor, Department of Claims and Investigations of the Directorate of Legal Affairs; Director of Administration; Head, Customer Service Division; San Juan Area Manager; District Manager; Head, Consumer Relations Department; and Customer Service Supervisor.

Edgardo L. Torres, Director of Administrative Services, is a licensed professional civil engineer with 20 years of service in the Authority. Among the positions he has held are Chief, Irrigation Services, Dams & Reservoir Division; Administrator, Dams Inspection Unit; Operations Engineer-Irrigation Services; Superintendent - South Coast Irrigation District; and Civil Engineer - Irrigation Services.

Juan Villafaña López, General Counsel, is an attorney and has served the Authority in various legal positions for 28 years. He has also occupied the position of Head, Industrial Relations Division.

The Authority retains the firm of Raytheon Engineers & Constructors, Inc., Cambridge, Massachusetts as Consulting Engineers to perform certain responsibilities under the 1974 Agreement. The Consulting Engineers' responsibilities include the submission to the 1974 Trustee of an annual report setting forth their recommendations (a) as to any necessary or advisable revisions of rates and charges, (b) as to the amount that should be deposited monthly during the ensuing fiscal year to the credit of the Reserve Maintenance Fund, the deposits during the ensuing fiscal year to the Capital Improvement Fund and the deposits, if any, during such fiscal year to the Self-insurance Fund for the purposes specified in the 1974 Agreement and (c) as to any other advices and recommendations as they deem advisable.

Coopers & Lybrand currently acts as the Authority's independent accountants responsible for auditing the Authority's books and accounts.

THE SYSTEM

The Authority is the producer and supplier of virtually all of the electric power consumed in Puerto Rico. As of January 31, 1997, the System served 1,287,589 clients.

Generating Facilities

As of January 31, 1997, investment in production plant in service totaled approximately \$1.6 billion, the total nameplate rating of the generating facilities of the System was 4,172 MW and the total dependable generating capacity was 4,149 MW, of which 98% was composed of oil-fired generating units.

Existing Generating Facilities (in MW)

Generating Plants	Total Nameplate Rating (74 Units)	Dependable Generating Capacity				
		Total (74 Units)	Steam (16 Units)	Combustion Turbine (32 Units)	Hydro (21 Units)	Other ⁽¹⁾ (5 Units)
Aguirre	1,554	1,534	900 ⁽²⁾	634 ⁽³⁾	—	—
South Coast	1,118	1,132	1,090	42 ⁽⁴⁾	—	—
Palo Seco	731	728	602	126 ⁽⁵⁾	—	—
San Juan	400	400	400	—	—	—
Mayaguez	90	84	—	84 ⁽⁶⁾	—	—
Other Locations	279	271	—	168 ⁽⁷⁾	100	3
	<u>4,172</u>	<u>4,149</u>	<u>2,992</u>	<u>1,054</u>	<u>100</u>	<u>3</u>

- (1) Consists of five diesel units on the island of Culebra with an aggregate dependable generating capacity of approximately 3 MW held on standby reserve.
- (2) Consists of the Authority's two largest units, Aguirre Units 1 and 2, each with a dependable generating capacity of 450 MW.
- (3) Consists of two combined-cycle units located at Aguirre, each made up of four 50 MW combustion turbines and two 96 MW steam-turbine heat recovery units, also includes two 21 MW combustion turbines.
- (4) Consists of two 21 MW units.
- (5) Consists of six 21 MW units.
- (6) Consists of four 21 MW units.
- (7) Consists of eight 21 MW units.

Transmission and Distribution Facilities

The System includes an integrated electric transmission system which permits each generating unit to provide electric power to the grid. Transmission plant in service as of January 31, 1997 totaled \$631.4 million. As of January 31, 1997, there were 2,213 circuit miles of transmission lines and 61 transmission switchyards. Transmission lines included 251 circuit miles of 230 kV lines, 683 circuit miles of 115 kV lines and 1,280 circuit miles of 38 kV lines. Transmission substations and 19 plant substations have a total capacity of 8,447,699/14,276,484 kilovolt amperes ("kVA").

Investment in distribution plant in service as of January 31, 1997 totaled \$1.3 billion. The capital improvement program for the five fiscal years ending June 30, 2001 totals \$417.6 million for extensions and improvements to existing distribution lines to serve new customers and substations for accommodating new load growth areas. The projected capital improvement program for fiscal years 1998 through 2001 may be modified as described under "Proposed Budget for Fiscal Year 1998." As of January 31, 1997, the electric distribution system included approximately 28,241 circuit miles of distribution lines and 928 (622 are customer-owned) distribution substations with a total installed capacity of 4,361,550/6,041,501 kVA.

The Authority has a continuing program to develop digitized circuit maps for its electric distribution system. This will allow the Authority to create a common electric distribution database. The establishment of cartographic facilities in the regional offices is in progress, as is training for mapping data processors and the acquisition of the related computer equipment. About 27% of the Authority's approximately 1,200 distribution feeders have been digitized. The program is scheduled to be completed during the course of the next five fiscal years.

The Authority's field operations are being computerized at the technical district level through an office automation program which links all of these offices electronically with the central distribution engineering office and database in San Juan. The system is in operation in all district offices. The Authority is developing the communication facilities to link all the regions and districts. A work management system integrated with a geographical information system is in the development stage.

The Consulting Engineers are of the opinion that the Authority's transmission and distribution systems and production plant are in good repair and sound operating condition.

The Authority regularly reviews and upgrades its operating and maintenance practices, with emphasis on improving the reliability of its transmission and distribution systems, further automating the reporting and analysis pertaining to the operation of these systems, improving productivity and reducing costs. In order to improve the productivity of its transmission and distribution employees, the Authority has instituted programs to assist them in both technical and supervisory training.

Adequacy of Capacity

General

For an electric utility to provide reliable service, its dependable generating capacity should be at least equal to its load plus a reserve sufficient to allow for scheduled maintenance, unscheduled outages (described below), reductions in generating capacity due to partial outages and other unforeseen events. Unlike most United States electric utilities which are able to purchase power from neighboring systems in the event of unscheduled outages of generating units, the Authority is not interconnected with and therefore is not able to purchase power from other utilities. In addition, the absence of significant seasonal variations in demand results in a relatively high load factor (75.4% in fiscal year 1995, 78.4% in fiscal year 1996 and 76.9% for the seven months ended January 31, 1997), which affords the Authority less flexibility to schedule maintenance. Therefore, the Authority must have greater total reserve capacity than other United States utilities to cover instances of generating unit outages (scheduled and unscheduled, partial or total).

For planning purposes, the Authority determines adequacy of capacity by probabilistic reliability criteria widely used throughout the electric utility industry. The use of probabilistic indices accounts for the unique operational aspects of individual utilities. The result is a calculated reserve requirement to supply the anticipated peak demand in a given year. This reserve capacity is the difference between dependable generating capacity (not all of which is available at any particular time) and peak demand. This difference divided by peak demand is called dependable reserve margin expressed as a percentage. For fiscal year 1996, the Authority's dependable reserve margin was 55.3%. In fiscal year 1996 the Authority was able to reduce outages (whether scheduled, forced or partial) thereby better utilizing its existing capacity by increasing the percentage of time its generating units were available for service. This percentage of time the units are available for service is defined as equivalent availability.

For the twelve months ended January 31, 1997, the Authority achieved an average availability of 78%. Because the Authority's capacity expansion plan is conservatively based on a 68% equivalent availability, the Authority believes that its capacity expansion plan will adequately meet the needs of the System through fiscal year 2001.

For day to day operations, the Authority uses a concept called “available reserve capacity,” that is the number of megawatts of total reserve capacity readily available to cover outages and surges in demand. The Authority has determined that its available reserve capacity should always exceed the capacity of the Authority’s largest generating unit, currently 450 MW. The average available reserve capacity for the twelve months ended January 31, 1997 was approximately 740 MW.

The Authority is engaged in an ongoing, long-term program to extend the life and increase the availability of its generating units. This program is composed of two parts. The first is a comprehensive preventive maintenance program pursuant to which the Authority continuously trains its maintenance employees and adheres to a schedule designed to ensure proper operating levels of all major generating units by removing units from service at regular intervals (“scheduled outages”). The second part of this program is a design modification program which includes a commitment by the Authority to improve the operation of generating units and the ability of units to operate at design capability and to reduce the risk of units being forced out of service or being forced to operate at partial output (“forced or unscheduled outages”). A substantial part of the \$588.7 million capital expenditures for the five fiscal years ended June 30, 1996 for production plant was spent for rehabilitation.

The table below shows annualized equivalent availability and the related equivalent forced outage rate (the average percentage of total dependable generating capacity which is unavailable throughout the year due to forced outages or partial generating capacity outages) for fiscal years 1992 through 1996 and for the twelve month period ended January 31, 1997.

Electric Generation Equivalent Availability and Reliability

	<u>Years Ended June 30,</u>					<u>Twelve Months Ended January 31,</u>
	<u>1992</u>	<u>1993</u>	<u>1994</u>	<u>1995</u>	<u>1996</u>	<u>1997</u>
Equivalent availability	60%	64%	69%	72%	75%	78%
Equivalent forced outage rate	26%	26%	21%	16%	13%	13%

Projected Load Growth

Projections of future load growth are critical to the Authority’s capacity planning. In its financial and capacity planning the Authority uses three forecasts of economic activity. One is prepared by Econométrica, Inc. using a macroeconomic model of the Puerto Rico economy tied to Data Resources, Inc., one by Inter-American University using a macroeconomic model developed in conjunction primarily with Wharton EFA, and one by the Puerto Rico Planning Board. The Authority’s forecasts are based in part on the correlations between the consumption of electricity and various economic and financial activities in Puerto Rico as represented in the above mentioned models.

The Authority continuously monitors actual performance relative to its forecasts and prepares new forecasts at least once a year in February or March or as soon as economic data becomes available for the fiscal year just ended.

The Authority incorporates the highest of the three forecasts as its base case for planning the addition of generating capacity to the System (the “base case capacity planning forecast”). The base case is the Authority’s best estimate or most probable case. Recognizing the inherent uncertainty of forecasting growth, the Authority ordinarily uses the lowest of the three forecasts in preparing its base case revenue forecast.

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

Additional Generating Facilities

Based on the Authority’s current peak load projections and improvement of the equivalent availability of its generating units, the Authority and the Consulting Engineers believe that the additional generating units included in the Authority’s capacity expansion plan will meet projected energy demands and provide adequate reserve margins through

fiscal year 2001. By more effectively utilizing maintenance outages, and by implementing major design modifications, the Authority has reduced the need for extended maintenance downtime and increased the overall reliability of all of its generating facilities. As a result, total production plant availability increased from an average of 68%, the basis on which the Authority's capacity expansion plan was developed, to an average of 78% for the twelve months ended January 31, 1997. The Authority calculates that each percentage point of increase of System availability is equivalent to adding approximately 60 MW of available capacity to the System.

To provide additional generating capacity, the Authority expects to bring on line during the fiscal year ending June 30, 1997 a three unit, 249 MW (total capacity) open cycle combustion turbine plant at Arecibo pursuant to a turn-key construction contract. One unit is completed and is being tested for acceptance by the Authority. The Authority expects the entire plant to be in commercial operation by the beginning of the next fiscal year. This facility could also provide the Authority with additional instantaneous spinning reserve. The Authority is also in the process of adding additional generating capacity by replacing the two 44MW steam units of the San Juan Steam Plant with 464MW of combined cycle capacity. This additional capacity is expected to be available in fiscal year 2000. These new units will burn No. 2 fuel oil or natural gas with substantially improved efficiency compared to the replaced units.

The Authority also expects to provide additional generating capacity by purchasing power from two proposed cogeneration facilities. The Authority has entered into agreements with AES and EcoElectrica a joint venture between subsidiaries of Kenetech Corporation and Enron for the supply of about 874 MW of capacity. The agreements provide a nominal range of plus or minus 10% in the committed capacity to be determined during unit testing. The EcoElectrica project is comprised of an LNG terminal and a combined cycle unit that will add 461 MW of capacity expected to be in service in fiscal year 1999. The EcoElectrica project has received all major permits. The agreement with AES contemplates a facility using two identical fluidized bed boilers and two steam turbines that will utilize clean burning coal technology and will add 413 MW of capacity expected to be in service in fiscal year 2000. The issuance of the environmental and site permits for the AES project is being challenged by an environmental group in a case which is currently pending resolution in the Puerto Rico Supreme Court. These two projects are expected to contribute to the Authority's efforts toward fuel diversification and improved reliability of service. See *Material Relationships*.

The agreements with both AES and EcoElectrica contemplate a monthly fixed charge to be paid by the Authority. This fixed charge would be subject to reduction if the applicable cogeneration project does not achieve certain availability guarantees determined on a 12-month rolling average basis. The variable costs of power purchases would be based on a number of factors including fixed prices and inflation indices. The Authority will have full dispatch control over the two cogeneration projects so that they are fully integrated into the System. The proposed EcoElectrica purchased power costs would incorporate a minimum annual power or fuel purchase requirement based on an average capacity utilization factor on the part of the Authority. The Authority anticipates that all of its purchased power costs will be accounted for as operating expenses on the Authority's financial statements and treated as a Current Expense under the 1974 Agreement. The Authority intends to recover its purchased power costs by utilizing a purchased power adjustment clause, similar to its fuel adjustment clause.

The following table sets forth the Authority's additional generating capacity plan and the fiscal years in which the additional capacity is expected to be in service.

<u>Capacity Expansion Projects</u>	<u>Additional Capacity (MW)</u>	<u>Expected In-Service Fiscal Year</u>
Cambalache (Arecibo)	83	1997
Cambalache (Arecibo)	166	1998
3 Diesel Vieques (3 MW)	9	1998
EcoElectrica Cogeneration Project	461	1999
San Juan Repowering	464	2000
AES Cogeneration Project	<u>413</u>	2000
Total	<u>1,596</u>	

Based on the Authority's current projections of peak load, the Authority believes that completion of the aforementioned projects will provide the additional generating capacity needed to continue to provide reliable service to its clients through fiscal year 2001. The Authority believes that the aforesaid schedule of capacity additions can be achieved; however, there is no assurance that permitting or construction delays may not have a material adverse effect on such schedule. Based on its projections of peak load and System's capacity, the Authority believes that a delay in the completion of those projects will not affect its ability to furnish reliable service.

For a detailed discussion of the costs to be incurred in connection with the above capacity expansion projects to be undertaken by the Authority, see "Projected Five-Year Capital Improvement and Financing Program" below.

The following table summarizes the Authority's projected peak load, dependable capacity, reserve margin and dependable reserve margin through fiscal year 2001 under the above peak load projections and incorporating the assumptions for additional capacity described above. Projections of future peak load (for capacity planning purposes) for the five fiscal years 1997-2001 prepared by the Authority show an average annual increase of 3.8%.

<u>Fiscal Years</u> <u>Ending</u> <u>June 30,</u>	<u>Peak</u> <u>Load</u>	<u>Dependable</u> <u>Capacity</u>	<u>Reserve</u> <u>Margin</u>	<u>Dependable</u> <u>Reserve</u> <u>Margin(%)</u>
	(in MW, except percentages)			
1997	2,929	4,232	1,386	47
1998	3,009	4,407	1,398	46
1999	3,094	4,868	1,774	57
2000	3,199	5,745	2,546	80
2001	3,300	5,745	2,445	74

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

Energy Management Programs

The Authority offers programs to educate and assist its commercial and industrial clients in energy-saving (based on time of use rates) and load management techniques. These demand-side management programs have the additional objective of increasing the effective utilization of the System and reducing peak demand. The Authority's projection of peak load includes a reduction by approximately 55 MW by the year 2000 through the implementation of energy management programs.

Statistical Information

The following table sets forth certain statistical information regarding the System for the five fiscal years ended June 30, 1996 and for the seven month periods ended January 31, 1996 and 1997.

Statistical Information

	Years Ended June 30,					Seven Months Ended January 31,	
	1992	1993	1994	1995	1996	1996	1997
	Nameplate rating at end of period (in MW)	4,201	4,201	4,201	4,259	4,260	4,260
Dependable generating capacity at end of period (in MW)	4,219	4,231	4,231	4,258	4,256	4,256	4,149
Peak load, 60-minute (in MW)	2,437	2,543	2,621	2,748	2,741	2,731	2,814
Reserve Margin (%)	73.1	66.4	61.4	54.9	55.3	55.8	47.4
Average load (in MW)	1,833	1,911	2,016	2,071	2,150	2,152	2,163
Load factor (%)	75.2	75.1	76.9	75.4	78.4	78.8	76.9
Energy generated and sold (in millions of kWh):							
Electric energy generated	16,104	16,745	17,667	18,144	18,883	11,103	11,162
Auxiliary equipment use	(936)	(926)	(1,026)	(1,089)	(1,093)	(644)	(661)
Net electric energy generated	15,168	15,819	16,641	17,055	17,790	10,459	10,501
Losses and unaccounted for	(1,553)	(1,880)	(1,825)	(1,796)	(1,845)	(1,058)	(1,123)
Electric Energy Sold	<u>13,615</u>	<u>13,939</u>	<u>14,816</u>	<u>15,259</u>	<u>15,945</u>	<u>9,401</u>	<u>9,378</u>
Electric Energy Sales:							
Residential	4,650	4,698	4,996	5,176	5,455	3,301	3,266
Commercial	5,082	5,266	5,635	5,826	6,131	3,597	3,622
Industrial	3,446	3,529	3,735	3,804	3,917	2,245	2,224
Other	437	446	450	453	442	258	266
	<u>13,615</u>	<u>13,939</u>	<u>14,816</u>	<u>15,259</u>	<u>15,945</u>	<u>9,401</u>	<u>9,378</u>
Electric Energy Revenues (in thousands):							
Residential	\$ 355,951	\$ 382,872	\$ 391,971	\$ 425,293	\$ 465,632	\$274,698	\$298,754
Commercial	527,938	574,625	591,206	631,572	679,326	390,277	422,495
Industrial	276,346	300,466	300,982	322,009	342,178	193,856	204,332
Other	60,870	65,276	65,446	68,265	69,825	39,918	42,816
	<u>\$1,221,105</u>	<u>\$1,323,239</u>	<u>\$1,349,605</u>	<u>\$1,447,139</u>	<u>\$1,556,961</u>	<u>\$898,749</u>	<u>\$968,397</u>
Average revenue per kWh (in cents):							
Residential	7.65	8.15	7.85	8.22	8.54	8.32	9.15
Commercial	10.39	10.91	10.49	10.84	11.08	10.85	11.66
Industrial	8.02	8.51	8.06	8.46	8.74	8.64	9.19
Other	13.93	14.64	14.54	15.08	15.79	15.47	16.10
All Classes	8.97	9.49	9.11	9.48	9.76	9.56	10.33
Average number of clients:							
Residential	1,067,313	1,088,117	1,107,118	1,128,307	1,147,983	1,143,766	1,164,705
Commercial	106,715	108,562	110,161	112,782	115,218	114,676	117,121
Industrial	2,480	2,422	2,355	2,287	2,194	2,216	2,160
Other	3,332	3,396	3,475	3,511	3,553	3,545	3,603
	<u>1,179,840</u>	<u>1,202,497</u>	<u>1,223,109</u>	<u>1,246,887</u>	<u>1,268,948</u>	<u>1,264,203</u>	<u>1,287,589</u>
Monthly average revenue per client:							
Residential	\$ 27.79	\$ 29.32	\$ 29.50	\$ 31.41	\$ 33.80	\$ 34.31	\$ 36.64
Commercial	412.26	441.09	447.23	466.66	491.33	486.19	515.33
Industrial	9,285.82	10,338.08	10,650.46	11,733.30	12,996.73	12,497.18	13,514.03
Other	1,522.36	1,601.79	1,569.45	1,620.26	1,637.70	1,608.61	1,697.65
All classes	86.25	91.70	91.95	96.72	102.25	101.56	107.44

Historical Capital Improvement and Financing Program

Capital improvements and their financing are made pursuant to a program established by the Authority and reviewed annually by the Consulting Engineers. The program for the five fiscal years ended June 30, 1996 and the seven month periods ended January 31, 1996 and 1997 is shown in the following table.

Historical Capital Improvement Program (in thousands)

	Years Ended June 30,					Total	Seven Months Ended January 31,	
	1992	1993	1994	1995	1996		1996	1997
Capital Improvements								
Production plant	\$ 62,042	\$ 98,554	\$122,013	\$173,435	\$132,665	\$ 588,709	\$ 56,002	\$ 88,713
Transmission facilities	50,552	54,017	56,685	52,197	62,808	276,259	33,589	27,170
Distribution facilities	93,064	63,447	101,560	83,308	107,864	449,243	41,441	28,438
Other ⁽¹⁾	24,124	37,634	22,678	25,224	50,057	159,717	30,745	29,338
	<u>\$229,782</u>	<u>\$253,652</u>	<u>\$302,936</u>	<u>\$334,164</u>	<u>\$353,394</u>	<u>\$1,473,928</u>	<u>\$ 161,777</u>	<u>\$ 173,659</u>
Financing Sources								
Internally generated funds	\$ 41,480	\$ 32,466	\$ 51,576	\$ 62,508	\$ 70,574	\$ 258,604	\$ 26,347	\$ 31,820
Long-term debt ⁽²⁾	173,043	200,943	385,380	73,900	238,100	1,071,366	49,961	150,000
Amounts provided from (or used for) unexpended financing or other funds	15,259	20,243	(134,020)	197,756	44,720	143,958	85,469	(8,161)
	<u>\$229,782</u>	<u>\$253,652</u>	<u>\$302,936</u>	<u>\$334,164</u>	<u>\$353,394</u>	<u>\$1,473,928</u>	<u>\$ 161,177</u>	<u>\$ 173,659</u>
Allowance for funds used during construction ⁽³⁾	\$ (14,717)	\$ (9,165)	\$ (5,158)	\$ (11,186)	\$ (17,137)	\$ (57,363)	\$ (7,207)	\$ 0

- (1) Includes general land and buildings, general equipment, preliminary surveys and investigations, and provision for incidental and emergency work.
- (2) Includes interim financing for capital improvements and bond proceeds applied directly to construction.
- (3) Includes allowance for funds used during construction of \$57.4 million for the five fiscal years ended June 30, 1996. The inclusion of such funds increases the carrying value of improvements by the amount of interest on borrowed construction funds used to finance plant additions during the period. See Note 1 (b) to the Financial Statements.

Projected Five-Year Capital Improvement and Financing Program

Following a public hearing and approval by the Consulting Engineers, the Board must adopt the Authority's capital budget on or before the first day of the ensuing fiscal year. If revisions are required, the Board may amend the capital budget at any time during the fiscal year with the approval of the Consulting Engineers. The capital budget for fiscal year 1997 was adopted on June 20, 1996.

The projected capital improvement program for the five fiscal years ending June 30, 2001 aggregates approximately \$1.7 billion. It is currently estimated that \$338 million, or approximately 20.4%, of the projected five-year capital improvement program will be financed by internally generated funds. Estimated capital costs reflect, among other factors, construction contingency allowances of 15% and annual cost escalation of approximately 5% during the five-year period.

The five-year capital improvement program includes \$577.6 million for production plant. A substantial part of this amount represents investment in the rehabilitation and replacement of generating plants to continue to improve their reliability and efficiency and increase the generating capacity of the System. The projected capital improvement program is consistent with the Authority's base case capacity expansion plan described under "Adequacy of Capacity" above.

In connection with its measures to provide for additional generating capacity, the Authority projects the cost of rehabilitating the generating plants to be approximately \$296.7 million, and the cost of site repowering at the San Juan Steam Plant to be approximately \$224.9 million. All of the above projected expenditures have been included

in the five-year capital improvement program for the five fiscal years ending June 30, 2001. In addition to the Authority's projected capital improvement program for fiscal years 1997 through 2001, the Authority has entered into agreements to purchase power from two cogeneration facilities with an aggregate generating capacity of approximately 874 MW that are expected to be operational, respectively, by fiscal year 1999 and fiscal year 2000. For a detailed discussion of each of the above capacity expansion projects, see "Adequacy of Capacity—Additional Generating Facilities" above.

The Consulting Engineers have examined the projected capital improvement program and found it to be reasonable. The capital improvement program is subject to periodic review and adjustment because of changes in expected demand, environmental requirements, design, equipment delivery schedules, costs of labor, equipment and materials, interest rates and other factors. The following table presents a summary of the capital improvement program for the five fiscal years ending June 30, 2001 and its projected financing.

Projected Capital Improvement Program
Fiscal years 1997-2001
(in thousands)

	<u>Years Ending June 30,</u>					<u>Total⁽¹⁾</u>
	<u>1997</u>	<u>1998</u>	<u>1999</u>	<u>2000</u>	<u>2001</u>	
Capital Improvements						
Production plant	\$133,844	\$161,451	\$148,600	\$ 78,839	\$ 54,883	\$ 577,617
Transmission facilities	69,549	98,608	93,597	72,044	70,949	404,747
Distribution facilities	80,827	88,236	79,504	83,816	85,250	417,633
Other ⁽²⁾	69,601	68,501	47,773	40,268	32,270	258,413
	<u>\$353,821</u>	<u>\$416,796</u>	<u>\$369,474</u>	<u>\$274,967</u>	<u>\$243,352</u>	<u>\$1,658,410</u>
Financing Sources						
Internally generated funds	\$ 65,388	\$ 55,701	\$ 64,000	\$ 83,678	\$ 69,237	\$ 338,004
Borrowed funds ⁽³⁾	437,024	175,000	300,000	200,000	193,200	1,305,224
Amounts provided from (or used for) unexpended financing or other funds ⁽⁴⁾	<u>(148,591)</u>	<u>186,095</u>	<u>5,474</u>	<u>(8,711)</u>	<u>(19,085)</u>	<u>15,182</u>
	<u>\$353,821</u>	<u>\$416,796</u>	<u>\$369,474</u>	<u>\$274,967</u>	<u>\$243,352</u>	<u>\$1,658,410</u>

- (1) Includes allowance for funds used during construction of \$51.5 million for the five-year period (see footnote (3) to the table under "Historical Capital Improvement and Financing Program" above).
- (2) Includes general land and buildings, general equipment, preliminary surveys and investigations, and provision for incidental and emergency work.
- (3) Reflects available proceeds after deducting estimated cost of issuance. Includes notes issued to Government Development Bank for Puerto Rico ("Government Development Bank") to be repaid from proceeds of additional notes or Power Revenue Bonds. See *Debt*. For the purpose of this table, it is assumed that of the total \$1,364 million Power Revenue Bonds that will be issued in the five-year period, \$575 million will be used to pay such notes to be issued during the period.
- (4) Includes interest on money in the 1974 Construction Fund.

As part of the Proposed Budget, the projected capital expenditures for fiscal years 1998 through 2001, set forth in the above table, may be modified as described under "Proposed Budget for Fiscal Year 1998" under *Net Revenues and Coverage*.

Rates

The Authority has the power to determine, alter, establish and collect reasonable rates for electric service which shall produce sufficient revenues to cover the operating costs of the Authority, the payment of the principal of and the interest on its bonds, and other contractual obligations. Public hearings are required before the setting of permanent rates, with

the final approval vested solely within the Authority. Act No. 21 of the Legislature of Puerto Rico, approved May 31, 1985 (“Act No. 21”), provides uniform procedures for public hearings and review of the actions of certain public corporations, including the Authority, in connection with changes in the rates set by such public corporations. Act No. 21 also authorizes the Legislature by resolution to review rates of certain public corporations, including the Authority. At the request of another public corporation covered by Act No. 21, the Secretary of Justice has rendered an opinion to the effect that Act No. 21 does not grant a veto power to the Legislature over rates adopted properly by such public corporation.

Electric service rates consist primarily of (i) basic charges, consisting of demand, client and energy related costs, which includes a base fuel price of \$2.00 per barrel; and (ii) fuel adjustment charges to recover the cost to the Authority of fuel oil above a base price of \$2.00 per barrel. Consequently, Revenues will reflect changes in the fuel adjustment charge caused by fluctuations in the price of fuel oil. The following table presents the electric sales revenues derived from basic charges and fuel adjustment charges for the five fiscal years ended June 30, 1996 and the seven months ended January 31, 1996 and 1997.

**Electric Sales Revenues
(in thousands)**

	<u>Years Ended June 30,</u>					<u>Seven Months Ended January 31,</u>	
	<u>1992</u>	<u>1993</u>	<u>1994</u>	<u>1995</u>	<u>1996</u>	<u>1996</u>	<u>1997</u>
Basic charges	\$ 830,914	\$ 849,679	\$ 904,477	\$ 930,969	\$ 972,807	\$573,568	\$574,455
Fuel adjustment charges	390,191	473,560	445,128	516,170	584,154	325,181	393,942
	<u>\$1,221,105</u>	<u>\$1,323,239</u>	<u>\$1,349,605</u>	<u>\$1,447,139</u>	<u>\$1,556,961</u>	<u>\$898,749</u>	<u>\$968,397</u>

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

The Authority intends to recover the costs of power purchased from the cogeneration facilities by utilizing a purchased power adjustment clause similar to its fuel adjustment clause. See “Adequacy of Capacity—Additional Generating Facilities” above.

Under the Act, certain residential clients receive a subsidy (formerly from the Commonwealth and currently from the Authority) for the fuel adjustment charge. Residential clients who qualify for the subsidy are billed the full applicable basic charges and fuel adjustment charges, with the applicable subsidy taking the form of a credit against the bill. Certain other clients also receive subsidies from the Authority, such as hotels and clients who elect to shift their electricity consumption to off-peak periods. See “Fuel Oil Subsidy and Contributions in Lieu of Taxes” below for a more detailed description of these subsidies.

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

Major Clients

The public sector, which consists of the Commonwealth government and its public corporations and the municipalities (included primarily in the commercial category), accounted for 17.2% of kWh sales and 15.1% of revenues from electric energy sales for the fiscal year ended June 30, 1996. For the seven months ended January 31, 1997, the public sector accounted for 16.1% of kWh sales and 18.2% of revenues from electric energy sales.

The ten largest industrial clients listed below accounted for 6.2% of kWh sales and 5.0% of revenues from electric energy sales for the twelve months ended January 31, 1997.

Major Industrial Clients

Clients	Location	kWh Electric Energy Sales	Revenue from Electric Energy Sales
(in thousands)			
Yabucoa Sun Oil	Yabucoa	169,449	\$13,397
Puerto Rican Cement	Ponce	141,105	10,537
Phillips Puerto Rico	Guayama	127,181	10,524
Abbott Chemicals, Inc.	Manatí	108,738	9,883
San Juan Cement	Dorado	106,029	8,540
Upjohn Manufacturing	Barceloneta	103,696	8,349
Squibb Manufacturing	Humacao	62,660	5,241
Schering Industrial Development Corp.	Manatí	61,004	5,105
Eli Lilly	Carolina	56,760	4,704
Ayerst Wyeth Pharmaceuticals	Guayama	50,989	4,338
		987,611	\$80,618

Residential Service Comparison of the Authority with United States Electric Utilities

In comparing revenue per kWh of the Authority and United States electric utilities, it should be noted that fuel oil is the major operating cost of generating electricity in Puerto Rico. Therefore, the price of fuel oil, in addition to changes in operating efficiency, has a disproportionate effect on revenue per client and revenue per kWh. The following table compares residential client usage of electricity and revenue in Puerto Rico and the mainland United States for the calendar years 1992 through 1996.

Puerto Rico and United States Average Residential Usage and Residential Revenue

Calendar Years	Puerto Rico			United States ⁽¹⁾		
	kWh per Client	Revenue per Client ⁽²⁾ (dollars)	Revenue per kWh ⁽²⁾ (cents)	kWh per Client	Revenue per Client (dollars)	Revenue per kWh (cents)
1992	4,329	346.60	8.01	9,392	772.10	8.22
1993	4,471	353.20	7.90	9,874	821.07	8.31
1994	4,531	360.76	7.96	9,824	829.90	8.45
1995	4,713	392.09	8.32	10,032	843.07	8.40
1996	4,688	420.95	8.98	10,330 ⁽³⁾	870.80 ⁽³⁾	8.43 ⁽³⁾

(1) Source: Edison Electric Institute: Statistical Year.

(2) Includes the subsidy for certain residential clients. See "Subsidies, Contributions in Lieu of Taxes and Set Asides" below.

(3) Based upon eleven months of available data.

Fuel

For the fiscal year ended June 30, 1996, fuel oil expenses amounted to \$585.2 million, or 51.1% of total Current Expenses. For the seven months ended January 31, 1997, fuel oil expenses amounted to \$392.0 million, or 54.3% of total Current Expenses. For the five fiscal years ended June 30, 1996, fuel oil expense was a fairly stable component of total Current Expenses, averaging 49.0% of total Current Expenses. See "Management's Discussion and Analysis of Operating Results" under *Net Revenues and Coverage*.

The Authority's thermal generating units, which produced 99% of the net electric energy generated by the System in fiscal year 1996, are fueled by No. 6 residual fuel oil, except for the smaller combustion-turbine units and the two Aguirre combined-cycle units, which burn No. 2 distillate fuel oil. These combined-cycle units are equivalent to 14% of total installed capacity. The smaller combustion turbine units represent 11% of the System's aggregate dependable generating capacity.

As of January 31, 1997, 100% of the Authority's fuel requirements were covered by one-year contracts, which expire at various times. The Authority does not expect any difficulty in renewing such contracts at prices similar to those currently in effect. The Authority customarily maintains a 25-day supply of fuel oil. Although sources of fuel oil are continually changing as a result of variations in relative price, availability and quality, the Authority has never been forced to curtail service to its customers because of fuel oil shortages.

The Authority's total inventory capacity for fuel oil is 3.1 million barrels. As of January 31, 1997, the Authority had an inventory of 2.4 million barrels of fuel oil.

Average fuel oil costs and related costs of production for the five fiscal years ended June 30, 1996 and for the seven months ended January 31, 1996 and 1997 are shown in the following table.

	Fuel Costs					Seven Months Ended	
	Years Ended June 30,					January 31,	
	1992	1993	1994	1995	1996	1996	1997
Average fuel oil cost per barrel (net of handling costs)	\$14.58	\$16.72	\$15.26	\$17.17	\$18.69	\$17.81	\$20.95
Number of barrels used (in millions)	27.3	28.9	29.9	30.5	31.3	18.4	18.7
Fuel oil cost (in millions)	\$398.7	\$483.3	\$456.5	\$523.2	\$585.2	\$327.3	\$392.0
Net kWh generated (in millions)	15,047.4	15,667.4	16,548.4	17,012.1	17,658.2	10,379.5	10,409.4
Average net kWh per barrel	550.3	541.9	553.1	557.8	564.2	564.1	556.4
Average fuel oil cost per net kWh generated (in cents)	2.65	3.08	2.76	3.08	3.31	3.16	3.77

Ninety-eight percent of the Authority's generating capacity is provided by oil-fired units. Because of its dependence on oil, the Authority is extremely sensitive to changes in fuel prices. Accordingly, changes in fuel costs have a direct impact on electricity costs. The Authority projects a 6.1% average annual increase in fuel oil prices during the five fiscal years ending June 30, 2001.

In order to reduce its dependence on fuel oil, the Authority has been evaluating the use of alternative fuels, primarily gaseous fuels, for future additions of generating capacity or the conversion of existing generating units and has entered into agreements to purchase the output of cogeneration facilities using fuels other than fuel oil. See "Adequacy of Capacity—Additional Generating Facilities" above. For the Aguirre combined-cycle units, the Authority is studying the viability of using natural gas as an alternative to No. 2 fuel oil.

Subsidies, Contributions in Lieu of Taxes and Set Asides

Subsidies

Under the Act, the Authority (and prior to July 1, 1991, the Commonwealth) provides a subsidy for the cost of fuel adjustments to qualifying residential clients who use up to 425 kWh monthly or 850 kWh bi-monthly. This subsidy has taken the form of a credit against their electric bills.

The Act limits the subsidy to a maximum of \$100 million per year and limits the cost of fuel oil used in calculating the amount of such subsidy to a maximum of \$30 per barrel. Any fuel adjustment resulting from a price of fuel oil in excess of \$30 per barrel must be paid by the residential clients. By revising its subsidy implementing regulations under the Act, the Authority has been able to limit the subsidy to approximately \$7 million per year for each of the five fiscal years ended June 30, 1996.

Up to fiscal year 1991, the subsidy was paid by the Commonwealth and was recorded as a receivable by the Authority. As of June 30, 1991, the amount owed by the Commonwealth to the Authority on account of the fuel oil subsidy program was \$94.9 million. In October 1991, the Authority and the Commonwealth entered into a non-interest bearing fifteen year payment plan, starting with fiscal year 1993, for the payment of this amount. As of January 31, 1997, the amount owed by the Commonwealth was approximately \$63 million. As of that date, the Commonwealth was current in the payments due under the plan.

Hotels receive from the Authority a subsidy in an amount equal to 11% of their monthly billing. The subsidy amounts are charged to operations in the Authority's financial statements as part of the "electric energy sales set aside" discussed below. In order to receive this subsidy, hotels must maintain current their electric service accounts.

Contributions In Lieu of Taxes and Set Asides

Under the Act, the Authority is required to pay to the Secretary of the Treasury (for distribution to the municipalities) from its Net Revenues, after certain defined expenditures and subject to compliance with its obligations under the 1974 Agreement, contributions in lieu of taxes in the amount of 6% of its gross electric energy sales computed on the basis of an annual average fuel oil price of up to \$30 per barrel. Under certain circumstances, the Authority is empowered to raise the ceiling (if the price exceeds \$30 per barrel) to provide the municipalities, through contributions in lieu of taxes, with sufficient income to offset their billings for consumption plus the necessary amounts to fulfill their obligations to the Authority. Contributions in lieu of taxes to municipalities can be used to offset accounts receivable balances owed to the Authority, as permitted by law. For fiscal year 1996, contributions in lieu of taxes to municipalities amounted to \$78.4 million, of which \$1.9 million was reimbursed to the municipalities and \$76.5 million was used to offset or reduce outstanding accounts receivable balances.

The Act also requires the Authority to set aside annually from its Net Revenues an additional amount equal to 5% of the Authority's annual gross electric energy sales (the "electric energy sales set aside"). One fifth of the electric energy sales set aside is to be applied to cover the costs of the fuel oil subsidy program arising after June 30, 1991 (with any balance remaining being used to reduce the amounts owed by the Commonwealth to the Authority on account of such subsidy as of June 30, 1991). Another one fifth of the electric energy sales set aside must be paid to the Secretary of the Treasury for distribution among the various municipalities (in addition to the contributions in lieu of taxes described above). The balance of the set aside must be used to fund certain of the Authority's capital improvements and other purposes. The Authority's obligation to make available the electric energy sales set aside is also subject to the Authority's obligations under the 1974 Agreement (and in prior years, under the 1947 Indenture as well).

If the Authority's Net Revenues, as defined in the Act, in any year are not sufficient to cover the contribution in lieu of taxes and the electric energy sales set aside, said contribution and set aside is reduced to the amount available, and the excess does not carry forward as a liability for future years. During the last five fiscal years ended June 30, 1996, the Net Revenues of the Authority were not sufficient to permit the payment to the municipalities of the full contribution in lieu of taxes and the electric energy sales set aside due to the priority payments of certain obligations which are required by the 1974 Agreement and 1947 Indenture.

DEBT

The following table sets forth the bond, note and other debt obligations of the Authority as of February 1, 1997 and as adjusted for the issuance of the Bonds and the refunding of the Refunded Power Revenue Bonds.

	Outstanding as of February 1, 1997	As Adjusted
	(in thousands)	
Power Revenue Bonds		
Publicly offered	\$3,064,604 ⁽¹⁾	\$3,530,194 ⁽¹⁾
Rural Electrification Bonds	<u>184,311</u>	<u>184,311</u>
	<u>\$3,248,915</u>	<u>\$3,714,505</u>
Notes		
General Obligation Notes	\$ 140,000	\$ 140,000
Bond Anticipation Notes	<u>150,000</u>	<u>0</u>
	<u>290,000</u>	<u>140,000</u>
Total	<u>\$3,538,915</u>	<u>\$3,854,505</u>

(1) Includes \$92.7 million of accretion on Capital Appreciation Bonds.

Rural Electrification Bonds

The Rural Utilities Service ("RUS") (formerly the Rural Electrification Administration) has purchased bonds issued by the Authority to provide funds for the construction of generation, transmission and distribution facilities to service RUS qualified areas. As of January 31, 1997, the Authority had issued to RUS a total of \$301 million of its Power Revenue Bonds, \$184 million of which were outstanding, at interest rates of 2% and 5%.

No additional Power Revenue Bonds are expected to be issued to RUS during the five fiscal years ending June 30, 2001.

General Obligation Notes

The Authority has issued \$125.0 million of its general obligation notes to certain commercial banks to finance the purchase of fuel oil. The notes are due on July 3, 1997. The Authority intends to refinance these notes. Also, in August 1993, the Authority issued \$45.0 million of notes to Government Development Bank. Proceeds from the notes were used to pay employer contributions owed to the Employee's Retirement System of the Authority. As of January 31, 1997, \$15.0 million of such notes to Government Development Bank were outstanding.

Bond Anticipation Notes

The Authority has issued to Government Development Bank bond anticipation notes for the interim financing of its capital improvement program. These notes were in the principal amount of \$150 million as of February 1, 1997 and \$230 million as of May 8, 1997. The Authority expects to retire these notes from the proceeds of the Bonds.

Principal and Interest Requirements

Principal and Interest Requirements, as used herein and as defined in the 1974 Agreement, means for any fiscal year the sum of all principal of, including Amortization Requirements for, and interest on, outstanding Power Revenue Bonds which is payable on January 1 in such fiscal year and on July 1 in the following fiscal year. The following table shows the annual Principal and Interest Requirements for the outstanding Power Revenue Bonds after giving effect to the issuance of the Bonds and the refunding of the Refunded Power Revenue Bonds. The Amortization Requirements

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

Years Ending <u>June 30,</u>	<u>The Bonds*</u>				Total Debt Service Requirements
	Outstanding Principal and Interest Requirements	Maturity and Amortization Requirements	Interest	Total	
1997	\$ 286,306,866.43	\$ —	\$ —	\$ 0.00	\$ 286,306,866.43
1998	280,969,000.75	—	36,059,795.63	36,059,795.63	317,028,796.38
1999	281,498,284.55	—	30,908,396.26	30,908,396.26	312,406,680.81
2000	280,982,045.44	7,180,000.00	30,585,296.26	37,765,296.26	318,747,341.70
2001	275,468,576.22	7,505,000.00	30,228,808.76	37,733,808.76	313,202,384.98
2002	281,773,392.05	7,860,000.00	29,851,528.76	37,711,528.76	319,484,920.81
2003	281,283,856.75	8,240,000.00	29,398,328.76	37,638,328.76	318,922,185.51
2004	281,896,580.87	8,690,000.00	28,963,828.76	37,653,828.76	319,550,409.83
2005	274,443,358.81	9,125,000.00	28,507,578.76	37,632,578.76	312,075,937.57
2006	274,836,297.05	9,585,000.00	28,037,913.76	37,622,913.76	312,459,210.81
2007	267,212,669.25	10,055,000.00	27,434,613.76	37,489,613.76	304,702,283.01
2008	229,016,838.79	17,655,000.00	26,551,863.76	44,206,863.76	273,223,702.55
2009	229,855,744.41	22,120,000.00	25,445,863.76	47,565,863.76	277,421,608.17
2010	200,236,915.50	23,315,000.00	24,163,538.76	47,478,538.76	247,715,454.26
2011	195,546,305.80	24,640,000.00	22,623,538.76	47,263,538.76	242,809,844.56
2012	199,075,518.71	26,180,000.00	21,052,738.76	47,232,738.76	246,308,257.47
2013	204,257,180.75	27,705,000.00	19,390,438.76	47,095,438.76	251,352,619.51
2014	201,745,821.77	29,280,000.00	17,809,318.76	47,089,318.76	248,835,140.53
2015	201,145,086.25	30,975,000.00	16,144,412.50	47,119,412.50	248,264,498.75
2016	172,751,304.92	16,205,000.00	15,293,650.00	31,498,650.00	204,249,954.92
2017	171,537,449.29	17,055,000.00	14,398,262.50	31,453,262.50	202,990,711.79
2018	100,361,510.17	17,950,000.00	13,455,887.50	31,405,887.50	131,767,397.67
2019	98,551,322.78	18,895,000.00	12,393,043.76	31,288,043.76	129,839,366.54
2020	96,239,257.48	19,955,000.00	11,270,575.00	31,225,575.00	127,464,832.48
2021	95,873,843.35	21,080,000.00	10,084,825.00	31,164,825.00	127,038,668.35
2022	73,815,370.77	22,265,000.00	8,832,418.76	31,097,418.76	104,912,789.53
2023	73,527,303.69	23,515,000.00	7,509,700.00	31,024,700.00	104,552,003.69
2024	53,392,100.00	24,840,000.00	6,112,450.00	30,952,450.00	84,344,550.00
2025	25,607,800.00	26,235,000.00	4,702,318.76	30,937,318.76	56,545,118.76
2026	2,154,475.00	27,650,000.00	3,216,131.26	30,866,131.26	33,020,606.26
2027	2,154,250.00	29,135,000.00	1,650,125.00	30,785,125.00	32,939,375.00
2028	<u>2,155,200.00</u>	<u>30,700,000.00</u>	<u>—</u>	<u>30,700,000.00</u>	<u>32,855,200.00</u>
Total	<u>\$5,695,671,527.60</u>	<u>\$565,590,000.00</u>	<u>\$582,077,190.83</u>	<u>\$1,147,667,190.83</u>	<u>\$6,843,338,718.43</u>

* Totals may not add due to rounding.

NET REVENUES AND COVERAGE

Management's Discussion and Analysis of Operating Results

The following represents the Authority's analysis of its operations for the five fiscal years ended June 30, 1996 and the seven months ended January 31, 1996 and 1997.

For the seven months ended January 31, 1997, as compared to January 31, 1996, Revenues increased by \$70.2 million and Current Expenses increased by \$72.7 million, resulting in a decrease of \$2.5 million in Net Revenues. The growth in Revenues was due mainly to an increase of \$68.8 million in fuel adjustment clause revenues as a result of a higher fuel oil price. Energy demand reflected a slight decrease of 0.2% during this period due mainly to the effects

of Hurricane Hortense and cooler temperatures. Current Expenses increased due mainly to a \$3.14 per barrel increase in the average cost of fuel oil.

For the fiscal year ended June 30, 1996 as compared to June 30, 1995, Revenues increased by \$112.9 million and Current Expenses increased by \$111.8 million resulting in an increase in Net Revenues of \$1.1 million. The growth in Revenues was due mainly to an increase of 4.5% in energy sales with energy consumption increases occurring in the three major categories of clients. Revenues also increased as a result of additional fuel adjustment clause revenues. Current Expenses growth was due mainly to a \$1.52 per barrel increase in the price of fuel oil. Maintenance and Administrative and General expenses rose due mainly to additional reserves required for employees fringe benefits and salary raises granted during the year. Accounts Receivable of the Authority increased from \$333.9 million on June 30, 1995 to \$356.2 million on June 30, 1996. Accounts receivable from the governmental sector decreased from \$160.7 million on June 30, 1995 to \$159.4 million on June 30, 1996.

For the fiscal year ended June 30, 1995 as compared to June 30, 1994, Revenues increased by \$100.5 million and Current Expenses increased by \$75.8 million, resulting in an increase in Net Revenues of \$24.7 million. The growth in Revenues was due mainly to an increase of 3.0% in energy sales with energy consumption increases in all categories of clients. In addition, Revenues increased due to a \$1.91 per barrel increase in the cost of fuel oil. The increase in Current Expenses was primarily due to the increase in fuel oil price and the use of an additional .6 million barrels of fuel oil. In addition, on June 30, 1995, accounts receivable of the Authority were \$333.9 million as compared to \$306.3 million on June 30, 1994. Accounts receivable from the governmental sector increased from \$136.9 million on June 30, 1994 to \$160.7 million on June 30, 1995.

For the fiscal year ended June 30, 1994 as compared to June 30, 1993, Revenues increased by \$23.4 million and Current Expenses decreased by \$24.1 million, resulting in an increase in Net Revenues of \$47.5 million. The growth in revenues was due mainly to an increase of 6.3% in energy sales, with energy consumption increases in all categories of clients. The increase in energy sales revenues was partially offset by a reduction in fuel adjustment clause revenues due to a decrease of \$1.46 per barrel in the price of fuel oil. The decrease in Current Expenses was due primarily to the reduction in the price of fuel oil despite an increase of 1.0 million barrels used. Accounts receivable amounted to \$306.3 million (net of \$74.5 million of reduction through charges accounted for as a contribution in lieu of taxes) on June 30, 1994, down from \$322.0 million on June 30, 1993. See "Subsidies, Contributions in Lieu of Taxes and Set Asides" for a more detailed description of this reduction.

For the fiscal year ended June 30, 1993, as compared to June 30, 1992, Revenues increased by \$105.4 million, and Current Expenses increased by \$99.6 million, resulting in an increase in Net Revenues of \$5.8 million. Energy sales rose by 2.4% with energy consumption increases taking place in all major categories of clients. The growth in Revenues was due mainly to a \$2.14 per barrel increase in the average cost of fuel oil, and the use of an additional 1.6 million barrels of fuel oil. The increase in Current Expenses was due primarily to the increase in fuel oil cost. Customer accounting and collection expenses rose due mainly to a \$5.9 million provision for doubtful accounts to cover possible losses on accounts receivable from the government. The increase in Administrative and general, as well as production expenses, was due primarily to salary increases granted to employees. The decrease in maintenance expenses was due to a change in the accounting treatment for asbestos removal costs, which provided for the capitalization of a portion of such costs.

For the fiscal year ended June 30, 1992, compared with June 30, 1991, Revenues decreased by \$45.9 million and Current Expenses decreased by \$54.3 million, resulting in an increase in Net Revenues of \$8.4 million. Energy sales rose by 4.0% with energy consumption increases taking place in all categories of clients. The decrease in Revenues was due principally to a \$3.38 per barrel reduction in the average cost of fuel oil, notwithstanding a 1.5 million barrel increase in fuel oil use. The decrease in Current Expenses was due principally to the reduction in fuel oil cost. Administrative and general and Customer accounting and collection expenses increased by \$5.2 million due mainly to salary increases granted under the collective bargaining agreement signed in May 1992.

The following table presents the Net Revenues (exclusive of certain investment income) of the Authority under the provisions of the 1947 Indenture and the 1974 Agreement for the four fiscal years ended June 30, 1995 and under the 1974 Agreement for the fiscal year ended June 30, 1996 and the seven months ended January 31, 1996 and 1997 and the ratio of such Net Revenues to Principal and Interest Requirements on the Electric Revenue Bonds and Power Revenue Bonds. These calculations of Net Revenues differ in several important respects from the Authority's calculations of net income prepared in conformity with generally accepted accounting principles in that they do not include, for example, depreciation as a current expense and do not reflect interest expense as a deduction from Net Revenues.

Historical Net Revenues and Coverage

	Years Ended June 30,					Seven Months Ended January 31,	
	1992	1993	1994	1995	1996	1996	1997
Average number of clients	1,179,840	1,202,497	1,223,109	1,246,887	1,268,948	1,264,203	1,287,589
Electric energy sales							
(in millions of kWh)	13,615	13,939	14,816	15,259	15,945	9,401	9,378
Source of Net Revenues							
(dollar amounts in thousands)							
Revenues :							
Sales of electrical energy:							
Residential ⁽¹⁾	\$ 355,951	\$ 382,872	\$ 391,971	\$ 425,293	\$ 465,632	\$274,698	\$298,754
Commercial	527,938	574,625	591,206	631,572	679,326	390,277	422,495
Industrial	276,346	300,466	300,982	322,009	342,178	193,856	204,332
Other	60,870	65,276	65,446	68,265	69,825	39,918	42,816
	<u>1,221,105</u>	<u>1,323,239</u>	<u>1,349,605</u>	<u>1,447,139</u>	<u>1,556,961</u>	<u>898,749</u>	<u>968,397</u>
Revenues from Commonwealth for rural electrification	2,017	1,936	1,280	1,269	1,124	658	623
Other operating revenues	5,961	6,620	7,483	7,848	8,805	5,135	5,323
Other (principally interest earned)	20,566	23,257	20,042	22,635	24,857	13,276	13,643
	<u>1,249,649</u>	<u>1,355,052</u>	<u>1,378,410</u>	<u>1,478,891</u>	<u>1,591,747</u>	<u>917,818</u>	<u>987,986</u>
Current Expenses:							
Operations:							
Fuel	398,653	483,251	456,492	523,235	585,157	327,273	391,951
Other production	40,056	42,883	39,638	43,226	36,350	23,937	22,984
Transmission and Distribution ..	48,662	56,430	61,049	66,883	71,608	42,238	46,201
Customer accounting and collection	64,453	69,366	70,971	68,718	70,323	39,130	39,765
Administrative and General ...	106,873	115,587	119,404	113,231	138,609	80,062	87,041
Maintenance ⁽²⁾	214,638	207,542	203,182	210,274	241,462	135,633	133,106
Other	6,187	6,607	6,814	7,781	1,626	1,410	1,385
	<u>879,522</u>	<u>981,666</u>	<u>957,550</u>	<u>1,033,348</u>	<u>1,145,135</u>	<u>649,683</u>	<u>722,433</u>
Net Revenues	<u>\$ 370,127</u>	<u>\$ 373,386</u>	<u>\$ 420,860</u>	<u>\$ 445,543</u>	<u>\$ 446,612</u>	<u>\$268,135</u>	<u>\$265,553</u>
Coverage							
Principal and Interest Requirements:							
Electric Revenue Bonds	\$ 69,174	\$ 66,072	\$ 68,295	\$ 68,102	—	—	—
Power Revenue Bonds	151,163	161,809	170,088	193,097	277,387 ⁽³⁾	161,809 ⁽³⁾	167,596
	<u>\$ 220,337</u>	<u>\$ 227,881</u>	<u>\$ 238,383</u>	<u>\$ 261,199</u>	<u>\$ 277,387</u>	<u>\$161,809</u>	<u>\$167,596</u>
Ratio of Net Revenues to Principal and Interest Requirements:							
Electric Revenue Bonds	5.35	5.65	6.16	6.54	—	—	—
Electric and Power Revenue Bonds ⁽³⁾	1.68	1.64	1.77	1.71	1.61	1.66	1.58

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

(2) Includes, for maintenance of generating facilities, \$143.0 million, \$130.8 million, \$125.7 million, \$125.2 million and \$148.2 million for fiscal years ended June 30, 1992, 1993, 1994, 1995 and 1996, respectively. For the seven months ended January 31, 1996 and 1997 maintenance expense of generating facilities was \$82.4 million and \$76.8 million, respectively.

(3) For fiscal year 1996, includes two months debt service payments on the Electric Revenue Bonds.

The following table presents the disposition of Net Revenues, in the order of priority of payment, for the five fiscal years ended June 30, 1996 and for the seven months ended January 31, 1996 and 1997, in accordance with the provisions of the 1947 Indenture and the 1974 Agreement. As discussed above, the Net Revenues shown below are calculated in a manner which differs in several important respects from the Authority's calculation of net income prepared in accordance with generally accepted accounting principles.

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

<u>Disposition of Net Revenues</u>	<u>Years Ended June 30,</u>					<u>Seven Months Ended January 31,</u>	
	1992	1993	1994	1995	1996	1996	1997
1947 Sinking Fund:							
Principal	\$ 31,546	\$ 35,037	\$ 34,878	\$ 42,738	\$ 6,309	\$ 6,309	\$ —
Interest	39,045	35,737	33,861	32,018	5,090	5,090	—
1947 Reserve Account ⁽¹⁾	—	—	—	(5,720)	(68,756)	(68,756)	—
1947 General Reserve Fund ⁽¹⁾	5,138	5,442	5,667	6,051	(93,371)	3,728	—
1947 Renewal and Replacement Fund / 1974 Revenue Fund:							
1974 Sinking Fund⁽²⁾:							
Interest	106,725	132,142	138,979	153,904	189,294	107,316	112,057
Principal	40,587	43,029	46,325	51,678	101,905	58,994	64,170
1974 Reserve Account	—	—	3,600	—	35,001	35,001	—
Reserve Maintenance Fund	—	—	—	—	—	—	2,310
Self-insurance Fund	—	—	—	—	99,262	—	—
Capital Improvement Notes:							
Interest	1,249	887	4,753	346	707	707	—
Amortization of debt discount, financing expenses	4,288	4,663	4,880	5,251	3,309	2,070	1,812
Available for capital improvements	41,480	32,466	51,576	62,508	70,574 ⁽¹⁾	60,102	31,820
General Obligation Notes:							
Interest	477	1,180	526	1,640	1,332	820	641
Principal	4,583	—	—	—	—	—	—
Contribution in lieu of taxes and other ⁽³⁾	95,009	82,803	95,815	95,129	95,956	56,754	52,743
Net Revenues	<u>\$370,127</u>	<u>\$373,386</u>	<u>\$420,860</u>	<u>\$445,543</u>	<u>\$446,612</u>	<u>\$268,135</u>	<u>\$265,553</u>

- (1) In connection with the issuance by the Authority of its Power Revenue Refunding Bonds, Series V and W, in August, 1995, all of the Authority's outstanding Electric Revenue Bonds under the 1947 indenture were retired and the Authority covenanted not to issue any further Electric Revenue Bonds thereunder. Upon such retirement, all of the moneys to the credit of the 1947 Reserve Account were transferred to the credit of the 1974 Reserve Account in accordance with the 1974 Agreement. Upon the defeasance and release of the 1947 indenture in June 1996, all of the moneys to the credit of the 1947 General Reserve Fund were transferred to the 1974 General Fund. As a result of these transfers during fiscal 1996, the Authority recorded an internal fund contribution to the Self-insurance Fund of \$99.3 million and to the Capital Improvement Fund of approximately \$32 million.
- (2) Interest earned by the 1974 Sinking Fund is applied to provide for part of the required deposit in the 1974 Sinking Fund.
- (3) Including the following amounts retained by the Authority to offset certain Commonwealth obligations to the Authority, the residential subsidy and other subsidies granted to the hotel industry: \$17.5 million, \$17.7 million, \$18.3 million, \$16.8 million and \$17.6 million for fiscal years ended June 30, 1992, 1993, 1994, 1995 and 1996, respectively. For the seven months ended January 31, 1996 and 1997, those subsidies amounted to \$10.0 million and \$10.7 million, respectively.

Factors Affecting the Utility Industry Generally

The electric utility industry generally has faced and is facing certain adverse factors. These include (1) the effect of inflation on the cost of construction and operation of utility facilities, (2) the uncertain cost of capital, (3) regulations, licensing procedures, litigation and other factors which may delay the construction and increase the cost of new facilities or limit the use of, or necessitate costly modifications to, existing facilities, and (4) the substantially increased capital outlays and longer construction periods required for new facilities. The Authority is unable to predict the future effect of these or other factors upon its operations and financial condition.

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

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

The Authority’s competition thus far has been limited to large industrial clients which generate their own power. These clients must rely on the Authority for back-up services. The Authority has established a new electric rate for large industrial clients which is designed to induce such clients to buy more power from the Authority.

The Authority continues to improve its competitive position by (i) improving its quality of service, (ii) rehabilitating its generating facilities to improve reliability and efficiency, (iii) diversifying its fuel sources, and (iv) adopting a capacity expansion plan which will meet its load requirements at the lowest System cost.

Projected Net Revenues

The following table presents the Authority’s estimates of Net Revenues for the five fiscal years ending June 30, 2001, in accordance with the provisions of the 1974 Agreement, and the ratio of Net Revenues to Principal and Interest Requirements for Power Revenue Bonds. See “Proposed Budget for Fiscal Year 1998” below for certain changes to the Authority’s estimates of Net Revenues that would result if the 1998 Proposed Budget is approved.

The major assumptions used by the Authority in preparing the estimates of Net Revenues shown below are the following:

- Revenues— Projected Revenues from sales of electric energy are based upon economic growth projections for the Commonwealth. The Revenue projections assume annual sales growth of 3.0% which is more conservative than the rate of growth assumed in planning for capacity growth.
- Fuel— Projected fuel prices are based upon an analysis prepared by the Authority and reflect average annual price increases of approximately 6.1% for the forecast period. The following table sets forth projected average per barrel fuel prices:

<u>Years Ending June 30,</u>	<u>Average Price Per Barrel</u>
1997	\$21.38
1998	22.02
1999	22.98
2000	25.00
2001	27.16

Beginning in fiscal year 1999, a portion of the Authority’s electric sales is expected to be derived from energy purchased from independent cogeneration power producers. See “Adequacy of Capacity” under *The System*. For purposes of the following table and the 1974 Agreement, all payments by the Authority for the purchase of such energy will be treated as a Current Expense, which payments the Authority contemplates, after a hearing procedure, passing

through to its clients in the same manner as its fuel costs are passed through. Payments to be made by the Authority for the purchase of power will fluctuate based on plant availability, price changes and other factors.

Projected Net Revenues and Coverage

	Years Ending June 30,				
	1997	1998	1999	2000	2001
Average number of clients	1,288,898	1,308,315	1,327,955	1,347,823	1,367,705
Electric energy sales (in millions of kWh)	16,168.0	16,726.9	17,328.9	17,891.5	18,089.6
Authority generation (gross)(in millions of kWh) ..	19,224.7	19,889.4	18,020.2	15,939.7	14,699.9
Purchased generation (gross)(in millions of kWh) ..	—	—	2,585.0	5,393.0	6,870.0
Sources of Net Revenues					
(dollar amounts in thousands)					
Revenues:					
Sales of electrical energy:					
Residential	\$ 514,793	\$ 530,063	\$ 575,655	\$ 631,539	\$ 647,873
Commercial	730,254	752,125	844,206	950,162	977,995
Industrial	358,782	381,840	427,220	478,512	496,454
Others	73,067	73,638	76,762	80,800	81,513
	<u>1,676,896</u>	<u>1,737,666</u>	<u>1,923,843</u>	<u>2,141,013</u>	<u>2,203,835</u>
Rural electrification	1,068	1,007	941	881	941
Other operating revenues	—	—	—	—	—
Other (principally interest earned)	33,029	33,690	34,363	35,051	35,752
	<u>1,710,993</u>	<u>1,772,363</u>	<u>1,959,147</u>	<u>2,176,945</u>	<u>2,240,528</u>
Current Expenses:					
Operations:					
Fuel	679,822	706,409	659,864	604,260	592,294
Purchased Power	—	—	170,095	376,334	428,060
Other Production	41,489	41,846	42,876	43,794	45,279
Transmission and Distribution	69,228	73,422	75,230	76,840	79,446
Customer accounting and collection	67,576	68,194	69,873	71,369	73,789
Administrative and general	144,494	138,237	141,640	144,673	149,579
Maintenance	223,253	236,281	242,095	247,278	255,666
Other	3,014	3,544	3,633	3,724	3,817
	<u>1,228,876</u>	<u>1,267,933</u>	<u>1,405,306</u>	<u>1,568,272</u>	<u>1,627,930</u>
Net Revenues	<u>\$ 482,117</u>	<u>\$ 504,430</u>	<u>\$ 553,841</u>	<u>\$ 608,673</u>	<u>\$ 612,598</u>
Coverage					
Principal and Interest Requirements ⁽¹⁾	\$ 291,518	\$ 312,236	\$ 347,020	\$ 373,434	\$ 389,476
Ratio of Net Revenues to Principal and Interest Requirements ⁽¹⁾	1.65	1.62	1.60	1.63	1.57

(1) Includes debt service requirements for (i) the outstanding Power Revenue Bonds (including the Bonds after taking into account the refunding of the Refunded Power Revenue Bonds), and (ii) expected Power Revenue Bond issues, all at an assumed interest rate of 7.0% (\$388.2 million in fiscal year 1999, \$310.6 million in fiscal year 2000 and \$200.0 million in fiscal year 2001) (no repayments of principal of these issues are assumed until after fiscal year 1999).

The Authority's estimates of Net Revenues, which estimates were made as part of the adoption of its budget of current expenses for fiscal year 1997, have been reviewed and analyzed by the Consulting Engineers. The Consulting Engineers have concluded that (i) the methodology used by the Authority in preparing its revenue and capacity

projections generally follows accepted utility practice and is appropriate for the Authority, (ii) the Authority's estimates of future growth form a reasonable basis for its projected operating results, and (iii) the Authority's rates should generate sufficient revenues to pay its current expenses and debt service and to finance that portion of its capital improvement program that is currently anticipated to be financed with current operating revenues. See Appendix III, *Letter of Consulting Engineers*.

Although the Authority and the Consulting Engineers believe that the assumptions upon which the estimates of Net Revenues are based are reasonable, actual results may differ from the estimates as circumstances change. See "Proposed Budget for Fiscal Year 1998" below for potential changes in the estimates of Net Revenues that would result from the adoption of the 1998 Proposed Budget.

The following table presents the projected disposition of Net Revenues, in the order of priority of payment, for the five fiscal years ending June 30, 2001, in accordance with the provisions of the 1974 Agreement.

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

<u>Disposition of Net Revenues</u>	<u>Years Ending June 30,</u>				
	<u>1997</u>	<u>1998</u>	<u>1999</u>	<u>2000</u>	<u>2001</u>
1974 Sinking Fund:					
Interest	\$197,858	\$213,284	\$234,103	\$254,818	\$262,689
Principal	110,045	116,199	129,919	135,593	140,824
Reserve	—	—	—	—	—
Reserve Maintenance Fund	3,960	5,000	5,000	5,000	5,000
Self-insurance Fund	—	—	—	—	—
Capital Improvement Fund	65,388	55,701	64,000	83,678	69,237
Contributions in lieu of taxes and other ⁽¹⁾	<u>104,866</u>	<u>114,246</u>	<u>120,819</u>	<u>129,584</u>	<u>134,848</u>
Total Net Revenues	<u>\$482,117</u>	<u>\$504,430</u>	<u>\$553,841</u>	<u>\$608,673</u>	<u>\$612,598</u>

(1) Includes amounts to be retained by the Authority and used to pay interest on its General Obligation Notes and to offset certain Commonwealth obligations to the Authority, the residential subsidy and the subsidy granted to the hotel industry: \$14.4 million, \$16.3 million, \$12.1 million, \$14.1 million and \$15.9 million for fiscal years ending June 30, 1997, 1998, 1999, 2000 and 2001, respectively.

Proposed Budget for Fiscal Year 1998

On April 29, 1997, the Board adopted the 1998 Proposed Budget. The 1998 Proposed Budget is subject to a public hearing, approval by the Consulting Engineers and ratification by the Board prior to June 30, 1997 and may be modified as a result of such process. Under the 1998 Proposed Budget, the projected capital improvement program for fiscal years 1998 through 2002 aggregates approximately \$1.6 billion. It is currently estimated that \$281.3 or approximately 17.3% of the proposed five year capital improvement program would be financed with internally generated funds. As part of the 1998 Proposed Budget, the projected total capital expenditures for fiscal years 1998 through 2001, set forth in the table under "Projected Five-Year Capital Improvement and Financing Program" under *The System*, would increase by approximately \$42 million.

Under the 1998 Proposed Budget, the Authority's estimates of Net Revenues for fiscal years 1998 through 2001 and the ratio of Net Revenues to Principal and Interest Requirements for Power Revenue Bonds for such years, set forth in the table under "Projected Net Revenues and Coverage" under *Net Revenues and Coverage*, were also modified.¹ Net Revenues for fiscal year 1998 are projected to increase by approximately \$2.8 million and are projected to be

¹The assumptions used by the Authority in preparing the revised estimates of Net Revenues under the 1998 Proposed Budget were changed by increasing for fiscal years 1998, 1999 and 2000 the average per barrel fuel prices to \$22.48, \$24.00 and \$25.37, respectively, and by reducing such price to \$26.53 for fiscal year 2001.

reduced, for fiscal years 1999, 2000 and 2001 by approximately \$12.0 million, \$24.6 million and \$8.8 million, respectively, resulting in a total reduction of approximately \$42.6 million for the four fiscal year period. Such modifications, if ratified by the Board, would change the projected ratios of Net Revenues to Principal and Interest Requirements for fiscal years 1999, 2000 and 2001 to 1.55, 1.55 and 1.53, respectively.

ENVIRONMENTAL MATTERS

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

Litigation

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

In October 1993, EPA and the United States Department of Justice filed a suit against the Authority seeking injunctive relief and approximately \$50 million in civil penalties for violations of and noncompliance by the Authority with several federal and local environmental laws, including the Clean Air Act, the Clean Water Act, and the National Pollutant Discharge Elimination System permit requirements. The Authority and EPA undertook negotiations to resolve the issues and to ensure future compliance with all applicable regulations. As a result of the negotiations, the Authority and EPA, with the active participation of the United States Department of Justice, reached an agreement which resulted in a proposed Consent Decree. In the proposed Consent Decree, the Authority agreed to pay a civil penalty of \$1.5 million, to implement additional compliance projects costing \$4.5 million, and to undertake improvements to its existing compliance programs (some of which are discussed below) and its operations in order to assure compliance with environmental laws and regulations.

The Consent Decree was signed on December 19, 1996 and filed on January 10, 1997 in the United States District Court for the District of Puerto Rico for approval. The Department of Justice is required to receive comments relating to this Consent Decree for a period of 90 days after its publication in the Federal Register on February 4, 1997, after which the Department of Justice will move the Court to enter the Consent Decree if it appears that its approval is in the best public interest.

Compliance Programs

The Authority continues to develop and implement a comprehensive program to improve environmental compliance in all applicable environmental media. This program has been and continues to be updated to conform to new regulatory requirements. The Authority's current compliance proposal entails spending approximately \$33.6 million on capital improvements and environmental projects for fiscal year 1997.

Opacity Compliance

The Authority is currently working on a compliance plan that addresses the flue gas opacity levels and is focused on the "visible" component of the opacity issue. In accordance with this plan, the Authority is committed to burn a better quality fuel oil with a lower sulfur content (1.5% sulfur) at each of its four thermoelectric plants. The new fuel specifies a required viscosity level and also has lesser amounts of asphaltenes and vanadium. No add-on air emissions control technology (e.g. precipitators) is being considered at this time, but the possibility of its installation has not been ruled out. The implementation of these measures, which is still ongoing, has enabled the Authority to achieve and maintain compliance with visible emissions regulations at the Palo Seco and San Juan power plants and at the four smaller generating units of the South Coast plant. At this time, all efforts are focused on Aguirre and South Coast power plants so as to reduce their visible emissions. The Authority is currently testing several fuel additives in Aguirre units 1 and 2 and South Coast units 5 and 6 to reduce the formation of sulfur trioxide, which is responsible for the white opacity observed in the emissions of these units.

In the Quality Assurance and Quality Control (QA/QC) area, the Authority is also committed to complete the installation of continuous monitoring systems (i.e., opacity monitors) in its generating units to ensure long term

compliance of its operations. In addition, the Authority is also committed to calibrate, perform tests, conduct quality assurance procedures, and install alarms in the control rooms for the applicable monitors.

To ensure long-term compliance with opacity limits, the Authority is spending approximately \$10.1 million on capital improvements and environmental projects for fiscal year 1997, excluding the cost of any fuel additives. Should fuel additives be required, they could cost as much as an additional \$6 million per year.

The completion of the EcoElectrica and the AES cogeneration projects will enable the Authority to reduce its dependence on fuel oil, thereby improving significantly its emission profile and providing the opportunity for the future conversion of existing oil-fired plants to cleaner burning natural gas.

Water Pollution Compliance

The Authority has signed consent orders with EPA that include compliance plans for abating water pollution at the Aguirre, South Coast, Palo Seco and San Juan power plants. The Authority has proposed to EPA some extensions in the compliance schedules for certain activities, primarily because the scope of the work has broadened. The Authority incurred \$5.9 million in expenses for water pollution abatement during the fiscal year ended June 30, 1996. The Authority estimates that it will spend \$8.0 million for fiscal year 1997 to complete all water quality related projects.

The Authority started field studies to acquire the data necessary to update its previous submittals of Section 316 waiver requests under the Clean Water Act for the Aguirre, South Coast, San Juan and Palo Seco power plants. The Authority submitted to EPA a report and a waiver request on February, 1995 related to the results of the San Juan power plant study. The same waiver request will be submitted by June 30, 1997 for the Palo Seco power plant. A Plan of Study 316 waiver request has been submitted to EPA for approval for the Aguirre and South Coast plants. The field studies are scheduled for fiscal year 1998 after EPA's approval of the Plans of Study. These studies will take about a year to complete at a total cost of approximately \$1 million.

Underground Injection Control Regulation

The Authority is preparing a compliance plan in order to comply with the Puerto Rico Environmental Quality Board (EQB) Underground Injection Control Regulation. The Compliance Plan consists of the licensing of existing septic systems, construction of new systems and the closing of systems that can be connected to Puerto Rico Aqueduct and Sewer Authority. The Authority estimates that it will spend \$22.5 million during fiscal years 1996 through 1999 to comply with the compliance plan. It is estimated that the Authority will spend \$1.5 million for fiscal year 1997.

Spill Prevention Control and Countermeasures Plan

To meet its obligations with respect to the Spill Prevention Control and Countermeasures Plan Act requirements, the Authority has agreed to continue implementation of corrective measures at all four thermoelectric power plants as well as its Monacillos Transmission Center. As of this date, the corrective measures with respect to the four thermoelectric power plants and the Monacillos Transmission Center have been implemented. This phase of the compliance program was completed at a total cost of approximately \$8.0 million. The Authority estimates that it will spend \$14.0 million during fiscal year 1997 to comply with the regulations of this program in all its other facilities.

Underground Storage Tanks Compliance

The Authority continues to pursue its program of complying with the regulations relating to underground storage tanks pursuant to the EPA's Underground Storage Tank Program. The program focuses on the gradual closure of old or inactive tanks, followed by the installation of new ones.

Between 1990 and 1995, 46 tanks were replaced. During fiscal year 1997 the Authority will replace 13 other old tanks and will replace 6 additional tanks before fiscal year 1998. To date, the Authority has spent approximately \$4 million to comply with this program. For fiscal year 1997, \$200,000 were allocated to cover the cost of this program.

The Authority is required under the Consent Decree to certify that all underground storage tanks have been permanently closed on site or removed from all power plants and from the Monacillos Transmission Center by the date of entry of the Decree. In addition, the Authority must certify that no underground storage tanks are present at South Coast Power Plant and that any Underground Storage System at the Aguirre plant is exempted from the regulations.

PCB Testing

The Authority is in the fifth year of a ten-year EPA-mandated program to sample, test and dispose of its oil-filled transformers and other equipment in order to comply with applicable PCB regulations. The Authority is sampling and analyzing an average of approximately 12,600 distribution transformers per year. The Authority sampled and analyzed 14,021 distribution transformers during fiscal year 1996. The cost of the analysis program was approximately \$277,000. The cost of the disposal of PCB wastes, which includes the disposal of PCB and contaminated distribution equipment and transformers, was approximately \$1,049,000. To date, 75,733 distribution transformers have been sampled and analyzed. In fiscal year 1996 approximately \$252,000 were spent for the disposal of PCB wastes. For fiscal year 1997 \$2.0 million was allocated for this PCB sampling and testing program.

Asbestos Abatement

The Authority is engaged in encapsulating and/or gradually removing asbestos-containing insulation from the power plants as needed, which is consistent with current industry practice. For the seven months ended January 31, 1997, the Authority spent approximately \$642,000 on asbestos abatement projects as part of its generating plant upgrade program.

Environmental Compliance Costs

The Authority's Capital Improvement Program for the five fiscal years ending June 30, 2001 includes \$47.3 million to comply with existing Commonwealth and federal environmental regulations. The Authority believes it is taking the necessary steps to comply with all applicable environmental regulations.

INSURANCE

Coverage

The Authority maintains, among others, casualty insurance covering all-risk property, boiler and machinery and public liability. The all-risk property policy (excluding coverage of transmission and distribution facilities) covers \$300 million per occurrence and in the aggregate for the annual policy period. Business interruption is limited to \$20 million plus \$10 million extra expense allowance. Deductibles under this policy are 2% per location for windstorm, 5% per location for earthquake, subject to a maximum deductible of \$25 million per occurrence and a minimum deductible of \$2 million per occurrence. The proceeds of the all-risk property policy are used prior to drawing upon the Reserve Maintenance Fund or the Self-insurance Fund (hereinafter defined) established under the 1974 Agreement.

The boiler and machinery policy covers direct damage to property caused by explosion and fire with a limit of \$100 million per occurrence and in the aggregate for the policy period with a deductible of \$2 million per occurrence.

The public liability policy covers property damage and bodily injury to third parties with a limit of \$750,000 per occurrence in excess of the self retention limit of \$250,000 per occurrence and \$50 million in the aggregate for the policy period in excess of \$1 million.

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

In the Authority's opinion, its insurance coverage adequately indemnifies it against property damage or bodily injury resulting from the possession, operation and maintenance of the System by the Authority. Worker's compensation insurance is provided by the State Insurance Fund, a Commonwealth agency, which is funded by mandatory contributions from employers. The Consulting Engineers reviewed the Authority's insurance program in May 1996, recommended that the Authority continue to follow its insurance consultant's recommendations and found that the property and liability coverages address the principal exposure to loss. See "Insurance" and "Consulting Engineers" under Appendix I, *Summary of Certain Provisions of the 1974 Agreement Excluding Proposed Supplemental Agreements*.

Self-insurance Fund

The Authority has supplemented the 1974 Agreement to create a Self-insurance Fund (the "Self-insurance Fund"), which is funded from Net Revenues (after deposits to the Sinking Fund and the Reserve Maintenance Fund). The Authority has no obligation to make deposits to, or to replenish, the Self-insurance Fund in the event of withdrawals therefrom. Amounts on deposit in the Self-insurance Fund are available for the payment of principal of and interest on the Power Revenue Bonds. See "Disposition of Revenues" under Appendix I, *Summary of Certain Provisions of the 1974 Agreement Excluding Proposed Supplemental Agreements*.

LABOR RELATIONS

As of January 31, 1997, the Authority had 10,640 employees (including Irrigation System Employees), including 792 temporary unionized employees. Of such employees, 7,721 were represented by four local unions. The Electrical Industry and Irrigation Workers Union ("UTIER") represents 6,270 employees engaged in operations and maintenance. The three other unions represent construction workers (Insular Union of Industrial and Electrical Construction Workers Union ("UITICE")), professional employees (Independent Professional Employees Union ("UEPI")) and pilots (Power Authority Pilots Union ("UPAEE")) employed by the Authority.

The agreement with UITICE expires on January 23, 2001. The agreement with UTIER, expires on May 16, 1998. The agreement with UPAEE, expires on June 27, 1998, and the agreement with UEPI, expires on December 11, 2000.

Of the 10,640 employees, 3,358 are employed in the transmission and distribution facilities directorate, 2,808 are employed in the generating facilities directorate, 1,716 are employed in the customer service directorate and the remainder are employed in the administrative directorate and other areas. In order to improve the productivity of its employees, the Authority has instituted various programs to reduce absenteeism, increase safety measures and reduce the level of drug abuse among its workers. In addition, the Authority continues to implement programs to provide both technical and supervisory training to its employees. The Authority believes that the implementation of these programs provides for a higher reliability of service to its customers.

PENSION PLAN

Employees' Retirement System of Puerto Rico Electric Power Authority (the "Retirement System"), a separate trust fund created by the Authority, administers the Authority's pension plan, which provides employee retirement and death benefits. The pension plan provides for contributions by both the Authority, based on annual actuarial valuations, and the plan members. The financial statements of the Retirement System are audited annually by independent public accountants. Although all benefits of the Authority's pension plan are administered by the Retirement System, only the basic benefits are funded through contributions to the Retirement System. Supplemental benefits, such as spousal survivor benefits are unfunded and the Authority reimburses the Retirement System for such benefits when paid. The Retirement System's funding policy provides for actuarially determined periodic contributions so that sufficient assets will be available to pay benefits when due. The contribution requirements are determined using a projected benefit method with aggregate level normal cost rate and open-end supplemental (accrued) liability. Experience gains and losses are reflected in the accrued liability. The unfunded accrued liability is being amortized over a 40-year period from June 30, 1975. The Authority's policy is generally to fund these contributions currently as they become due in accordance with actuarially determined requirements. The contributions recorded as of June 30, 1996 and 1995 were \$33.3 million and \$34.2 million, respectively, representing 6.13% and 8.47% and 6.13% and 8.49%, respectively, of covered payroll for normal cost and unfunded actuarial accrued liability for each of the indicated years. Employee contributions and other withholdings are being paid to the Retirement System on a current basis. In fiscal year 1996, total pension expense of the Authority was approximately \$33.3 million, including approximately \$23.2 million for past service costs. Unfunded past service liability to be borne entirely by the Authority approximated \$234.4 million as of June 30, 1996. In addition, portions of the pension benefits payable to employees who elect early retirement but receive credit for unused sick leave to qualify for full pensions are paid for by the Authority and, beginning with fiscal year 1987, a spousal survivor benefit was instituted. Total unfunded pension benefit obligations for these two benefits amounted to approximately \$290.2 million as of June 30, 1996, and total pension expense for these two benefits for fiscal year 1996 was approximately \$15.1 million.

LITIGATION

The Authority is involved in various lawsuits arising in the normal course of business none of which, in the opinion of the Authority and its General Counsel, if determined adversely to the Authority, would have a material adverse effect on the Authority's financial condition or operations.

In February 1993, the EPA filed a complaint against the Authority seeking imposition of substantial civil fines for alleged violations of the federal Clean Air Act, Clean Water Act and the National Pollutant Discharge Elimination System permit requirements. For a discussion of this lawsuit and environmental compliance programs adopted by the Authority, see *Environmental Matters*.

TAX EXEMPTION

The Internal Revenue Code of 1986, as amended (the "Code"), includes requirements which the Authority 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 Authority'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 Authority has covenanted 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 Authority from complying with the requirements of the Code.

In the opinion of Bond Counsel, subject to continuing compliance by the Authority 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 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 entitled to the earned income credit or deemed to have incurred or continued indebtedness to purchase or carry tax-exempt obligations.

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 applicability and impact of any collateral consequences.

Legislation affecting municipal bonds 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. Corporate investors should note that President Clinton's budget proposal for fiscal year 1998 would reinstate the corporate environmental tax for taxable years beginning after December 31, 1996 and before January 1, 2008.

DISCOUNT BONDS

Under the Code, the difference between the principal amount of the Series AA Power Revenue Bonds stated to mature July 1 of the years 2001, 2004, 2005, 2007, 2008, 2013 through 2017, inclusive, 2023 and 2027 and of the Series BB Power Revenue Refunding Bonds stated to mature July 1 of the years 2001, 2004, 2005, 2007, 2008, 2013 and 2014 (collectively, the "Discount Bonds"), and the initial offering price to the public (excluding bond houses and brokers) at which price a substantial amount of such Discount Bonds of the same maturity 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 the distribution requirements of certain regulated investment companies and may result in some of the collateral federal income tax consequences described above under *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, 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 the Authority's capital appreciation bonds. Interest not includable in gross income for federal income tax purposes equal to the original issue discount accruing during the period a Beneficial Owner holds such Discount Bond will increase the adjusted basis of 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 original issue discount 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

Under the Code, the difference between the amount payable at maturity of the Series AA Power Revenue Bonds stated to mature July 1 of the years 2002, 2006 and 2009 through 2012, inclusive, and of the Series BB Power Revenue Refunding Bonds stated to mature July 1 of the years 2002, 2006, and 2009 through 2012, inclusive, 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) who purchases the Bonds at the initial offering price 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 their 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 premium upon redemption, sale or other disposition of such Bonds and with respect to the state and local tax consequences of owning and disposing of such Bonds.

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 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 Power Revenue Bonds. Deloitte & Touche LLP will express no opinion on the assumptions provided, nor as to the exemption from taxation of the interest on the Bonds.

UNDERWRITING

The Underwriters have jointly and severally agreed, subject to certain conditions, to purchase the Bonds from the Authority at an aggregate discount of \$4,207,688.15 from the initial public offering prices set forth or derived from information contained on the inside front cover hereof. The obligations of the Underwriters are subject to certain conditions precedent, and they will be obligated to purchase all such Bonds if any such Bonds are purchased. The Bonds may be offered and sold to certain dealers (including dealers depositing the Bonds into investment trusts) and institutional purchasers at prices lower than such public offering prices, and such public offering prices may be changed, from time to time, by the Underwriters. The Authority has agreed to indemnify, to the extent permitted by law, the Underwriters against certain liabilities, including liabilities under federal securities laws.

Morgan Stanley & Co. Incorporated ("Morgan Stanley"), an underwriter, has entered into a written agreement with Popular Securities, Inc. ("Popular Securities"), a subsidiary of BanPonce Corporation pursuant to which Popular Securities has agreed to cooperate in connection with Morgan Stanley's provision of underwriting and investment banking services to the Authority with respect to the Bonds. Pursuant to these arrangements, the existence of which has been disclosed to the Authority and Government Development Bank, Popular Securities will be entitled to receive a portion of Morgan Stanley's actual net profits, if any, in connection with the underwriting of the Bonds.

MATERIAL RELATIONSHIPS

Raytheon Engineers & Constructors, Inc. (“Raytheon”), independent Consulting Engineers to the Authority, has a subcontract relationship with EcoElectrica to provide engineering procurement and construction services in connection with EcoElectrica’s cogeneration project in Puerto Rico. Gramatges & Associates, a general partnership (the partners of which are employees of Raytheon) licensed to perform professional engineering services in the Commonwealth, has performed environmental support services for EcoElectrica. Gramatges & Associates has performed environmental and engineering services with the Authority and continually pursues work in the engineering and construction areas. Raytheon currently provides engineering services to AES on a number of power projects. In addition, Raytheon may provide various environmental assessments for AES in connection with AES’ proposed cogeneration project in Puerto Rico.

Merrill Lynch, Pierce Fenner & Smith Incorporated (“Merrill Lynch”), a subsidiary of Merrill Lynch & Co., one of the Underwriters of this offering, has served as underwriter of debt and equity offerings of Kenetech Corporation and an affiliate of AES. Merrill Lynch has acted and is currently acting as an underwriter of debt offerings of Enron.

Goldman, Sachs & Co., one of the Underwriters of this offering, currently has an agreement with AES to serve as underwriter on certain debt that may be issued in connection with AES’ cogeneration project in Puerto Rico.

PaineWebber Incorporated, one of the Underwriters of this offering, is acting as financial advisor to EcoElectrica in the development of EcoElectrica’s cogeneration project in Puerto Rico.

Lehman Brothers, one of the Underwriters of this offering, provides investment banking services to Enron and AES.

Smith Barney, Inc., one of the Underwriters of this offering, provides investment banking services to Kenetech Corporation.

Prudential Securities Incorporated, one of the Underwriters of this offering, has acted and may in the future act as underwriter or financial advisor to Enron in its equity and debt offerings.

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

LEGAL MATTERS

The proposed form of opinions of Brown & Wood LLP, New York, New York, Bond Counsel, is set forth in Appendix IV to this Official Statement. Certain legal matters will be passed upon for the Underwriters by Pietrantonio Méndez & Alvarez, San Juan, Puerto Rico.

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.

GOVERNMENT DEVELOPMENT BANK FOR PUERTO RICO

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

INDEPENDENT ACCOUNTANTS

The financial statements as of June 30, 1996 and June 30, 1995 of the Authority included in Appendix II hereto have been audited by Coopers & Lybrand, San Juan, Puerto Rico, independent accountants as set forth in their report therein.

RATINGS

The Bonds have been assigned ratings of Baa1 by Moody's and of BBB+ by Standard & Poor's. These ratings do not reflect the Policy. Moody's and Standard & Poor's have given the Insured Bonds ratings of Aaa and AAA, respectively, based on the Policy. The ratings reflect only the respective opinions of such rating agencies. Any explanation of the significance of ratings must be obtained from the respective rating agency. There is no assurance that the ratings will continue for any given period of time or will not be revised downward or withdrawn entirely by any or all of such rating agencies. Any such downward revision or withdrawal of the ratings could have an adverse effect on the market prices of the Bonds.

CONTINUING DISCLOSURE

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

(a) to file within 275 days after the end of each fiscal year beginning after its fiscal year 1997, 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 Authority's audited financial statements, prepared in accordance with generally accepted accounting principles in effect from time to time, and (ii) material historical quantitative data (including financial information and operating data) on the Authority's System and revenues, expenditures, financial operations and indebtedness generally found in this Official Statement; and

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

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

With respect to the following events:

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

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

Event (viii). The Authority does not undertake to provide the above-described event notice of a mandatory scheduled redemption, not otherwise contingent upon the occurrence of an event, if the

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

As of May 8, 1997, there is no Commonwealth SID, and the name and address of each NRMSIR is: 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; Thompson Financial, 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 Authority may from time to time choose to provide notice of the occurrence of certain other events in addition to those listed above if, in the judgment of the Authority, such other events are material with respect to the Bonds, but the Authority does not undertake to provide any such notice of the occurrence of any material event except those events listed above.

The Authority acknowledges that its undertaking pursuant to the Rule described above is intended 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 Authority’s obligations hereunder.

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

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 Authority, or type of business conducted; the Covenant, 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 interests of Beneficial Owners, as determined by parties unaffiliated with the Authority; 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 resolution, ceases to be in effect for any reason, and the Authority elects that the Covenant shall be deemed amended accordingly.

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

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

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

MISCELLANEOUS

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

There are appended to this Official Statement (i) summaries of the 1974 Agreement and the proposed Supplemental Agreements, (ii) the financial statements of the Authority for the fiscal year ended June 30, 1996, together with the independent accountants' report of Coopers & Lybrand, San Juan, Puerto Rico for said fiscal year, (iii) a letter from the Authority's Consulting Engineers, Raytheon Engineers & Constructors, Inc., regarding their opinion as to certain engineering matters in this Official Statement, (iv) the proposed form of opinions of Brown & Wood LLP, Bond Counsel, and (v) a specimen copy of the Policy.

Reference is made to Appendix I to the Official Statement of the Commonwealth, dated March 13, 1997, relating to the sale of \$326,845,000 Commonwealth of Puerto Rico Public Improvement Refunding Bonds, Series 1997 and \$369,000,000 Commonwealth of Puerto Rico Public Improvement Bonds of 1997, containing financial and other information of the Commonwealth (the "*Commonwealth Appendix*"), which the Commonwealth has filed with each NRMSIR and the MSRB and is incorporated herein by reference.

Any Appendix I of an Official Statement of the Commonwealth or any appendix of an Official Statement of any instrumentality of the Commonwealth containing the same information as the *Commonwealth Appendix*, filed with each NRMSIR and the MSRB after the date hereof and prior to the termination of any offering of the Bonds shall be deemed to be incorporated by reference into this Official Statement and to be part of this Official Statement from the date of filing of such document. Any statement contained herein or in any of the above described documents incorporated herein by reference shall be deemed to be modified or superseded for purposes of this Official Statement to the extent that a statement contained herein or in any other subsequently filed document modifies or supersedes such statement. Any such statement so modified or superseded shall not be deemed, except as so modified or superseded, to constitute a part of this Official Statement.

For a discussion of recent developments relating to the information appearing in the *Commonwealth Appendix*, see *Recent Developments* in the Official Statement of the Commonwealth, dated April 10, 1997, relating to the sale of \$147,710,000 Commonwealth of Puerto Rico Public Improvement Bonds of 1997, Series B, which has been filed with each NRMSIR and the MSRB and is also incorporated herein by reference.

The Commonwealth will provide without charge to any person to whom this Official Statement is delivered, on the written or oral request of such person, a copy of any or all of the foregoing documents incorporated herein by reference. Requests for such documents should be directed to Director-New York Office, Government Development Bank for Puerto Rico, 140 Broadway, 38th Floor, New York, NY 10005, telephone number (212) 422-6420, or to Director-General Obligations Division, Government Development Bank for Puerto Rico, P.O. Box 42001, San Juan, PR 00940, telephone (787) 722-7060.

The information set forth in this Official Statement, except the information appearing in *Underwriting, Material Relationships*, Appendices III, IV, and V and the information pertaining to DTC and the Insurer was supplied by the Executive Director of the Authority in his official capacity as such Executive Director and is included in this Official Statement on his authority. The information incorporated herein by reference was supplied by certain officials of the Commonwealth, in their respective official capacities, or was obtained from publications of the Commonwealth, and is incorporated by reference in this Official Statement on the authority of such officials or the authority of such publications as public official documents, respectively. The information pertaining to DTC and the Insurer was supplied by DTC and the Insurer, respectively.

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

PUERTO RICO ELECTRIC POWER AUTHORITY

By: _____ /s/ Miguel A. Cordero
Executive Director

DEFINITIONS OF CERTAIN TERMS

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

“Accreted Value” means with respect to any Capital Appreciation Bonds (i) as of any Valuation Date, the amount set forth for such date in the resolution authorizing such Capital Appreciation Bonds and (ii) as of any date other than a Valuation Date, the sum of (a) the Accreted Value on the preceding Valuation Date and (b) the product of (1) a fraction, the numerator of which is the actual number of days having elapsed from the preceding Valuation Date and the denominator of which is the actual number of days from such preceding Valuation Date to the next succeeding Valuation Date and (2) the difference between the Accreted Values for such Valuation Dates. (1974 Agreement, Section 101).

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

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

If at the close of any fiscal year the total principal amount of term bonds of any Series retired by purchase or redemption, or prior to the close of such fiscal year called for redemption under the provisions of Section 511 of the 1974 Agreement, shall be in excess of the amount of the Amortization Requirements for the term bonds of such Series for such fiscal year, then the amount of the Amortization Requirements for the term bonds of such Series shall be reduced for such subsequent fiscal years in such amounts aggregating the amount of such excess as shall be determined by the Executive Director in an order filed with the 1974 Trustee on or before the 10th day of July following the close of such fiscal year.

If at the close of any fiscal year the total principal amount of term bonds of any Series retired by purchase or redemption, or called for redemption under the provisions of Section 511 of the 1974 Agreement, prior to the close of such fiscal year shall be less than the amount of the Amortization Requirements for the term bonds of such Series for such fiscal year, then the amount of the Amortization Requirements for the term bonds of such Series for the next succeeding fiscal year shall be increased by the amount of the excess of such deficiency over the amount then held to the credit of the Redemption Account in the 1974 Sinking Fund.

It shall be the duty of the 1974 Trustee, on or before the 15th day of July in each fiscal year, to compute the Amortization Requirements for the then current fiscal year for the term bonds of each Series then outstanding. The Amortization Requirement for the then current fiscal year shall continue to be applicable during the balance of such current fiscal year and no adjustment shall be made therein by reason of term bonds purchased or redeemed or called for redemption during such current fiscal year. (1974 Agreement, Section 101) .

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

conversion, the bonds shall be viewed as any other bonds of the same type for purposes of the 1974 Agreement. (1974 Agreement, Section 101).

“Current Expenses” means the Authority’s reasonable and necessary current expenses of maintaining, repairing and operating the System, including, but not limited to, all administrative expenses, insurance premiums, expenses of preliminary surveys not chargeable to capital expenditures, engineering expenses relating to operations and maintenance, fees and expenses of the 1974 Trustee and any paying agents, legal expenses, any payment to pension or retirement funds and all other expenses required to be paid by the Authority under the 1974 Agreement or by law or permitted by standard practices for public utility systems similar to the properties and business of the Authority, but shall not include any deposits to the credit of the 1974 Sinking Fund, the Reserve Maintenance Fund, the Self-insurance Fund or the Capital Improvement Fund. (1974 Agreement, Section 101).

“Designated Maturity Bonds” means the indebtedness incurred by the Authority under the terms of a separate trust agreement or resolution, which indebtedness has a maturity of at least ten (10) years and is secured, as to the unamortized principal thereof, on a subordinate basis to the bonds and for which (i) no amortization of principal has been established or (ii) the aggregate amount of the amortized principal that has been established is less than the principal amount of the indebtedness; provided that interest on said indebtedness and any amortized principal of said indebtedness may be payable on a parity, respectively, with interest on bonds and Amortization Requirements on term bonds, in which case said interest and amortized principal shall be calculated as Principal and Interest Requirements on bonds for purposes of the 1974 Agreement and shall otherwise be deemed to be, and be payable as interest and Amortization Requirements on, bonds for purposes of the 1974 Agreement. (1974 Agreement, Section 101).

“Extendible Maturity Bonds” means bonds the maturities of which, by their terms, may be extended by and at the option of the bondholder or the Authority. (1974 Agreement, Section 101).

“Net Revenues” means, for any particular period, the excess of the Revenues for such period over the Current Expenses for such period. (1974 Agreement, Section 101).

“Prerefunded Municipals” means any bonds or other obligations of any state of the United States of America or the Commonwealth or of any agency, instrumentality or local governmental unit of such state or the Commonwealth (a) which are (x) not callable prior to maturity or (y) as to which irrevocable instructions have been given to the trustee of such bonds or other obligations by the obligor to give due notice of redemption and to call such bonds for redemption on the date or dates specified in such instructions, (b) which are secured as to principal, redemption premium if any, and interest by a fund consisting only of cash or Government Obligations or Time Deposits, secured in the manner set forth in Section 601 of the 1974 Agreement, which fund may be applied only to the payment of such principal of and interest and redemption premium, if any, on such bonds or other obligations on the maturity date or dates thereof or the specified redemption date or dates pursuant to such irrevocable instructions, as appropriate, and (c) as to which the principal of and interest on the Government Obligations or Time Deposits secured in the manner set forth in Section 601 of the 1974 Agreement, which have been deposited in such fund along with any cash on deposit in such fund, are sufficient to pay principal of and interest and redemption premium, if any, on the bonds or other obligations on the maturity date or dates thereof or on the redemption date or dates specified in the irrevocable instructions referred to in the subclause (a) of this clause, as appropriate. (1974 Agreement, Section 101).

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

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

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

To the extent all or a portion of the principal of, Amortization Requirements for or interest on, any bonds of any Series are payable from moneys irrevocably set aside or deposited irrevocably for such purpose with a bank or trust company (which may include the 1974 Trustee) or from Investment Obligations, as defined in the 1974 Agreement, irrevocably set aside or deposited irrevocably for such purpose with a bank or trust company (which may include the 1974 Trustee) or Time Deposits secured in the manner set forth in Section 601 of the 1974 Agreement and irrevocably set aside for such purpose, the principal of and the interest on which when due will provide sufficient moneys to make such payments, such principal, Amortization Requirements or interest shall not be included in determining Principal and Interest Requirements; provided, however, that for purposes of the definition of Principal and Interest Requirements as used in Sections 502(A)(b) and 502(B)(b), respectively, of the 1974 Agreement said definition shall include any interest payable from any amount deposited to the credit of the Bond Service Account in the 1974 Sinking Fund from the proceeds of bonds to pay interest to accrue thereon. The Executive Director or his designee shall deliver to the 1974 Trustee a certificate describing the principal of, Amortization Requirements for and interest on any bonds for which moneys, Investment Obligations or Time Deposits have been set aside or deposited, and stating that such principal, Amortization Requirements and interest should not be included in the calculation of Principal and Interest Requirements. Upon request of the 1974 Trustee, the Authority shall cause to be delivered to the 1974 Trustee a certificate of an independent verification agent as to the sufficiency of the maturing principal amounts of any Investment Obligations or Time Deposits, together with interest thereon, set aside or deposited to pay said principal, Amortization Requirements and interest.

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

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

Principal and Interest Requirements on bonds shall be deemed to include the amount required to pay interest on outstanding Designated Maturity Bonds and any amortized principal of said Designated Maturity Bonds for any fiscal year, if said interest and amortized principal are payable, under the trust agreement or resolution providing for said Designated Maturity Bonds, on a parity with interest and Amortization Requirements on bonds. (1974 Agreement, Section 101).

"Put Bonds" means bonds, other than Variable Rate Bonds, which by their terms may be tendered by and at the option of the holders thereof for payment prior to the stated maturity thereof (1974 Agreement, Section 101).

"Reserve Account Insurance Policy" means the insurance policy, surety bond or other acceptable evidence of insurance, if any, deposited in the 1974 Reserve Account in lieu of or in partial substitution for cash or securities on deposit therein, for the purpose of making the payments required to be made from the 1974 Reserve Account under Section 510 of the 1974 Agreement. The issuer providing such insurance shall be a municipal bond insurer whose policy or bond results in the rating of municipal obligations secured by such policy or bond to be rated, at the time of deposit into the 1974 Reserve Account, in one of the three highest grades by either Standard & Poor's Ratings Services

or Moody's Investors Service, or if both such corporations no longer perform the functions of a securities rating agency, a nationally recognized rating agency. (1974 Agreement, Section 101).

"Reserve Account Letter of Credit" means the irrevocable, transferable letter of credit, if any, deposited in the 1974 Reserve Account in lieu of or in partial substitution for cash or securities on deposit therein, for the purpose of making the payments required to be made from the 1974 Reserve Account under Section 510 of the 1974 Agreement. The issuer providing such letter of credit shall be a banking association, bank or trust company or branch thereof whose letter of credit results in the rating of municipal obligations secured by such letter of credit to be rated, at the time of deposit into the 1974 Reserve Account, in one of the three highest grades by either Standard & Poor's Ratings Services or Moody's Investors Service, or if both such corporations no longer perform the functions of a securities rating agency, a nationally recognized rating agency. (1974 Agreement, Section 101).

"Revenues" or "revenues of the System" means all money received by the Authority in connection with or as a result of its ownership or operation of the System, including income derived from the sale of electricity generated or distributed by the System, the proceeds of use and occupancy insurance on the System or any part thereof and income from the investment of moneys under the 1974 Agreement, except income from the investment of moneys in the 1974 Construction Fund, the Reserve Maintenance Fund and the Capital Improvement Fund. (1974 Agreement, Section 101).

"System" means all the properties presently owned and operated by the Authority as a single integrated system, together with all works and properties which may be hereafter acquired or constructed by the Authority in connection with the production, distribution or sale of electric energy and the acquisition or construction of which shall be financed in whole or in part from the proceeds of bonds issued under the provisions of the 1974 Agreement or from moneys deposited to the credit of the 1974 Construction Fund.

"Valuation Date" means with respect to any Capital Appreciation Bonds the date or dates set forth in the resolution authorizing such bonds on which Accreted Values are assigned to the Capital Appreciation Bonds. (1974 Agreement, Section 101).

"Variable Rate Bonds" means bonds issued with a variable, adjustable, convertible or similar interest rate which is not fixed in percentage at the date of issue for the term thereof but which may or may not be convertible to a fixed interest rate for the remainder of their term. (1974 Agreement, Section 101).

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

(See also Summary of Certain Provisions of Proposed Supplemental Agreements)

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

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

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

which principal and interest shall be deemed to accrue on said bonds and the amount of any deposit required for the 1974 Reserve Account. (1974 Agreement, Sections 208, 209 and 210).

Security for the Power Revenue Bonds

The Power Revenue Bonds are secured by a pledge of moneys in the Puerto Rico Electric Power Authority Power Revenue Bonds Interest and Sinking Fund (the "1974 Sinking Fund"), a special fund created by the 1974 Agreement. (1974 Agreement, Section 513).

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

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

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

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

- (i) The Net Revenues for any 12 consecutive calendar months out of the 18 calendar months immediately preceding the date of the issuance of such bonds, adjusted to reflect the then current rate schedule, are not less than 120% of the maximum aggregate Principal and Interest Requirements for any fiscal year thereafter on account of all outstanding Power Revenue Bonds (excluding the bonds then to be issued), and
- (ii) the estimated average annual Net Revenues for the five fiscal years immediately following the fiscal year in which the issuance of such bonds occurs, adjusted to reflect the then current rate schedule and any rate schedule the Authority has covenanted to put in effect during such five fiscal years, shall be not less than 120% of the maximum aggregate Principal and Interest Requirements for any fiscal year thereafter on account of all outstanding Power Revenue Bonds and the bonds then to be issued. (1974 Agreement, Section 208).

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

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

Collection of Revenues

1974 General Fund

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

1974 Revenue Fund

A special fund is created by the 1974 Agreement and designated the "Puerto Rico Electric Power Authority Power Revenue Fund" (the "1974 Revenue Fund"). The Treasurer of the Authority is required to transfer each month from the 1974 General Fund to the 1974 Revenue Fund an amount equal to the amount of all moneys held in the 1974 General Fund at the end of the preceding month less an amount to be held as a reserve for Current Expenses equal to not more than 1/6 of the amount shown by the Annual Budget to be necessary for Current Expenses for the current fiscal year, such transfers to be made on the books of the Authority as of the close of the preceding month. (1974 Agreements Section 506).

Disposition of Revenues

1974 Sinking Fund and Reserve Maintenance Fund

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

1. the Bond Service Account in the 1974 Sinking Fund, until there has been accumulated therein an amount equal to the sum of (i) the amount of the interest then or to become within the next ensuing six months due and payable on the outstanding Power Revenue Bonds, (ii) the amount of the principal of the serial bonds of each Series of Power Revenue Bonds then or to become within the next six months due and payable and (iii) one-half of the amount of principal of the serial bonds of each such Series to become due and payable following such next ensuing six months and within the next ensuing 12 months; provided that in the case of Variable Rate Bonds, the amount deposited shall be the amount of interest estimated, on the 25th day of the month, to be due and payable within the next ensuing six (6) months, which interest shall be based initially on the interest rate in effect on the date of issuance and then shall be adjusted on the 25th day of each subsequent month based on the actual interest accrued from the 25th day of the previous month to the date of adjustment; provided, further, that in the case of a shortfall in the Bond Service Account for interest payable on any interest payment date, the amount of shortfall shall be funded on the business day immediately preceding such interest payment date from amounts on deposit in the 1974 Reserve Account;

2. the Redemption Account in the 1974 Sinking Fund, until there has been deposited in the then current fiscal year an amount equal to one-half of, if such deposit is made prior to December 31, and all of, if such deposit is made after December 31, the Amortization Requirements for such fiscal year for the term bonds of each Series of Power Revenue Bonds then outstanding plus applicable premiums;

3. the 1974 Reserve Account until the balance therein is equal to the interest payable on all outstanding Power Revenue Bonds within the next ensuing 12 months; provided, however, that the monthly deposit in respect of any Series of Power Revenue Bonds issued under Section 208 or 209 of the 1974 Agreement need not exceed

1/60 of the amount of the increase in the interest payable within the next ensuing 12 months resulting from the issuance of bonds of such Series, and provided, further, that the monthly requirements for deposits to the 1974 Reserve Account shall be cumulative; provided, further, that in the case of Variable Rate Bonds, the minimum amount to be deposited in the 1974 Reserve Account which shall be funded over the period required herein, shall be based initially on the interest rate in effect on the date of issuance of the Variable Rate Bonds and then shall be adjusted on the 25th day of each subsequent month based on the actual interest accrued from the 25th day of the previous month to the date of adjustment and any short-fall in the 1974 Reserve Account due to a withdrawal to fund interest pursuant to the proviso contained in subparagraph (1) above shall be funded on the 25th day of the next month; provided, further, that in the case of Capital Appreciation Bonds, the minimum amount required to be deposited in the Reserve Account shall be an amount derived from the interest rate which has been used to calculate the assumed yield on such bonds through their maturity times the Accreted Value of such bonds on the Valuation Date occurring at or after the first day of the twelfth succeeding month to the date of calculation of this requirement, as may be further specified in the resolution authorizing Capital Appreciation Bonds;

4. the Puerto Rico Electric Power Authority Reserve Maintenance Fund (the "Reserve Maintenance Fund"), a special fund created by the 1974 Agreement, such amount of any balance remaining after making the deposits mentioned in paragraphs 1, 2 and 3 above as may be recommended by the Consulting Engineers; provided, that the monthly requirements for deposit to the Reserve Maintenance Fund shall be cumulative;

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

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

Any balance remaining after making the deposits under paragraphs 1 through 6 above may be used for any lawful purpose of the Authority. (1974 Agreement, Section 507).

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

Moneys in the 1974 Reserve Account shall be used by the 1974 Trustee first for the purpose of paying the interest on the Power Revenue Bonds and maturing principal of serial bonds whenever moneys in the Bond Service Account are insufficient for such purposes and thereafter for the purpose of making the required deposits to the Redemption Account mentioned in paragraph 2 above whenever the withdrawals from the Renewal and Replacement Fund or the 1974 Revenue Fund, as the case may be, are insufficient for such purpose. Excess moneys in the 1974 Reserve Account shall be transferred to the Bond Service Account or may be used to reduce any Reserve Account Insurance Policy or Letter of Credit. (1974 Agreement, Section 510). The Authority may deposit a Reserve Account Insurance Policy or Letter of Credit into the 1974 Reserve Account, in lieu, or in partial substitution, of any required deposit into the 1974 Reserve Account. Said Reserve Account Insurance Policy or Letter of Credit may be secured by a lien on Revenues not inconsistent with the provisions of the 1974 Agreement and shall be payable or available to be drawn upon, as the case may be (upon the giving of notice as required thereunder), on any date on which moneys are required to be paid out of the 1974 Reserve Account pursuant to Section 510 of the 1974 Agreement. If a disbursement is made under any Reserve Account Insurance Policy or Letter of Credit, the Authority shall be obligated either to reinstate the limits of such Reserve Account Insurance Policy or Letter of Credit following such disbursement or to deposit into the 1974 Reserve Account moneys in accordance with the provisions of Section 507 of the 1974 Agreement in the amount of the disbursement made under such Reserve Account Insurance Policy or Letter of Credit. The Authority may at any time substitute (i) all or a portion of the moneys held to the credit of the 1974 Reserve Account with a Reserve Account Insurance Policy or Letter of Credit, (ii) all or a portion of any Reserve Account Insurance Policy on deposit in the 1974 Reserve Account with moneys or a Reserve Account Letter of Credit, or (iii) all or a portion of any Reserve Account Letter of Credit on deposit in the 1974 Reserve Account with moneys or a Reserve Account Insurance Policy. Any moneys on deposit in the 1974 Reserve Account in substitution of which a Reserve Account Insurance Policy or Letter of Credit is deposited shall, to the extent not required to fund any deficiencies in the amount then required to be on

deposit in the 1974 Reserve Account, be released and immediately paid over to the Authority to be used by the Authority for any of its lawful corporate purposes Prior to the expiration date of any Reserve Account Insurance Policy or Letter of Credit then on deposit to the credit of the 1974 Reserve Account, the Authority shall be required to (x) cause the term of such Reserve Account Insurance Policy or Letter of Credit to be extended, (y) replace any such Reserve Account Insurance Policy with moneys (which may include, without limitation, moneys available under the Reserve Account Insurance Policy or from any other source available for such purpose) or a Reserve Account Letter of Credit, or (z) replace any such Reserve Account Letter of Credit with moneys (which may include, without limitation, moneys available under the Reserve Account Letter of Credit or from any other source available for such purpose) or a Reserve Account Insurance Policy; provided, that in the event that the Authority has not extended or replaced the expiring Reserve Account Insurance Policy or Letter of Credit by the fifth business day prior to the date of expiration, the expiring Reserve Account Insurance Policy or Letter of Credit shall, on such date, be drawn upon to fund the 1974 Reserve Account. (1974 Agreement, Section 510).

Moneys in the Reserve Maintenance Fund shall be used only for the purpose of paying the cost of unusual or extraordinary maintenance or repairs, maintenance or repairs not recurring annually and renewals and replacements, including major items of equipment. The Reserve Maintenance Fund also serves as an additional reserve for the payment of the principal of and the interest on the Power Revenue Bonds and meeting the Amortization Requirements to the extent that moneys in the 1974 Sinking Fund, including moneys in the 1974 Reserve Account, and they are insufficient for such purpose. (1974 Agreement Section 512).

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

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

1974 Construction Fund

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

Rate Covenant

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

The Authority further covenants that if at any time the Revenues shall not be sufficient to make such deposits, transfers and payments, it will revise the rates and charges for the services and facilities furnished by the System and, if necessary, it will revise its regulations in relation to the collection of bills for such services and facilities, so that such deficiency will be made up before the end of the next ensuing fiscal year. Should any deficiency not be made up in such next ensuing fiscal year, the requirement therefor, except for the payment to the Commonwealth and municipalities

described above, shall be cumulative and the Authority shall continue to revise such rates until such deficiency shall have been completely made up. (1974 Agreement, Section 502).

Investment of Funds

The 1974 Agreement provides for the following types of investments:

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

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

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

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

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

Accounting

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

Release of Property

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

Notwithstanding the previous paragraph, the Authority may abandon, sell, lease or transfer any property forming a part of the System, if, among other things, the Net Revenues for any 12 consecutive calendar months out of the 18 calendar months next preceding the date of such abandonment, sale, lease or transfer, adjusted to give effect to such abandonment, sale, lease or transfer and any replacement and to reflect the rate schedule then in effect, are not less than 120% of the maximum aggregate Principal and Interest Requirements for any fiscal year thereafter on account of all outstanding Power Revenue Bonds and if the 1974 Reserve Account is fully funded. Any transferee of said property may be considered in lieu of or in addition to the Authority for purposes of such coverage if the transferee agrees to assume the Authority's obligations under the 1974 Agreement. Said coverage test need not be met if the transferee is a public corporation or other governmental entity provided the coverage is not reduced due to such transfer. The proceeds of such sale shall be deposited in the Redemption Account or in the 1974 Construction Fund, at the option of the Authority, or shall be applied to the replacement of the property so sold. The rentals under any such lease shall be deposited in the 1974 Revenue Fund.

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

Insurance

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

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

Consulting Engineers

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

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

Modifications

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

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

Remedies of Bondholders

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

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

In the event of any such default the 1974 Trustee may, and upon the written request of the holders of not less than 20% in aggregate principal amount of all Power Revenue Bonds then outstanding shall, declare the principal of the Power Revenue Bonds then outstanding to be due and payable, and, providing it shall be indemnified to its satisfaction, the 1974 Trustee may, and upon the written request of the holders of not less than 10% in aggregate principal amount of the Power Revenue Bonds then outstanding shall, proceed to protect and enforce its rights and the rights of the bondholders under the 1974 Agreement by such suits, actions or special proceedings in equity or at law, or by such proceedings in the office of any board or officer having jurisdiction, either for the appointment of a receiver of the

System as authorized by the Act or for the specific performance of any covenant or agreement or for the enforcement of any proper legal or equitable remedy, as the 1974 Trustee shall deem most effectual to protect and enforce the rights aforesaid; provided, however, that the 1974 Trustee shall not be required to proceed for the appointment of a receiver unless it shall have received the written request of the holders of not less than 25 % in principal amount of such bonds. (1974 Agreement, Sections 803, 804 and 902).

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

Defeasance

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

Bonds Not Deemed Outstanding

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

SUMMARY OF CERTAIN PROVISIONS OF PROPOSED SUPPLEMENTAL AGREEMENTS

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

Third Supplemental Agreement

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

Eighth Supplemental Agreement

The 1974 Agreement will be supplemented to permit the 1974 Trustee to use the effective fixed interest rate resulting from a qualifying interest rate swap agreement in lieu of the variable rate on related Variable Rate Bonds to determine interest for the purpose of calculating the Principal and Interest Requirements for the issuance of additional and refunding bonds and for the disposition of assets but not for the purpose of the rate covenant. A swap party must have its senior debt rated in one of the three highest rating categories (without regard to gradations within a category) by either (i) Standard & Poor's Ratings Services or its successor or (ii) Moody's Investors Service or its successor. The definition of "Principal and Interest Requirements" will be supplemented to include in a fiscal year principal payments on serial bonds after July 31 in such fiscal year and on or before July 31 in the following fiscal year.

[This page intentionally left blank]



certified public accountants

Banco Popular Center
Suite 1101
Hato Rey, Puerto Rico 00918
P.O. Box 363929
San Juan, Puerto Rico 00936-3929

telephone (809) 756-6050

facsimile (809) 754-7316-BA
(809) 753-0659-TAX

APPENDIX II

PUERTO RICO ELECTRIC POWER AUTHORITY
FINANCIAL STATEMENTS,
SUPPLEMENTAL SCHEDULES AND SUPPLEMENTARY INFORMATION
JUNE 30, 1996 AND 1995
AND
REPORT OF INDEPENDENT ACCOUNTANTS

Table of Contents

	Pages
Report of Independent Accountants	1
Financial Statements:	
Balance Sheets	2 - 3
Statements of Income and Retained Earnings	4
Statements of Cash Flows	5 - 6
Notes to Financial Statements	7 - 26
Supplemental Schedules:	
Required by 1947 Trust Indenture and 1974 Trust Agreement:	
Funds Under the Provisions of the 1947 Indenture and the 1974 Agreement (Schedule I)	27
Sources and Disposition of Net Revenues under the Provisions of the 1947 Indenture and the 1974 Agreement (Schedule II)	28 - 29
Changes in Cash and Investments by Fund (Schedule III)	30 - 31
Changes in Long-Term Debt and Current Portion of Long-Term debt (Schedule IV)	32
Supplementary Information - Funding Progress	33 - 34

Report of Independent Accountants

To the Governing Board of
Puerto Rico Electric Power Authority:

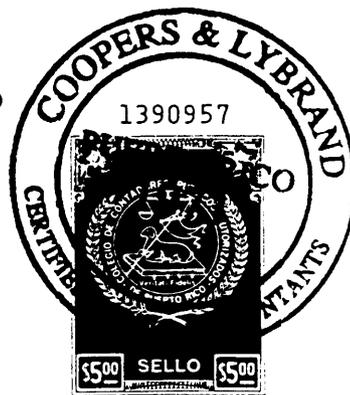
We have audited the accompanying balance sheets of PUERTO RICO ELECTRIC POWER AUTHORITY (a component unit of the Commonwealth of Puerto Rico) as of June 30, 1996 and 1995 and the related statements of income and retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Authority's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the 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 audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Puerto Rico Electric Power Authority as of June 30, 1996 and 1995 and the results of its operations and its cash flows for the years then ended, in conformity with generally accepted accounting principles.

Our audits were made for the purpose of forming an opinion on the basic financial statements taken as a whole. The supplemental schedules listed in the preceding table of contents are presented for purposes of additional analysis and are not a required part of the basic financial statements. Such information has been subjected to the auditing procedures applied in the audit of the basic financial statements and, in our opinion, is fairly stated in all material respects in relation to the basic financial statements taken as a whole, and is prepared in accordance with the terms of the 1947 Trust Indenture and the 1974 Trust Agreement. The supplementary information listed in the preceding table of contents is not a required part of the basic financial statements but is supplementary information required by the Governmental Accounting Standards Board. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the supplementary information. However, we did not audit the information and express no opinion on it.

San Juan, Puerto Rico
September 27, 1996



Coopers & Lybrand

PUERTO RICO ELECTRIC POWER AUTHORITY

BALANCE SHEETS

June 30, 1996 and 1995

(In Thousands)

ASSETS

	1996	1995
Utility plant:		
Electric plant in service	\$ 3,840,412	\$ 3,561,052
Accumulated depreciation	<u>(1,768,667)</u>	<u>(1,652,615)</u>
	2,071,745	1,908,437
Construction in progress	<u>927,477</u>	<u>885,231</u>
Utility plant, net	2,999,222	2,793,668
Other properties	<u>12,095</u>	<u>13,094</u>
Total utility plant and other properties	<u>3,011,317</u>	<u>2,806,762</u>
Restricted assets:		
Cash and investments held by trustees for payment of certain liabilities and other specific purposes	206,782	169,175
Investments held by trustees	312,877	300,054
Construction funds	<u>15,255</u>	<u>16,109</u>
Total restricted assets	<u>534,914</u>	<u>485,338</u>
Current assets:		
Cash and cash equivalents	59,815	57,115
Receivables - net	334,236	314,879
Fuel oil - at average cost	29,391	50,396
Materials and supplies - at average cost	126,345	116,710
Prepayments and other assets	<u>10,289</u>	<u>9,554</u>
Total current assets	<u>560,076</u>	<u>548,654</u>
Other non-current receivables	<u>115,029</u>	<u>120,372</u>
Deferred debits:		
Unamortized debt expense	15,776	13,521
Other	<u>16,639</u>	<u>11,742</u>
Total deferred debits	<u>32,415</u>	<u>25,263</u>
	<u>\$ 4,253,751</u>	<u>\$ 3,986,389</u>

PUERTO RICO ELECTRIC POWER AUTHORITY

BALANCE SHEETS, Continued

June 30, 1996 and 1995

(In Thousands)

CAPITALIZATION AND LIABILITIES

	1996	1995
Capitalization:		
Contributed capital	\$ 120,714	\$ 120,714
Retained earnings	<u>211,085</u>	<u>195,084</u>
	331,799	315,798
Long-term debt, excluding current portion	<u>2,947,607</u>	<u>2,721,622</u>
Total capitalization	<u>3,279,406</u>	<u>3,037,420</u>
Noncurrent liabilities:		
Sick leave benefits to be liquidated after one year	101,487	93,851
Supplemental spouse survivor benefits	38,962	36,924
Pension benefit exchanged for forfeited sick leave	<u>18,560</u>	<u>20,205</u>
Total noncurrent liabilities	<u>159,009</u>	<u>150,980</u>
Current portion of long-term debt which will be paid from restricted assets	<u>198,014</u>	<u>151,017</u>
Commitments and contingencies (Note 15)		
Current liabilities:		
Notes payable - Government Development Bank	5,000	5,000
Notes payable - banks	125,000	110,000
Bond anticipation notes	0	73,900
Accounts payable and accrued liabilities	307,026	288,672
Accrued interest	89,294	84,126
Customers' deposits	89,011	83,526
Current portion of obligations under capital leases	<u>1,991</u>	<u>1,748</u>
Total current liabilities	<u>617,322</u>	<u>646,972</u>
	<u>\$ 4,253,751</u>	<u>\$ 3,986,389</u>

The accompanying notes are an integral part of these financial statements.

PUERTO RICO ELECTRIC POWER AUTHORITY

STATEMENTS OF INCOME AND RETAINED EARNINGS

For the years ended June 30, 1996 and 1995

(In Thousands)

	1996	1995
Operating revenues	\$ 1,556,961	\$ 1,447,139
Operating expenses:		
Operations:		
Fuel	585,157	523,235
Other production	36,350	43,226
Transmission and distribution	71,608	66,883
Customer accounting and collection	70,323	68,718
Administrative and general	138,609	113,231
Maintenance	241,462	210,274
Depreciation	148,839	141,671
Total operating expenses	<u>1,292,348</u>	<u>1,167,238</u>
Operating income	264,613	279,901
Other income, net - principally interest	<u>41,733</u>	<u>36,205</u>
Income before interest charges, contribution in lieu of taxes and cumulative effect of change in accounting principles	<u>306,346</u>	<u>316,106</u>
Interest charges:		
Interest on bonds	194,384	185,922
Interest on other long-term debt	2,039	1,986
Other interest	1,626	7,781
Amortization of debt discount and issuance costs	13,477	16,473
Allowance for funds used during construction	<u>(17,137)</u>	<u>(11,186)</u>
Total interest charges, net	<u>194,389</u>	<u>200,976</u>
Income before contribution in lieu of taxes and cumulative effect of change in accounting principle	111,957	115,130
Contribution in lieu of taxes	<u>95,956</u>	<u>95,129</u>
Income before cumulative effect of change in accounting principles	16,001	20,001
Cumulative effect on prior years of adopting the new method to account for self insurance (Note 1I)	<u>0</u>	<u>(3,973)</u>
Net income	16,001	16,028
Retained earnings, at beginning of year	<u>195,084</u>	<u>179,056</u>
Retained earnings, at end of year	<u>\$ 211,085</u>	<u>\$ 195,084</u>

The accompanying notes are an integral part of these financial statements.

PUERTO RICO ELECTRIC POWER AUTHORITY

STATEMENTS OF CASH FLOWS

For the years ended June 30, 1996 and 1995

(In Thousands)

	1996	1995
Cash flows from operating activities:		
Operating income	\$ 264,613	\$ 279,901
Adjustments to reconcile operating income to net cash provided by operating activities:		
Depreciation	148,839	141,671
Amortization of asbestos removal costs	1,468	908
Provision for uncollectible accounts	2,613	2,685
Contribution in lieu of taxes	(95,956)	(95,129)
Changes in assets and liabilities:		
Receivables	(16,627)	(15,122)
Fuel oil	21,005	(11,352)
Materials and supplies	(9,635)	15,992
Prepayments and other assets	(735)	(425)
Other deferred debits	(6,365)	1,431
Noncurrent liabilities	8,029	14,980
Accounts payable and accrued liabilities	18,354	25,377
Customers' deposits	5,485	(16,635)
Net cash flows provided by operating activities	<u>341,088</u>	<u>344,282</u>
Cash flows from noncapital financing activities:		
Restricted cash and investments held by trustee, net	(37,607)	(5,485)
Principal paid on general obligation notes	(5,000)	(5,000)
Interest paid on general obligation notes	(1,443)	(2,844)
Principal paid on electric revenue bonds - working funds	0	(7,744)
Interest paid on electric revenue bonds - working funds	0	(6,471)
Principal paid on fuel line of credit	(470,000)	0
Proceeds from fuel line of credit	485,000	0
Interest paid on fuel line of credit	(6,191)	(4,602)
Net cash flows used for noncapital financing activities	<u>(35,241)</u>	<u>(32,146)</u>

PUERTO RICO ELECTRIC POWER AUTHORITY

STATEMENTS OF CASH FLOWS, Continued

For the years ended June 30, 1996 and 1995

(In Thousands)

	1996	1995
Cash flows from capital and related financing activities:		
Construction expenditures	(353,394)	(334,164)
Allowance for funds used during construction	17,137	11,186
Construction funds, net	854	142,736
Power revenue bonds:		
Proceeds from issuance of bonds, net of original discount	312,000	0
Proceeds from issuance of refunding bonds, net of original discount	738,030	0
Principal paid on revenue bonds maturities	(52,787)	(46,396)
Interest paid on revenue bonds	(153,661)	(130,164)
Proceeds from bond anticipation note - GDB	15,800	73,900
Defeased bonds, net of original discount	(311,984)	0
Payment of bond anticipation notes - GDB	(89,700)	0
Interest paid on bond anticipation notes	(1,053)	0
Electric revenue bonds:		
Principal paid on revenue bonds maturities	(13,900)	(33,716)
Interest paid on revenue bonds	(20,771)	(26,511)
Defeased bonds, net of original discount	(418,661)	0
Principal paid on lease obligations	(1,748)	(2,223)
Net cash flows used for capital and related financing activities	<u>(333,838)</u>	<u>(345,352)</u>
Cash flows from investing activities:		
Purchases of investment securities	(33,931)	(33,887)
Proceeds from sale and maturities of investment securities	21,108	26,737
Interest on investments	43,514	34,408
Net cash flows provided by investing activities	<u>30,691</u>	<u>27,258</u>
Net increase (decrease) in cash and cash equivalents	2,700	(5,958)
Cash and cash equivalents at beginning of year	<u>57,115</u>	<u>63,073</u>
Cash and cash equivalents at end of year	<u>\$ 59,815</u>	<u>\$ 57,115</u>

The accompanying notes are an integral part of these financial statements.

PUERTO RICO ELECTRIC POWER AUTHORITY

Notes to Financial Statements

June 30, 1996 and 1995

1. REPORTING ENTITY AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES:

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

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

Effective June 6, 1996, the 1947 Trust Indenture ("1947 Indenture") was cancelled with the transfer of the monies available in the 1947 General Reserve Fund to the 1974 Self-insurance Fund. As more fully explained in the bond resolution the Authority covenants that it will not issue any additional bonds under the 1947 Indenture.

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

a. Basis of Accounting:

The accounting and reporting policies of the Authority conform with the accounting rules prescribed by the Governmental Accounting Standard Board (GASB). Although the Authority is not under Federal Energy Regulatory Commission (FERC) regulations, the Authority has adopted the uniform system of accounts prescribed by FERC.

b. Utility Plant, Depreciation, and Allowance for Funds Used During Construction (AFUDC):

Utility plant is carried at cost, which includes labor, materials, overhead, and an allowance for the cost of funds used during construction (AFUDC).

NOTES TO FINANCIAL STATEMENTS, CONTINUED

1. REPORTING ENTITY AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES, Continued

Maintenance, repairs, and the cost of renewals of minor items of property units are charged to expense. Replacements of major items of property are charged to the plant accounts. The cost of retired property, together with removal cost, less salvage, is charged to accumulated depreciation with no gain or loss recognized. Depreciation is computed on the straight-line method at rates considered adequate to allocate the cost of the various classes of property over their estimated service lives. The annual composite rate of depreciation, determined by the Authority's consulting engineers, was approximately 3.91% for 1996 and 1995. AFUDC represents the cost of borrowed funds used to finance the portion of construction work in progress not financed through internally generated funds. AFUDC is capitalized as an additional cost of property and as a reduction of interest expense. Capitalized interest expense is reduced by interest income earned on related investments acquired with proceeds of tax exempt borrowings. Such costs are recovered from customers as a cost of service through depreciation charges in future periods.

c. Unamortized Debt Expense:

Debt expenses and discounts incurred in the issuance of bonds are deferred and amortized using the straight-line method which approximates the interest method. The excess of reacquisition cost over the carrying value of long-term debt is deferred and amortized to expense using the straight-line method over the remaining life of the old debt or the life of the new debt, whichever is shorter.

d. Materials and Supplies:

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

e. Cash Equivalents:

For purposes of the statements of cash flows, the Authority considers all highly liquid debt instruments purchased with original maturities of three months or less to be cash equivalents. Cash and cash equivalents included in the restricted funds are not included as such in the statements of cash flows.

f. Asbestos Containment Deferred Costs:

Maintenance costs incurred in the containment of asbestos are deferred and included in other deferred debits. Such costs are amortized as recovered in billings over an estimated life of 12 years. The Authority estimates future asbestos containment costs of approximately \$40 to \$50 million.

g. Revenue Recognition and Fuel Costs:

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

NOTES TO FINANCIAL STATEMENTS, CONTINUED

1. REPORTING ENTITY AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES, Continued

h. Contribution in Lieu of Taxes and Governmental Subsidies:

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

Municipalities:

To the extent net revenues as defined are available, the Authority is required under the Act, as amended, to make contributions in lieu of taxes of 6% of gross electric sales. For these purposes, net revenues include gross electric energy sales (with certain exemptions) computed on the basis of an annual average fuel oil price of up to a maximum of \$30 per barrel. The Authority, subject to its obligations under the 1974 Agreement may modify the maximum annual average fuel price per barrel to a higher level to provide the Municipalities with sufficient income to absorb their billings for electricity consumption plus the necessary amounts to fulfill their obligations to the Authority. Contributions in lieu of taxes to Municipalities can be used to offset accounts receivable balances owed by the Municipalities to the Authority as permitted by law. Should, in any given year, the Authority's net revenues, as defined in the Act, not be sufficient to cover the calculated maximum contribution in lieu of taxes, said contribution shall be reduced to the amounts available, and the excess does not carry forward as a liability for future years.

Commonwealth of Puerto Rico:

To the extent net revenues are available, the Authority is required under the Act, as amended, to set aside 5% of gross electric sales for the purpose of (i) financing of capital improvements, (ii) offsetting other subsidies (other than cost of fuel adjustments to certain residential clients) of the Commonwealth, and (iii) any other lawful corporate purpose. Amounts assigned to (ii) above are classified as contributions in lieu of taxes in the accompanying statements of income and reduce the related accounts receivables in the balance sheets.

In July of 1989, an amendment to the Act was approved which, among other things, changed the amount of the Authority's required contributions in lieu of taxes to the Municipalities. The amendment increased the Authority's contribution in lieu of taxes to the Municipalities by 1%, subject to the Authority's obligation under the 1974 Agreement. The amendment requires an annual payment to the Secretary of the Treasury who is required to distribute the amount so received in each year among the various Municipalities in addition to the year's contribution in lieu of taxes.

As required by the Act, certain residential clients of the Authority are granted a credit for all or part of the cost of fuel adjustments up to a maximum stipulated amount of \$105,000,000 per year.

The Authority, as allowed by the Act, has reduced substantially the number of residential clients who qualify for fuel adjustment subsidy. The Authority eliminated the subsidy for residential clients other than public housing residents, lifeline clients, university students, the elderly, and the handicapped.

NOTES TO FINANCIAL STATEMENTS, CONTINUED

1. REPORTING ENTITY AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES, Continued

h. Contribution in Lieu of Taxes and Governmental Subsidies, Continued

The Act was further amended to provide that (i) an additional 20% of the 5% electric energy sales set aside for the Commonwealth discussed above would be applied against the cost of fuel oil subsidy program arising after June 30, 1991 (with any balance remaining used to reduce the above receivable balance owed to the Authority as of June 30, 1991) (see Note 5), (ii) the regulations of the Authority regarding fuel adjustment subsidy would no longer be subject to the Governor's approval, and (iii) the cost or subsidy amounts arising after June 30, 1991 will be incurred by the Authority and not the Commonwealth.

i. Accounting for Compensated Absences:

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

The amount accumulated for vacations is the amount adjusted to current salary costs which is expected to be liquidated. Amounts computed for sick leave pay have been actuarially determined. Significant actuarial assumptions used in the valuations at both June 30, 1996 and 1995 include (a) a discount rate of 8.5%, (b) projected annual salary increases of 6%, and (c) forfeitures by employees who exchange such benefits for supplemental pension benefits as described in Notes 10 and 11.

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

j. Investments:

The Authority carries noncurrent investments at amortized cost. If the market value of any of these investments declines below cost and the decline is considered permanent, the investments are written down to the market value and the losses are charged to operations. Realized gains and losses on the sale of investments are charged to operations.

k. Contributions in Aid of Construction:

Contributions received in aid of construction are recorded as a reduction of the cost basis of the related property.

NOTES TO FINANCIAL STATEMENTS, CONTINUED

1. REPORTING ENTITY AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES, Continued

i. Accounting and Financial Reporting:

The Authority implemented the provisions of GASB Statement No. 20 "Accounting and Financial Reporting for Proprietary Funds and Other Governmental Entities that Use Proprietary Fund Accounting", which requires proprietary activities to apply all applicable GASB pronouncements as well as all Financial Accounting Standard Board Statements (FASB) and Interpretations, Accounting Principle Board Opinions and Accounting Research Bulletins issued on or before November 30, 1989, unless the pronouncements conflict or contradict GASB pronouncements. This pronouncement permits the adoption of all FASB Statements and Interpretations issued after November 30, 1989, except for those that conflict or contradict GASB pronouncements. The Authority, as allowed by GASB, decided not to implement any FASB or Interpretation issued after November 30, 1989.

During 1995, the Authority implemented the provisions of GASB Statement No. 10 "Accounting and Financial Reporting for Risk Financing and Related Insurance Issues", which requires that a liability for claims be reported if information prior to issuance of the financial statements indicates that it is probable that a liability has been incurred at the date of the financial statements and the amount of loss can be reasonably estimated.

The adoption of GASB Statement No. 10 resulted in a net charge and an increase in the liability of approximately \$3,973,000 for the cumulative effect of the change in accounting principle for periods prior to fiscal 1995, which were not restated. The effect of the adoption of this new standard was not significant to the statements of income for 1995.

m. Reclassifications:

Certain reclassifications have been made to the 1995 financial statements to conform with the 1996 financial statements presentation.

2. UTILITY PLANT:

As of June 30, utility plant consists of:

	1996 (In Thousands)	1995
Production plant	\$ 1,167,217	\$ 1,087,157
Other production plant	230,376	201,631
Hydroelectric plant	80,064	75,464
Distribution plant	1,312,624	1,205,009
Transmission plant	613,612	612,547
General plant	436,519	379,244
	<hr/>	<hr/>
	3,840,412	3,561,052
Less accumulated depreciation	<hr/> 1,768,667	<hr/> 1,652,615
	<hr/> \$ 2,071,745	<hr/> \$ 1,908,437

NOTES TO FINANCIAL STATEMENTS, CONTINUED

3. OTHER PROPERTIES:

As of June 30, other properties which are carried at cost, not in excess of their estimated net realizable value, consist of:

	1996	1995
	(In Thousands)	
Generating units, construction materials and supplies and other properties available for sale and future use	\$ 542	\$ 1,541
Generator held for sale	<u>11,553</u>	<u>11,553</u>
	<u>\$ 12,095</u>	<u>\$ 13,094</u>

4. CASH AND INVESTMENTS:

a. Cash Deposits:

At June 30, 1996 and 1995, the carrying amount of cash deposits held by the Authority was \$75.1 million and \$73.2 million, respectively.

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

Pursuant to present statutes, deposits of the Authority shall be in banks designated by the Secretary as depository institutions of public funds. Such deposits shall be guaranteed by sufficient collateral under the name and custody of the Secretary.

b. Investments:

Investments are held by trustees under the 1947 Indenture for 1995 and 1974 Agreement for 1995 and 1996. The Authority is authorized to invest in:

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

The Authority's investment securities at June 30, 1996 and 1995, were held by the trustees in the Authority's name. Cash deposits, except for minor amounts, are uninsured and uncollateralized, and are held by the trustees primarily for debt service to be made on January 1 and July 1 of each year.

NOTES TO FINANCIAL STATEMENTS, CONTINUED

4. CASH AND INVESTMENTS, Continued

Investments of \$.9 million in 1996 and \$5.5 million in 1995 have substantially all current maturities but are classified as restricted investments held by trustees as they are restricted to comply with long-term principal, interest debt service requirements and for self-insurance. Additionally, during the year the Authority invested in various repurchase agreements.

At June 30, cash and investments held by trustees consist of:

	1996	1995
	(In Millions)	
Cash deposits	\$ 205.9	\$ 163.7
Government and investment obligations (market value approximated \$305 million and \$300 million in 1996 and 1995, respectively)	<u>313.8</u>	<u>305.5</u>
Total	<u>\$ 519.7</u>	<u>\$ 469.2</u>

The Authority has issued bonds pursuant to the 1947 Indenture for 1995 and 1974 Agreement for 1995 and 1996. Under the provisions of the 1947 Indenture and the 1974 Agreement the Authority is required to establish certain fund accounts consisting of cash and investments whose use is limited. The investments, primarily U.S. Government securities, are stated at amortized cost. Interest accruing on investments is credited to the respective accounts when collected. A brief description of the significant funds and limitations on use is as follows:

General Purpose Funds:

General fund, revenue fund, and other general purpose funds - All funds received by the Authority, except construction funds obtained through financing, are first deposited in general purpose funds and any balance after payment of current expenses, as defined, is used to fund specific account requirements. Unrestricted balance at June 30, 1996 and 1995 amounted to approximately \$59,815,000 and \$57,115,000, respectively.

Sinking Funds - Restricted:

- Principal and interest - Current year requirements for principal and interest on Electric Revenue Bonds for 1995 and Power Revenue Bonds for 1996 and 1995.
- 1947 Reserve Account - For 1995, reserve to provide funds for future years principal and interest in the event 1947 sinking funds for such purpose are insufficient and for purchase or redemption of bonds.
- 1974 Reserve Account - Reserve for payment of principal and interest of serial bonds in the event 1974 sinking funds for such purpose are insufficient and for transfer to the redemption account to meet amortization requirements of term bonds if 1974 sinking funds are insufficient for such purpose.
- General Reserve Fund - Fund to make-up deficiencies in the 1947 sinking fund for 1995, including the reserve account, and to provide for damaged or destroyed property not fully covered by insurance and for loss of income from the System.

NOTES TO FINANCIAL STATEMENTS, CONTINUED

4. CASH AND INVESTMENTS, Continued

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

At June 30, investments held by trustees consists of:

	1996 (In Thousands)	1995 (In Thousands)
Restricted assets:		
1947 reserve account fund	\$ 0	\$ 65,734
1974 reserve account fund	213,615	146,129
1974 Self-insurance fund	99,262	0
General reserve fund	0	88,191
	<u>\$ 312,877</u>	<u>\$ 300,054</u>

5. ACCOUNTS RECEIVABLE:

At June 30, receivables consist of:

	1996 (In Thousands)	1995 (In Thousands)
Electric and related services:		
Government	\$ 159,398	\$ 160,701
Residential, industrial, and commercial	149,450	131,449
Recoveries under fuel adjustment clause under billed	2,298	2,462
Unbilled services	77,071	68,746
Commonwealth subsidy (fuel adjustment clause) for certain residential clients	69,621	75,947
Reimbursable costs - Irrigation Systems	16,230	15,101
Other subsidies receivable from the Commonwealth	2,908	4,772
Accrued interest on investments	3,556	5,337
Miscellaneous accounts and others	762	152
Allowance for uncollectible accounts	<u>(32,029)</u>	<u>(29,416)</u>
Total receivables	449,265	435,251
Less other non-current receivables	<u>115,029</u>	<u>120,372</u>
Total current receivables	<u>\$ 334,236</u>	<u>\$ 314,879</u>

On October 29, 1991, the Authority entered into an agreement with the Commonwealth for the payment of the outstanding fuel adjustment subsidy receivable amounting to approximately \$94,900,500. Under this agreement, the Commonwealth will pay the outstanding receivable over a fifteen year period in installments of approximately \$6,326,700 per year, without interest. As of June 30, 1996 the outstanding fuel adjustment subsidy receivable amounted to approximately \$69.6 million.

NOTES TO FINANCIAL STATEMENTS, CONTINUED

5. ACCOUNTS RECEIVABLE, Continued

In addition, the Authority has other subsidies and reimbursable costs receivable from the Commonwealth which are reduced by means of charges (accounted for as a contribution in lieu of taxes and to the extent net revenues, as defined, are available) against a portion of the 5% of gross electric sales it is required to set aside under the Act (see Note 1h). The portion of such receivables and other governmental receivables not expected to be collected during the next fiscal year are reflected in the accompanying financial statements as other non-current receivables.

6. DEFEASANCE OF DEBT:

During 1996 and prior years the Authority has advanced refunded certain Power Revenue Bonds and Electric Revenue Bonds by placing the proceeds of new debt in various irrevocable trusts to provide for future debt service payments on such bonds. Accordingly, the trust accounts, assets, and liabilities for the defeased bonds are not included in the Authority's financial statements. At June 30, 1996, \$712,943 million of series Electric Revenue Bonds and \$152,825 million of Power Revenue Bond series K, L, M, N, O, and P which remain outstanding are considered defeased.

During 1996 the Authority defeased all Electric Revenue Bonds under the 1947 Indenture which was cancelled on June 6, 1996.

7. LONG-TERM DEBT:

At June 30, long-term debt consists of:

	1996 (In Thousands)	1995
Revenue bonds payable:		
Electric revenue bonds:		
Publicly offered, interest ranging from 3% to 8.6%; maturing to 2007	\$ 0	\$ 540,590
RUS issues - interest from 2% to 5% maturing to 2004	<u>0</u>	<u>10,519</u>
	<u>0</u>	<u>551,109</u>
Power revenue bonds:		
Publicly offered, interest ranging from 4.2% to 8.7%; maturing to 2024	3,153,350	2,320,618
RUS issues - interest of 5%; maturing to 2028	<u>189,685</u>	<u>184,484</u>
	3,343,035	2,505,102
Less unamortized discount and debt reacquisition costs	<u>(215,533)</u>	<u>(208,532)</u>
Revenue bonds payable, net	3,127,502	2,847,679
Notes payable to GDB interest of 6.15%; due in equal installments of \$5,000,000 maturing to 2000	20,000	25,000
Obligations under capital leases	<u>5,110</u>	<u>6,708</u>
	3,152,612	2,879,387
Less current portion	<u>205,005</u>	<u>157,765</u>
Total long-term debt, excluding current portion	<u>\$ 2,947,607</u>	<u>\$ 2,721,622</u>

NOTES TO FINANCIAL STATEMENTS, CONTINUED

7. LONG-TERM DEBT, Continued

a. Revenue Bonds Payable:

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

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

Gross revenues, exclusive of income on certain investments, less current expenses as defined in the Agreement have been pledged to repay revenue bonds principal and interest (see Note 4).

On August 10 and September 14, 1995, the Authority issued \$1,050 million in Power Revenue Bonds with an average interest rate of 5.83% to advance refund \$771.2 million of outstanding N, P, and O, Power Revenue Bonds and all outstanding series Electric Revenue Bonds. The net proceeds of \$1,037.1 million (after payment of \$12.9 in underwriting fees, insurance, and other issuance costs) plus additional monies were used to purchase U.S. securities. Those securities were deposited in irrevocable trusts with an escrow agent to provide for all future debt service payments. As a result, the advance refunded bonds are considered defeased and the liability for those bonds has been removed from the accounting records.

Although the advance refund resulted in the recognition of a deferred accounting loss of \$40 million for the year ended June 30, 1996, the Authority reduced its aggregate debt service payments by almost \$40.6 million over the next 27 years and obtained an economic gain (difference between the present value of the old and new debt service payments) of \$31.8 million.

The remainder proceeds of the Revenue Bonds were deposited in the Construction Fund and were used to pay Bond Anticipation Notes.

b. Notes Payable:

The Authority borrowed \$45,000,000 from GDB pursuant to a nine year notes payable agreement. Proceeds from the notes were used to pay contributions payable to the Employees' Retirement System of the Authority. The principal and interest payments are subordinated to funding requirements of the 1974 Agreement. As of June 30, 1996, the notes had an outstanding balance of \$20,000,000.

c. Obligations Under Capital Leases:

On February 1, 1995, the Authority entered into various capital lease agreements for certain equipment expiring on January 1, 1999. At June 30, 1996, the gross amount of the equipment is approximately \$10,481,000. Amortization of equipment held under capital leases is included with depreciation expense.

NOTES TO FINANCIAL STATEMENTS, CONTINUED

7. LONG-TERM DEBT, Continued

The present value of future minimum capital lease payments as of June 30, 1996, follows:

Year Ending June 30,:	(In Thousands)
1997	\$ 2,228
1998	2,056
1999	<u>1,198</u>
Total minimum lease payments	5,482
Less amount representing interest	<u>(372)</u>
Present value of net minimum lease payments	5,110
Less current maturities of obligations under capital lease	<u>(1,991)</u>
Obligations under capital leases excluding current maturities	<u><u>\$ 3,119</u></u>

d. Scheduled Maturities of Long-Term Debt:

The scheduled maturities of long-term debt at June 30, 1996, including sinking fund debt service requirements, are as follow:

Year Ending June 30,	Power Revenue Bonds	RUS Power Revenue Bonds	Obligations Under Capital Leases	GDB Notes	Total
	(In Thousands)				
1997	\$ 535,281	\$ 22,016	\$ 2,228	\$ 5,000	\$ 564,525
1998	272,474	14,495	2,056	5,000	294,025
1999	269,078	14,287	1,198	5,000	289,563
2000	266,414	16,428		5,000	287,842
2001	248,713	15,760			264,473
2002-2006	1,300,456	72,884			1,373,340
2007-2011	1,136,918	64,632			1,201,550
2012-2016	853,727	51,141			904,868
2017-2021	477,263	30,609			507,872
2022-2026	214,327	14,170			228,497
2027-2028		4,309			4,309
Total	<u>5,574,651</u>	<u>320,731</u>	<u>5,482</u>	<u>20,000</u>	<u>5,920,864</u>
Less:					
Unamortized discount	(68,475)				(68,475)
Excess reacquisition costs	(147,058)				(147,058)
Amount representing interest	<u>(2,421,301)</u>	<u>(131,046)</u>	<u>(372)</u>		<u>(2,552,719)</u>
Total long-term debt	2,937,817	189,685	5,110	20,000	3,152,612
Current portion, net of discount and excess reacquisition costs	<u>(189,904)</u>	<u>(8,110)</u>	<u>(1,991)</u>	<u>(5,000)</u>	<u>(205,005)</u>
Long-term debt, excluding current portion	<u><u>\$ 2,747,913</u></u>	<u><u>\$ 181,575</u></u>	<u><u>\$ 3,119</u></u>	<u><u>\$ 15,000</u></u>	<u><u>\$ 2,947,607</u></u>

NOTES TO FINANCIAL STATEMENTS, CONTINUED

8. NOTES PAYABLE:

On July 3, 1995, the Authority, GDB, and certain banks entered into a new agreement for a revolving line of credit to be used for financing of fuel purchases. Under the agreement the Authority borrowed \$125 million.

The Authority has \$125 and \$110 million of credit facilities outstanding for 1996 and 1995, respectively. The average effective interest rate during each year and at year-end was 5.77% and 5.63%, respectively, for 1996 and 3.09% and 2.54%, respectively, for 1995.

9. ACCOUNTS PAYABLE AND ACCRUED LIABILITIES:

Accounts payable and accrued liabilities at June 30, consists of:

	1996 (In Thousands)	1995
Accounts payable, accruals, and withholdings in process of payment	\$ 148,434	\$ 145,104
Additional accruals and withholdings:		
Injuries and damages and other	10,280	8,451
Accrued vacation and payroll benefits	52,142	49,408
Accrued sick leave and payroll accrual - exclusive of benefits to be liquidated after one year of approximately \$101 million in 1996 and \$94 million in 1995	26,201	11,880
Accrued accident leave	3,973	3,973
Accrued compensation	12,469	10,540
Accrued pension plan contribution and withholding from employees:		
Employees' Retirement System	8,528	15,296
Supplemental unfunded benefit obligation spouse-survivor benefit - exclusive of benefit to be liquidated after one year of approximately \$39 million in 1996 and \$37 million in 1995	1,791	659
Supplemental unfunded pension obligation exchanged for forfeited sick leave benefits - exclusive of benefits to be liquidated after one year of approximately \$19 million in 1996 and \$20 million in 1995	13,220	10,330
Payroll taxes and withholdings	3,901	4,288
Employees health plan	8,639	8,236
Contract retention	7,462	5,318
Contribution in lieu of taxes	1,928	2,420
Other accrued liabilities	8,058	12,769
	<u>\$ 307,026</u>	<u>\$ 288,672</u>

10. COMPENSATED ABSENCES:

The Authority's employees with over 20 years of service are entitled to exchange accrued sick leave for supplemental pension benefits, as discussed in Note 11, and/or be paid in cash the value of such sick leave upon separation from employment. The amount of sick leave expected to be paid in cash is determined based on actuarial studies using the same significant actuarial assumptions as used to determine pension obligations funded through the Employees' Retirement System (see Note 1i). The liability for this benefit obligation was \$127.2 million and \$105.8 million as of June 30, 1996 and 1995, respectively.

NOTES TO FINANCIAL STATEMENTS, CONTINUED

11. EMPLOYEES' RETIREMENT BENEFITS:

a. Plan Description:

All of the Authority's permanent full-time employees are eligible to participate in the Employees' Retirement System of the Puerto Rico Electric Power Authority (the "System"), a single employer defined contribution benefit pension plan (the "Plan"). The basic salary payroll for employees covered by the System for the years ended June 30, 1996 and 1995 was \$243.3 million and \$239.5 million, respectively; the Authority's total payroll was \$413.1 million in 1996 and \$401.5 million in 1995.

Although all benefits of the Plan are administered by the System, only the basic benefits are funded through the System. Supplemental benefits are unfunded and such benefits are reimbursed to the System when paid. The pension plan is not subject to the requirements of the Employees Retirement Income Security Act of 1974 (ERISA).

Benefits include maximum retirement benefits of 75% of average basic salary (based on the three highest annual basic salaries) with 30 years of service; also, reduced benefits are available with early retirement. Disability and death benefits are also provided. Separation benefits fully vest upon reaching 10 years of credited service. During 1988, benefits were extended retroactively to July 1985 to cover spouse survivor benefits equal to 30% of the annuity received by the retired member just prior to death. Employees are required to contribute approximately 9.06% of their salary to the System. The benefits identified as spouse survivor benefits and pension benefits received by employees in exchange for forfeited unused sick leave benefits are fully unfunded. The Authority is required to contribute the remaining amounts necessary to fund the System, using the actuarial method described in Note 11b. These benefit provisions are established by rules and regulations of the System.

The Plan was amended effective January 2, 1990, to provide for the payment of an early "death benefit" equal to current earned salary. The early death benefits may be elected by any member with 20 or more years of service and members who elect the benefits will make supplemental contributions to the System to pay for the cost of the benefit.

Additionally, the Plan was amended effective February 9, 1993, to provide cost-of-living increases in pension benefits for retirees as of June 30, 1993, and automatic future cost-of-living increases every three years for current and future pensioners. This amendment also provided revised benefits and contribution rates for future System members who will be required to contribute 11% of their salary.

If a member's employment is terminated before he becomes eligible for any other benefits under this Plan, he shall receive a refund of his member contribution plus interest compounded annually.

b. Funding Status and Progress:

The amount shown below as the "pension benefit obligation" is a standardized disclosure measure of the present value of pension benefits, adjusted for the effects of projected salary increases, estimated to be payable in the future as a result of employee service to date. The measure is intended to help users assess the funding status of the System on a going-concern basis, assess progress made in accumulating sufficient assets to pay benefits when due, and make comparisons among employers. The measure is the actuarial present value of credited projected benefits, and is independent of the funding method used to determine contributions to the System.

NOTES TO FINANCIAL STATEMENTS, CONTINUED

11. EMPLOYEES' RETIREMENT BENEFITS, Continued

The pension benefit obligation was computed as part of an actuarial valuation performed as of June 30, 1994, and projected to June 30, 1996 and 1995 based on current year demographic data. Significant actuarial assumptions used in the valuation include (a) rate of return on the investment of present and future assets of 8.5%, compounded annually, (b) projected salary increases with a weighted average of 6% a year compounded annually.

Net assets of the System available for benefits, at cost, for June 30, 1996 and 1995 is obtained from information provided by the Authority's actuary.

GASB Statement No. 5 establishes standards for disclosure in the annual financial statements of pension information by government employers. Total unfunded pension and related benefits obligation applicable to the Authority's employees is \$524.6 million and \$489.8 million, respectively, at June 30, 1996 and 1995 (as projected in both years) as follows:

	1996	1995
	(In Millions)	
Benefits funded through the System:		
Pension benefits obligation:		
Retirees and beneficiaries currently receiving benefits and terminated employees not yet receiving benefits	\$ 394.8	\$ 396.3
Current employees:		
Accumulated employees' contributions with interest	285.8	268.0
System-financed vested benefits	168.3	143.2
System-financed nonvested benefits for current active employees	<u>370.2</u>	<u>364.4</u>
Total pension benefits obligation - General Fund	<u>1,219.1</u>	<u>1,171.9</u>
Death or retirement lump sum payment accrued benefits - Special Fund	<u>17.1</u>	<u>14.8</u>
Total pension benefits obligation	<u>1,236.2</u>	<u>1,186.7</u>
Unaudited net assets of the System available for benefits at cost, but recognizing depreciation of common stocks:		
General Fund	\$ 984.7	\$ 891.4
Special Fund	<u>17.1</u>	<u>14.8</u>
Total (both funds)	<u>1,001.8</u>	<u>906.2</u>
Unfunded portion of benefits obligation administered by the System	<u>234.4</u>	<u>280.5</u>
Supplemental unfunded benefits obligation:		
Pension benefits obligation exchanged for forfeited sick leave benefits to complete required years of service:		
Retirees and beneficiaries currently receiving benefits	79.1	77.8
Current employees	<u>134.5</u>	<u>66.9</u>
Total unfunded pension benefits exchanged for forfeited sick leave benefits	213.6	144.7
Spouse survivor benefits	<u>76.6</u>	<u>64.6</u>
Total supplemental unfunded pension benefits obligation	<u>290.2</u>	<u>209.3</u>
Total unfunded benefits obligation	<u>\$ 524.6</u>	<u>\$ 489.8</u>

NOTES TO FINANCIAL STATEMENTS, CONTINUED

11. EMPLOYEES' RETIREMENT BENEFITS, Continued

Unaudited investments, at market value, amounted to approximately \$1,081.0 million and \$944.8 million at June 30, 1996 and 1995, respectively, and were invested as follows:

	1996	1995
Common stocks	49%	39%
Bonds and fixed income investments	36%	36%
Personal loans to participants	10%	21%
Cash and cash equivalents	5%	4%

The Authority has not implemented GASB Statement No. 27 "Accounting for Pensions by State and Local Government Employers" and is currently evaluating its effects on the financial statements.

c. Actuarially Determined Contribution Requirements and Contributions Made:

Basic Benefits Funded Through the System:

The System's funding policy provides for actuarially determined periodic contributions so that sufficient assets will be available to pay benefits when due. The contribution requirements are determined using a projected benefit method with aggregate level normal cost rate and open-end supplemental (accrued) liability. Experience gains and losses are reflected in the accrued liability. The unfunded accrued liability is amortized over a 40-year period from June 30, 1975.

The Authority policy is generally to fund these contributions currently as they become due in accordance with actuarially determined requirements. The contributions recorded as of June 30, 1996 and 1995 were as follows:

	1996	1995
	(In Millions)	
Contributions:		
Employer	\$ 33.3	\$ 34.2
Employee	22.0	22.2
	<u>\$ 55.3</u>	<u>\$ 56.4</u>
Contributions as a percentage of covered payroll:		
Employer	14.62%	14.60%
Employee	9.23%	9.30%

For both years of covered payroll for normal cost and amortization of unfunded actuarial accrued liability for each of those years, follow:

	1996	1995
	(In Millions)	
Normal cost	\$ 10.15	\$ 10.42
Amortization of unfunded accrued liability	23.15	23.78
	<u>\$ 33.30</u>	<u>\$ 34.20</u>

NOTES TO FINANCIAL STATEMENTS, CONTINUED

11. EMPLOYEES' RETIREMENT BENEFITS, Continued

Supplemental Benefits not Funded Through the System:

- **Supplemental pension obligations exchanged for forfeited sick leave benefits:**

This benefit obligation is unfunded and expense is recognized in a combination of the accrual and the pay-as-you-go methods, which approximates the actuarial valuation. The pension benefit obligation is determined periodically based on actuarial studies using the same significant actuarial assumptions that are used to determine pension obligations funded through the System.

An accrual of \$32.2 and \$30.3 million existed as of June 30, 1996 and 1995, respectively. The expense for the years ended June 30, 1996 and 1995 amounted to approximately \$8.0 million and \$5.1 million, respectively.

- **Supplemental Spouse Survivor Benefits:**

The extension of benefits in 1988 retroactive to July 1, 1985 is unfunded but annual charges to operations commenced in 1988 based on actuarial studies using the same significant actuarial assumptions that are used to compute contributions to the System.

An accrual of \$40.8 and \$37.7 million existed as of June 30, 1996 and 1995, respectively. Pension expense is recognized using the accrual method, which approximates the actuarial valuation. The expense for the years ended June 30, 1996 and 1995 was \$7.1 million and \$5.2 million, respectively.

- d. **Trend Information:**

Trend information gives an indication of the progress made in accumulating sufficient assets to pay benefits when due. Available information is presented in the supplementary information on pages 33 and 34.

- e. **Post Retirement Health Benefits:**

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

Costs of benefits provided by the Authority are based on a cost plus plan. Such costs are recognized as expense as claims are received from the plan administrators, a charge for an administration fee and an accrual for incurred but not reported claims. The costs of health care benefits to retirees amounted to approximately \$13.6 million in 1996 and \$11.6 million in 1995. Currently, 6,433 retirees meet eligibility requirements.

NOTES TO FINANCIAL STATEMENTS, CONTINUED

12. REVENUES FROM MAJOR CLIENTS AND RELATED PARTIES:

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

	1996 (In Thousands)	1995
Governmental sector, principally instrumentalities, agencies, and corporations of the Commonwealth of Puerto Rico	\$ 195,071	\$ 187,525
Municipalities	<u>83,167</u>	<u>79,816</u>
	<u>\$ 278,238</u>	<u>\$ 267,341</u>

13. CONTRIBUTION IN LIEU OF TAXES:

Amounts charged to operations for the years ended June 30 are as follows:

	1996 (In Thousands)	1995
Municipalities	\$ 78,376	\$ 78,354
Commonwealth:		
Hotels	2,331	1,891
Fuel adjustment subsidy	7,675	7,321
Other subsidies (offset against outstanding accounts receivable and reimbursable costs)	<u>7,574</u>	<u>7,563</u>
	<u>\$ 95,956</u>	<u>\$ 95,129</u>

14. RETAINED EARNINGS:

Retained earnings at June 30, 1996 and 1995 include \$91.4 million and \$80.8 million, respectively, which have been appropriated principally to provide a reserve for damaged or destroyed property of the System not fully covered by insurance as required by the 1974 Agreement. Funds set aside for self-insurance purposes are deposited in the General Reserve Fund for 1995 and the Self-insurance Fund held by the trustee for 1996 (see Note 4).

15. COMMITMENTS AND CONTINGENCIES:

a. Environmental Matters:

Facilities and operations of the Authority are subject to regulations under numerous Federal and Commonwealth environmental laws, including the Clean Air Act, Clean Water Act, and the National Pollutant Discharge Elimination System (NPDES). In February 1992, the Environmental Protection Agency (EPA) performed a multimedia inspection of various facilities of the Authority and noticed deficiencies in different areas mainly air opacity; water quality; spill prevention control and countermeasures; and underground storage tanks. EPA is claiming alleged civil violations of \$50 million dollars. Since 1993, the EPA, the Federal Department of Justice (DOJ) and the Authority have been 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 \$81 million during the five fiscal years ending June 30, 1998. Also, the Authority agreed to use fuel oil not exceeding a sulfur content of 1.5%, a vanadium content of 150 PPM and asphaltenes content of 8% at the generating plants with an additional annual fuel oil cost of approximately \$54 million.

NOTES TO FINANCIAL STATEMENTS, CONTINUED

15. COMMITMENTS AND CONTINGENCIES, Continued

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 the Authority during 1992. The Authority and EPA are negotiating various aspects of the litigation including the schedule of depositions and final settlements. At June 30, 1996, it is not possible to estimate the ultimate liability to the Authority for civil penalties. However, management will continue settlement negotiations, and based on discussions with legal counsel and their recommended reserves, believes that the ultimate liability, if any, will not have a material effect on the Authority's financial position.

b. Commitments:

On August 25, 1992, the Authority entered into an agreement with the Cambalache Limited Partnership, S.P. for the construction of a 249 megawatt generation plant of open cycle combustion turbines. The Authority's estimated obligation under this agreement amounts to approximately \$147.3 million, as amended. The total obligation under the agreement will be subject to price adjustments (Escalation Formula). At June 30, 1996 the Authority had incurred construction costs amounting to approximately \$113 million.

On October 11, 1994, the Authority signed a contract with AES Puerto Rico, L.P. (AES) for the purchase of up to 413 megawatt power generated from a coal fluidized bed combustion facility. The Authority will pay its purchased power based on an energy and dependable capacity delivered, as more fully explained in the Agreement.

On March 1995, the Authority also signed a contract with EcoEléctrica, a joint venture of Kenetech Corporation and Enron Corporation, to purchase power from a 461 megawatt gas-fired combined cycle power plant. The Authority will pay its purchased power based on an energy and dependable capacity delivered, as more fully explained in the Agreement.

c. Risk Management:

The Authority is exposed to various risks of losses related to torts; thefts of, damage to, and destruction of assets; errors and omissions; injuries to employees; and natural disasters. Under the property and casualty insurance program the Authority provides coverage, among others, for up to a maximum of \$250,000 for each general and liability claim, and \$2,000,000, for each boiler and machinery and property liability claim. In addition, the property liability policy imposes windstorm and earthquake deductibles at 2% and 5% of the locations value subject to a maximum deductible of \$25 million per occurrence. The Authority purchases commercial insurance for claims in excess of coverage provided through the property and casualty insurance program. The Authority considers its Self-insurance Fund to provide for its self-insurance risk (see Note 4). Claims expenditures and liabilities are reported when it is probable that a loss has occurred and the amount of that loss can be reasonably estimated.

The Authority has a cost plus health insurance program covering substantially all employees. The Authority entered into contracts with two plan administrators for the processing, approval and payment of claims plus an administrative fee. The accrual includes claims processed and an estimate for claims incurred but not reported.

NOTES TO FINANCIAL STATEMENTS, CONTINUED

15. COMMITMENTS AND CONTINGENCIES, Continued

c. Risk Management, Continued

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

In addition, the Authority is self-insured for its transmission and distribution lines since June, 1993. Transmission and distribution plant amounted to approximately \$1.9 billion at June 30, 1996. The Authority considers its Self-insurance Fund to provide for its self-insurance risk. This fund represents, principally retained earnings and restricted assets set aside for self insurance amounting to approximately \$99.4 million and \$92.8 million in 1996 and 1995, respectively.

Changes in the balances of the health insurance program and other self-insurance risks during fiscal years 1996 and 1995 were as follows:

	Liability Beginning Balance	Expenses (In Thousands)	Payments	Liability Ending Balance
1994-1995	\$ 21,037	\$ 56,359	56,736	\$ 20,660
1995-1996	\$ 20,660	\$ 59,389	\$ 57,157	\$ 22,892

d. Contingencies:

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

16. SUPPLEMENTAL DISCLOSURES OF NONCASH CAPITAL AND FINANCING INFORMATION:

The accreted value of capital appreciation bonds equals the original principal amount of such capital appreciation bonds plus interest accrued from its date of issuance. During the year ended June 30, 1996 and 1995 the accrued interest on capital appreciation bonds amounted to \$14.3 and \$13.4 million, respectively.

On September 14, 1995, the Authority issued Series V Power Revenue Bonds and RUS Power Revenue Bonds for the purpose of exchanging Electric Revenue Bonds Series 1992 in the aggregate principal amount of \$101,510,000 and RUS Electric Revenue Bonds in the aggregate principal amount of \$9,624,000.

NOTES TO FINANCIAL STATEMENTS, CONTINUED

17. SUBSEQUENT EVENTS:

On September 10, 1996, the Authority's facilities suffered damages from Hurricane Hortense. Estimated property damages of approximately \$28.1 million could be funded through the self-insurance fund. The Authority's accounting policy for major replacements states that no loss will be recognized and that accumulated depreciation will be charged (see Note 1b).

Also, the Authority will claim certain business interruption of approximately \$10 million which is partially covered by insurance.

Management believes that the impact of the Hurricane Hortense on the Authority's operations was not significant.

PUERTO RICO ELECTRIC POWER AUTHORITY

Supplemental Schedule of Funds Under the Provisions of the
1947 Indenture for 1995 and 1974 Agreement for 1996 and 1995
Years ended June 30, 1996 and 1995
(In Thousands)

	1996			1995		
	Held by Authority Other Assets	Restricted Deposits with Trustees Other Assets	Non-Current Assets	Held by Authority Other Assets	Restricted Deposits with Trustees Other Assets	Non-Current Assets
By Accounts:						
1947 Indenture (restricted)						
Sinking fund - principal and interest					\$ 41,617	\$ 65,734
Reserve account						
General reserve fund (principally retained earnings set aside for self - insurance)					4,647	88,191
Construction fund					2	153,925
					<u>48,266</u>	<u>200,191</u>
1974 Agreement (restricted):						
Sinking fund - principal and interest					121,988	148,129
Reserve account						
Self Insurance Fund						
Construction funds:						
Rural Utilities Services (RUS)					1,133	212
Other					15,897	15,897
General purpose (unrestricted):						
General					55,517	55,517
Working funds					1,598	1,598
					<u>73,224</u>	<u>73,224</u>
					<u>342,262</u>	<u>342,262</u>
					<u>542,453</u>	<u>542,453</u>
Total					\$ 1,598	\$ 1,598
By Type of Assets Held:						
Working funds						
Cash in banks and time deposits (by depository institutions):						
Government Development Bank for Puerto Rico					5	5
Banco Popular de Puerto Rico					12,347	12,347
Citibank, N. A.					2,230	2,230
State Street Bank and Trust Co., N. A.						
Chase Manhattan Bank					46,444	46,444
Banco Central Hispano, San Juan, Puerto Rico					5,596	5,596
Banco Bilibao Vizcaya, Santurce, Puerto Rico					2,860	2,860
First Bank, San Juan, Puerto Rico					365	365
Banco Santander, Santurce, Puerto Rico					1,764	1,764
Smith Barney						
Western Bank					15	15
Other Institutions					73,224	73,224
					<u>163,715</u>	<u>163,715</u>
Investment Securities:						
1947 Indenture						153,915
1974 Agreement					4,539	145,984
						<u>921</u>
Total					<u>73,224</u>	<u>189,175</u>
					<u>542,453</u>	<u>300,054</u>

See accompanying Report of Independent Accountants.

PUERTO RICO ELECTRIC POWER AUTHORITY
Supplemental Schedule of Sources and Disposition
of Net Revenues under the Provisions
of the 1947 Indenture for 1995 and 1974 Agreement for 1996 and 1995
for the Years ended June 30, 1995 and 1996
(In Thousands)

	1996	1995
Sources of Net Revenues:		
Revenues:		
Electric revenues	\$1,556,961	\$1,447,139
Revenues from the Commonwealth for rural electrification	1,124	1,269
Other operating revenues	8,805	7,848
Other	24,857	22,635
	<u>1,591,747</u>	<u>1,478,891</u>
Current Expenses:		
Operations:		
Fuel	585,157	523,235
Other production	36,350	43,226
Transmission and distribution	71,608	66,883
Customer accounting and collection	70,323	68,718
Administrative and general	138,609	113,231
Maintenance	241,462	210,274
Interest (other than long term debt)	1,626	7,781
	<u>1,145,135</u>	<u>1,033,348</u>
Net revenues, as defined	<u>\$446,612</u>	<u>\$445,543</u>
Disposition of Net Revenues:		
1947 sinking fund:		
Electric revenue bonds:		
Principal	6,309	42,738
Interest	5,090	32,018
Reserve	(68,756)	(5,720)
	<u>(57,357)</u>	<u>69,036</u>
General reserve fund:	5,891	6,051
Renewal & replacement fund:		
Power revenue bonds - sinking fund requirements:		
Interest	189,294	153,904
Principal	101,905	51,678
Reserve	35,001	
Short - term notes - interest	707	346
Debt discount and expenses	3,309	5,251
Balance available for capital improvements and other needs	70,574	62,508
	<u>400,790</u>	<u>273,687</u>
General obligation notes:		
Interest	1,332	1,640
Principal		
	<u>1,332</u>	<u>1,640</u>
Contribution in lieu of taxes:	95,956	95,129
Net revenues, as defined	<u>\$446,612</u>	<u>\$445,543</u>

See accompanying Report of Independent Accountants.

PUERTO RICO ELECTRIC POWER AUTHORITY

Sources and Disposition of Net Revenues
Under the Provisions of the 1947 Indenture for 1995 and 1974 Agreement
for the Years ended June 30, 1998 and 1995
Statements of Income (GAAP) and Reconciliation of Net Income
(In Thousands)

	1996		1995	
	1947 Indenture and 1974 Agreement	Statement of Income (GAAP)	1947 Indent. and 1974 Agreement	Statement of Income (GAAP)
		Reconciliation of Net Income		Reconciliation of Net Income
Reconciliation of components of net income:				
Revenues:				
Electric sales	\$1,556,981	\$1,556,961	\$1,447,139	\$1,447,139
Revenues from Commonwealth for rural electrification	1,124	1,124	1,269	1,269
Other operating revenues	8,805	8,805	7,848	7,848
Other	24,857	24,857	22,635	22,635
1974 Agreement construction funds investment income and gain on sale of other properties		6,947		4,453
	<u>1,591,747</u>	<u>1,598,694</u>	<u>1,478,891</u>	<u>1,483,344</u>
Current Expenses:				
As shown	1,145,135	1,143,509	1,033,348	1,025,567
Other interest		1,626		7,781
Total as defined	<u>1,145,135</u>	<u>1,145,135</u>	<u>1,033,348</u>	<u>1,033,348</u>
Net revenues, as defined	<u>446,612</u>		<u>445,543</u>	
Depreciation		148,839		141,671
		<u>(148,839)</u>		<u>(141,671)</u>
Disposition of Revenues:				
Interest on long - term debt	199,732	199,732	193,159	193,159
Amortization of bond defeasance		10,168		11,222
Allowance for funds used during construction		<u>(17,137)</u>		<u>(11,186)</u>
Net interest on long - term debt	<u>199,732</u>	<u>192,763</u>	<u>193,159</u>	<u>193,195</u>
Electric revenue bonds:				
Principal	6,309	6,309	42,738	42,738
General reserve fund	5,891	5,891	6,051	6,051
Reserve fund	<u>(68,756)</u>	<u>(68,756)</u>	<u>(5,720)</u>	<u>(5,720)</u>
Power revenue bonds:				
Principal	101,905	101,905	51,678	51,678
Reserve	35,001	35,001	62,508	62,508
Balance available for capital improvements and other (internal funds)	70,574	70,574	95,129	95,129
General obligation notes - principal				
Contribution in lieu of taxes	95,956	95,956	95,129	95,129
Cumulative effect on prior years of adopting new accounting method				3,973
Total expenses (GAAP)	<u>\$446,612</u>	<u>1,582,893</u>	<u>\$445,543</u>	<u>1,467,316</u>
Net revenues, as defined		<u>\$16,001</u>		<u>\$16,028</u>
Net income		<u>\$16,001</u>		<u>\$16,028</u>

See accompanying Report of Independent Accountants.

PUERTO RICO ELECTRIC POWER AUTHORITY

Supplemental Schedule of Changes in Cash and Investments by Funds
Year ended June 30, 1998
(IN THOUSANDS)

	General Purposes Funds			Sinking Funds				Construction Funds					
	General Fund	Revenue Fund	Working Funds	General Obligation Notes Fund	General Reserve Fund	Interest Indenture 1947	Principal Indenture 1947	Reserve Indenture 1947	Interest Agreement 1974	Principal Agreement 1974	Reserve Agreement 1974	Self Insurance Fund	Renewal and Replacement Indenture 1947
1995-1998 Activity													
Balances at June 30, 1995	\$542,453	\$55,517	\$1,598	\$1	\$92,837	\$16,312	\$25,305	\$65,734	\$71,842	\$50,146	\$148,129		\$23
Operations:													
Net revenues	(446,812)	95,956		1,332	5,891	5,090	6,309						332,034
Funds provided from internal operations	182,197	(6,947)											17,137
1974 Agreement Investment Income													
Offset of current year's contribution in lieu of taxes against certain government accounts receivable	76,448	(76,448)											
Offset of current year's 6% contribution in lieu of taxes against Commonwealth of Puerto Rico debt and transfers to General Obligations Notes Fund	17,580	(17,580)											
Funds used for construction	(353,394)												6,947
Financing:													
Proceeds from new bond issues- net of original discount	1,050,030	738,030											
Defeased bonds- net of original discount	(730,645)	(730,645)											
Transfer of 1947 Trust Indenture funds	14,341	14,341					(17,543)	(68,756)	33,755		56,504	99,199	
Accrual of capital appreciation bonds													
Amortization of debt discount and excess reacquisition costs	12,424												(12,424)
Accrual of interest, renewal and replacements account transfers	188,553	188,553							154,632	97,862			88,544
Notes issued for construction	15,800	15,000											15,800
Notes issued for fuel purchases-net	(94,700)	(5,000)											
Payment of interest	(183,119)	(7,244)							(153,661)				(89,700)
Payment of current maturities of long-term debt	(68,435)	(1,748)								(52,787)			
Changes in assets and liabilities:													
Working funds			778										
Accounts receivable (includes non-current)	(16,627)	(16,627)											
Fuel oil	21,006	21,006											
Materials and supplies	(9,635)	(9,635)											
Prepayments and other	(735)	(735)											
Deferred debits	(6,385)	(6,385)											
Accounts payable and accrued liabilities (includes non-current)	28,383	28,383											
Customer deposits	5,485	5,485											
Interfund transfers, etc.	0	182,538		110	471	5,329	(171)	3,022	(2,871)	8,943	8,982	83	(42,243)
Total before interfund accounts	594,729	283,187	1,928	0	0	0	0	0	103,697	102,164	213,615	99,282	(65,039)
Add (deduct) interfund accounts	(225,728)	(1,928)											61,012
Balances at June 30, 1998	\$594,729	\$57,441	\$2,374	\$0	\$0	\$0	\$0	\$0	\$103,697	\$102,164	\$213,615	\$99,282	\$15,973
													\$203
													\$0

See accompanying Report of Independent Accountants.

PUERTO RICO ELECTRIC POWER AUTHORITY
Supplemental Schedule of Changes in Cash and Investments by Funds
Year ended June 30, 1995
(IN THOUSANDS)

	General Purposes Funds			Sinking Funds			Construction Funds					
	General Fund	Revenue Fund	Working Funds	General Obligation Notes Fund	General Reserve Fund	Interest Indenture 1947	Principal 1947 Indenture	Reserve 1947	Interest Agreement 1974	Principal Agreement 1974	Reserve Agreement 1974	Renewal and Replacement Indenture
1994-1995 Activity												
Balances at June 30, 1994	\$878,512	\$60,489	\$1,661	\$923	\$83,049	\$16,749	\$23,377	\$73,002	\$61,233	\$41,458	\$138,700	\$100
Operations:												
Net revenues												
Funds provided from internal operations	181,738	(445,543)	95,129		6,051	32,018	42,738	(5,720)				275,327
1974 Agreement investment income												11,186
Offset of current year's contribution in lieu of taxes against certain government accounts receivable		75,934	(75,934)									4,453
Offset of current year's 5% contribution in lieu of taxes against Commonwealth of Puerto Rico debt and transfers to General Obligations Notes Fund	(334,164)	16,775	(16,775)									
Funds used for construction		6,193										
Financing:												
Accrual of interest, renewal and replacement accounts transfers	180,497	180,497							165,962	26,013	1,785	47,000
Amortization of debt discount and bond defeasance	13,395	16,472										(240,740)
Accretion of capital appreciation bonds	73,900	13,395										73,900
Notes issued for construction	(170,592)	(7,446)				(32,982)			(130,164)			
Payment of interest												
Payment of current maturities of long-term debt	(90,079)	(2,223)					(41,460)					
Payment of notes	(5,000)	(5,000)										
Changes in assets and liabilities:												
Working funds		63	(63)									
Accounts receivable (includes non-current)	(15,122)	(15,122)										
Fuel oil	(11,352)	(11,352)										
Materials and supplies	15,992	15,992										
Prepayments and other	(425)	(425)										
Deferred debits	1,431	1,431										
Accounts payable and accrued liabilities (includes non-current)	40,357	40,357										
Customer deposits	(16,635)	(16,635)										
Interfund transfers, etc.	(99,762)	(99,762)										
Total before interfund accounts	542,453	(9,811)	2,420	1,598	3,797	527	650	(1,548)	(25,189)	29,071	5,664	(28,174)
Add (deduct) interfund accounts			(2,420)									
Balances at June 30, 1995	\$542,453	\$55,617	\$0	\$1,598	\$92,837	\$16,312	\$25,305	\$65,734	\$71,842	\$50,146	\$146,129	\$23
				\$1	\$92,837	\$16,312	\$25,305	\$65,734	\$71,842	\$50,146	\$146,129	\$23

See accompanying Report of Independent Accountants.

PUERTO RICO ELECTRIC POWER AUTHORITY

Supplemental Schedule of Changes in Long-Term
Debt and Current Portion of Long-Term Debt
Years ended June 30, 1996 and 1995
(In Thousands)

	1996	1995
Long-term debt excluding current portion:		
Balance at the beginning of year	<u>\$2,721,622</u>	<u>\$2,802,843</u>
Transfers to current liabilities:		
Electric and Power revenue bonds	(101,260)	(86,974)
General obligation notes	(5,000)	(5,000)
Obligations under capital lease	<u>(1,991)</u>	<u>(3,117)</u>
Total transfers	<u>(108,251)</u>	<u>(95,091)</u>
Remainder	2,613,371	2,707,752
New Issues:		
Power revenue bonds	326,560	
Power revenue refunding bonds	723,820	
Debt discount on new bond issues - net	(350)	
Defeasance of bonds	(711,210)	
Debt discount and excess reacquisition costs on canceled bonds - net	(18,925)	
Accretion of capital appreciation bonds	14,341	13,397
Payment of electric revenue bonds		(5,720)
Obligations under capital lease		<u>6,193</u>
Balance at the end of year	<u><u>\$2,947,607</u></u>	<u><u>\$2,721,622</u></u>
Current portion of long-term debt:		
Balance at beginning of year	<u>\$157,765</u>	<u>\$136,461</u>
Transfer from long-term debt	<u>108,251</u>	<u>95,091</u>
Payments to bondholders:		
Electric revenue - July 1	(13,900)	(13,560)
Electric revenue - January 1		(22,180)
Power revenue- July 1	(50,143)	(44,861)
Power revenue- January 1	(2,644)	(1,535)
Obligations under capital lease	(1,748)	(2,223)
General obligation notes	<u>(5,000)</u>	<u>(5,000)</u>
Total payments	<u>(73,435)</u>	<u>(89,359)</u>
Amortization of debt discount and excess reacquisition costs	<u>12,424</u>	<u>15,572</u>
Balance at end of year	<u><u>\$205,005</u></u>	<u><u>\$157,765</u></u>

See accompanying Report of Independent Accountants.

PUERTO RICO ELECTRIC POWER AUTHORITY

Supplementary Information

Fiscal Year	(1) Net Assets Available for Benefits (In Millions)	(2) Pension Benefits Obligation (PBO) (In Millions)	(3) % Funded (1)/(2)	(4) Unfunded PBO (2)-(1) (In Millions)	(5) Annual Covered Payroll (In Millions)	(6) Unfunded PBO as a % of Covered Payroll (4)/(5)	Actuarially Determined Contribution as a % of Covered Payroll
1996 (Note)							
Basic	\$984.7	\$1,219.1	80.8%	\$234.4	\$243.3	96.3%	Not determined
Supplemental	-	290.2		290.2	-		
Total	\$984.7	\$1,509.3	65.2%	\$524.6	\$243.3	215.6%	
1995 (Note)							
Basic	\$891.4	\$1,171.9	76.1%	\$280.5	\$239.5	117.1%	Not determined
Supplemental	-	209.3		209.3	-		
Total	\$891.4	\$1,381.2	64.5%	\$489.8	\$239.5	204.5%	
1994							
Basic	\$835.6	\$1,096.7	76.2%	\$261.1	\$233.0	112.1%	14.60%
Supplemental	-	205.1		205.1	-		
Total	\$835.6	\$1,301.8	64.2%	\$466.2	\$233.0	200.1%	
1993							
Basic	\$789.4	\$1,025.1	77.0%	\$235.7	\$216.8	108.7%	14.42%
Supplemental	-	193.2		193.2	-		
Total	\$789.4	\$1,218.3	64.8%	\$428.9	\$216.8	197.8%	
1992							
Basic	\$711.3	\$824.6	86.3%	\$113.3	\$195.6	57.9%	13.81%
Supplemental	-	188.2		188.2	-		
Total	\$711.3	\$1,012.8	70.2%	\$301.5	\$195.6	154.1%	
1991							
Basic	\$666.9	\$776.1	85.9%	\$109.2	\$188.4	58.0%	13.73%
Supplemental	-	191.7		191.7	-		
Total	\$666.9	\$967.8	68.9%	\$300.9	\$188.4	159.7%	
1990							
Basic	\$611.9	\$760.9	80.4%	\$149.0	\$177.6	83.9%	14.96%
Supplemental	-	194.7		194.7	-		
Total	\$611.9	\$955.6	64.0%	\$343.7	\$177.6	193.5%	
1989							
Basic	\$557.6	\$709.4	78.6%	\$151.8	\$171.3	88.6%	19.55%
Supplemental	-	186.5		186.5	-		
Total	\$557.6	\$895.9	62.2%	\$338.3	\$171.3	197.5%	
1988							
Basic	\$504.9	\$662.9	76.2%	\$157.2	\$153.2	102.6%	18.57%
Supplemental	-	178.1		178.1	-		
Total	\$504.9	\$841.0	60.0%	\$335.3	\$153.2	218.9%	
1987							
Basic	\$458.4	\$601.7	76.2%	\$143.3	\$138.7	103.3%	19.41%
Supplemental	-	130.4		130.4	-		
Total	\$458.4	\$732.1	62.6%	\$273.7	\$138.7	197.3%	

Note: The information for 1996 and 1995 is an estimate based on projections which are subject to adjustment when the actual actuarial computations are made.

See accompanying Report of Independent Public Accountants.

PUERTO RICO ELECTRIC POWER AUTHORITY

Supplementary Information

(In Thousands)

	7/1/86 6/30/87	7/1/87 6/30/88	7/1/88 6/30/89	7/1/89 6/30/90	7/1/90 6/30/91	7/1/91 6/30/92	7/1/92 6/30/93	7/1/93 6/30/94	7/1/94 6/30/95	7/1/95 6/30/96
Assets beginning of period	\$410,393	\$458,401	\$504,886	\$557,629	\$611,880	\$666,883	\$711,340	\$789,400	\$835,576	\$891,426
Employer contributions	25,809	27,955	30,244	32,973	35,785	33,191	32,446	34,882	34,176	33,302
Employee contributions	12,819	14,042	16,811	16,215	16,879	18,257	20,532	21,590	22,165	21,954
Income, net of expenses	40,776	38,903	44,050	42,577	46,049	41,710	80,639	45,552	58,687	101,301
Benefit payments (including refund of employee contributions)	<u>(31,396)</u>	<u>(34,415)</u>	<u>(38,362)</u>	<u>(37,514)</u>	<u>(43,710)</u>	<u>(48,701)</u>	<u>(55,557)</u>	<u>(55,848)</u>	<u>(59,178)</u>	<u>(63,189)</u>
Assets end of period	<u>\$458,401</u>	<u>\$504,886</u>	<u>\$557,629</u>	<u>\$611,880</u>	<u>\$666,883</u>	<u>\$711,340</u>	<u>\$789,400</u>	<u>\$835,576</u>	<u>\$891,426</u>	<u>\$984,794</u>

See accompanying Report of Independent Public Accountants.

Raytheon Engineers &
Constructors, Inc.
One Broadway
Cambridge, MA 02142
Tel 617.494.7000
Fax 617.494.7258

Raytheon Engineers &
Constructors

APPENDIX III

May 8, 1997

Puerto Rico Electric Power Authority
San Juan, Puerto Rico

Dear Sirs:

Raytheon Engineers & Constructors, Inc. ("Raytheon") serves as the Consulting Engineers under the provisions of the Trust Agreement, dated as of January 1, 1974, as amended, by and between Puerto Rico Electric Power Authority (the Authority) and State Street Bank and Trust Company, N.A., in the Borough of Manhattan, City and State of New York, successor trustee. Such Trust Agreement is referred to herein as the "Agreement", and the trustee under the Agreement is referred to herein as the "Trustee". The Agreement requires the Consulting Engineers annually to prepare and file with the Authority and the Trustee a report with their recommendations as to any necessary or advisable revisions of rates and charges and such other advices and recommendations as they may deem desirable. In addition, the report will include the amount that should be deposited monthly during the next fiscal year to the credit of the Reserve Maintenance Fund; the amount, if any, to be deposited to the Self-insurance Fund in the next fiscal year; and, the amount to be deposited to the Capital Improvement Fund in the next fiscal year. The most recent such recommendations and report provided to the Authority and the Trustee was dated as of June 10, 1996.

In preparing this letter and in reaching the conclusions and opinions contained herein and referred to in the Official Statement to which this letter is appended, Raytheon has relied upon inquires, observations and analyses made and conducted by it in the performance of its duties under the Agreement and upon its professional experience. Raytheon also has relied upon various financial, economic, political and other information and projections provided to it by the Authority and other sources, some of such information and projections having been accepted by Raytheon without its having conducted an independent investigation thereof. In addition, Raytheon has made assumptions which it believes to be reasonable to make including, but not limited to, the following:

1. that the Authority will adhere to its proposed schedule of programmed regular maintenance;
2. that the Authority will continue to maintain the effective availability of its generating units;
3. that the Authority's current capacity expansion plan will be realized as to increases in capacity and approximate timing;

4. that the Authority's forecasts of costs and availability of fuels are reasonable;
5. that financing will be available to the Authority at reasonable rates, in adequate amounts and at appropriate times;
6. that the Authority will not be adversely affected by labor disputes and will have adequate levels of labor productivity;
7. that there will be no material changes in the requirements of regulatory authorities, the Legislature of Puerto Rico will not enact any legislation that will adversely affect the Authority, nor will there be unforeseen technological developments;
8. that the demographic, statistical, economic and other information regarding Puerto Rico obtained by Raytheon from publicly available sources is reliable;
9. that the Authority will not be unduly affected by natural disasters; and
10. that the Authority will not experience unforeseeable or extraordinary conditions not included in usual estimates and opinions of engineers; and
11. that the Authority will keep in force and effect the levels and types of insurance that it currently maintains as indicated in the report of the Authority's insurance consultant, which report is assumed to be accurate in all respects, including the opinion set forth in such report that the insurance coverages of the Authority are commensurate with those maintained by United States mainland electric utilities.

Based upon and subject to the foregoing which should be read in conjunction with and as part of the following conclusions, it is our considered opinion with respect to the Authority that:

1. The Authority's production, transmission and distribution plant is in good repair and sound operating condition;
2. The Authority's generating capacity expansion plan is adequate and should allow the Authority to meet targeted electric reliability criteria;
3. The Authority's projections of future load growth and estimates of peak load referred to in the Official Statement, to which this letter is appended, under the caption "Adequacy of Capacity" are reasonable for base planning purposes;
4. The Authority's revenue and base capacity planning forecasts (and the methodologies and assumptions on which they are based) are reasonable for planning purposes and are generally consistent with utility industry practices;
5. The Authority's current projected capital improvement program is reasonable and the estimated expenditures are consistent with the Authority's future needs;
6. The Authority's estimates of future growth form a reasonable basis for its projected operating results;

7. The Authority's electric rates and charges should generate sufficient revenues to pay its current expenses and debt service and to finance that portion of its capital improvement program that is currently anticipated to be financed with current operating revenues;

8. The approximately 874 MW of capacity proposed to be provided by cogenerators as described in the Official Statement, to which this letter is appended, under the caption "Adequacy of Capacity" and its role in the Authority's capacity expansion program should not cause the Authority to experience a meaningful reduction in control over its revenue producing capability as a result of the purchase rather than self-generation of electricity; and, the methodology used by the Authority in determining its avoided cost of generating or otherwise obtaining an equivalent amount of energy, pursuant to the Public Utilities Regulatory Policies Act of 1978, as amended (which requires the Authority to pay an amount based upon such avoided cost for power generated and made available to the Authority), is reasonable;

9. The two cogenerating projects, one fueled by liquified natural gas and the other by coal, are the first significant non-oil capacity additions to be made to the available capacity of the Authority. Once these plants are in service, the Authority will have approximately 17% of its available capacity that is not oil dependent. It is estimated that this cogeneration capacity will account for approximately 32% of the Authority's energy sales; and

10. The major coverages of the Authority's insurance program are commensurate with those maintained by United States mainland electric utilities.

Very truly yours,

RAYTHEON ENGINEERS & CONSTRUCTORS, INC.



Stephen A. Kokolski
Manager, Utility Management Services
Department

[This page intentionally left blank]

B R O W N & W O O D L L P

**ONE WORLD TRADE CENTER
NEW YORK, N.Y. 10048-0557**

**TELEPHONE: 212-839-5300
FACSIMILE: 212-839-5599**

APPENDIX IV

[Proposed Form of Opinion of Bond Counsel]

May , 1997

Puerto Rico Electric Power Authority
San Juan, Puerto Rico

Gentlemen:

We have examined the Puerto Rico Electric Power Authority Act (Act No. 83 of the Legislature of Puerto Rico, approved May 2, 1941, as amended and re-enacted by Act No. 19, approved April 8, 1942, as amended), creating Puerto Rico Electric Power Authority (formerly called Puerto Rico Water Resources Authority and herein called the "Authority"), a governmental instrumentality of the Commonwealth of Puerto Rico, and also Act No. 111, approved May 6, 1941, as amended by Act No. 153, approved May 14, 1943 (said Acts No. 83, No. 19, No. 111 and No. 153, as amended, being herein collectively called the "Authority Act").

We have also examined certified copies of the proceedings of the Governing Board of the Authority in authorizing the execution and delivery of the Agreement hereinafter referred to and certified copies of the proceedings and other proofs submitted relative to the authorization, issuance and sale of

**\$464,840,000
PUERTO RICO ELECTRIC POWER AUTHORITY
POWER REVENUE BONDS, SERIES AA
Dated May 1, 1997.**

Issued in such denominations, transferable and exchangeable, bearing interest at such rates and payable on such dates, maturing on July 1 in the years and in such principal amounts, and subject to redemption prior to maturity, all as set forth in the resolution of the Authority authorizing the issuance of said Series AA Bonds.

We have also examined one of said Series AA Bonds (the "Bonds") as executed and authenticated.

From such examination we are of the opinion that:

1. The Authority Act is valid.
2. Said proceedings have been validly and legally taken.
3. The Bonds have been duly authorized and issued to provide funds for paying the cost of capital improvements to the electric power properties of the Authority (such properties, together with all improvements, renewals and replacements thereof and extensions and additions thereto, being herein called the "System"), including the repayment of moneys advanced to the Authority as the proceeds of notes issued by the Authority for the purpose of paying a portion of such cost.

4. As authorized by the Authority Act and by said proceedings, a trust agreement dated as of January 1, 1974, as amended (herein called the "Agreement"), has been duly executed by and between the Authority and State Street Bank and Trust Company, N.A., successor Trustee, which contains reasonable and sufficient covenants and provisions in accordance with law with respect to the custody and application of the proceeds of bonds issued thereunder, the collection and disposition of revenues, the maintenance, repair and operation of the System, the conservation and application of all funds, the safeguarding of moneys on hand or on deposit and the rights and remedies of the Trustee and the holders of all bonds issued thereunder.

5. The Agreement provides for the issuance of additional Puerto Rico Electric Power Authority Power Revenue Bonds under the conditions and limitations therein set forth.

6. The Bonds are valid and binding special obligations of the Authority payable solely from the Puerto Rico Electric Power Authority Power Revenue Bonds Interest and Sinking Fund established under the Agreement, to the credit of which Fund the Authority has covenanted to deposit a sufficient amount of revenues of the System, over and above the expenses of repair, maintenance and operation, to pay the principal of and interest on all bonds issued under the provisions of the Agreement (including the Bonds) as the same become due and payable and to create a reserve for such purpose, which Fund is pledged to and charged with the payment of the principal of and interest on such bonds (including the Bonds).

7. The Agreement provides for the fixing and collecting by the Authority of rates and charges for the use of the services and facilities of the System sufficient for the payment of the expenses of the Authority incurred in the repair, maintenance and operation of the System and for the payment of the principal of and the interest on all bonds issued under the provisions of the Agreement (including the Bonds) as the same become due and payable including reserves for such purposes.

8. The bonds issued under the provisions of the Agreement do not constitute a debt of the Commonwealth of Puerto Rico or of any of its municipalities or other political subdivisions, and neither the Commonwealth of Puerto Rico nor any such municipality or other political subdivision is liable thereon, and such bonds are payable only out of the revenues of the System, to the extent provided in the Agreement.

9. Under the provisions of the Acts of Congress now in force and under existing regulations and judicial decisions, (i) subject to compliance with the covenant referred to below and requirements of the Internal Revenue Code of 1986, as amended (the "Code"), 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 the computation of the alternative minimum 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 the Bonds or (b) the inclusion in certain computations (including, without limitation, those related to the corporate alternative minimum tax) of interest that is not included in gross income.

The Authority 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 Authority from complying with the requirements of the Code.

Respectfully submitted,

[To be signed "Brown & Wood LLP"]

B R O W N & W O O D L L P

**ONE WORLD TRADE CENTER
NEW YORK, N.Y. 10048-0557**

**TELEPHONE: 212-839-5300
FACSIMILE: 212-839-5599**

[Proposed Form of Opinion of Bond Counsel]

May , 1997

Puerto Rico Electric Power Authority
San Juan, Puerto Rico

Gentlemen:

We have examined the Puerto Rico Electric Power Authority Act (Act No. 83 of the Legislature of Puerto Rico, approved May 2, 1941, as amended and re-enacted by Act No. 19, approved April 8, 1942, as amended), creating Puerto Rico Electric Power Authority (formerly called Puerto Rico Water Resources Authority and herein called the "Authority"), a governmental instrumentality of the Commonwealth of Puerto Rico, and also Act No. 111, approved May 6, 1941, as amended by Act No. 153, approved May 14, 1943 (said Acts No. 83, No. 19, No. 111 and No. 153, as amended, being herein collectively called the "Authority Act").

We have also examined certified copies of the proceedings of the Governing Board of the Authority in authorizing the execution and delivery of the Agreement each hereinafter referred to and certified copies of the proceedings and other proofs submitted relative to the authorization, issuance and sale of

**\$100,750,000
PUERTO RICO ELECTRIC POWER AUTHORITY
POWER REVENUE REFUNDING BONDS, SERIES BB
Dated May 1, 1997.**

Issued in such denominations, transferable and exchangeable, bearing interest at such rates and payable on such dates, maturing on July 1 in the years and in such principal amounts, and subject to redemption prior to maturity, all as set forth in the resolution of the Authority authorizing the issuance of said Series BB Bonds.

We have also examined one of said Series BB Bonds (the "Bonds") as executed and authenticated.

From such examination we are of the opinion that:

1. The Authority Act is valid.
2. Said proceedings have been validly and legally taken.
3. The Bonds have been duly authorized and issued to refund all of the Authority's outstanding Puerto Rico Water Resources Authority Power Revenue Bonds, Series A.

4. As authorized by the Authority Act and by said proceedings, a trust agreement, dated as of January 1, 1974, as amended (herein called the "Agreement"), has been duly executed by and between the Authority and State Street Bank and Trust Company, N.A., successor Trustee, which contains reasonable and sufficient covenants and provisions in accordance with law with respect to the custody and application of the proceeds of bonds issued thereunder, the collection and disposition of revenues, the maintenance, repair and operation of the electric power properties of the Authority (such properties, together with all improvements, renewals and replacements thereof and extensions and additions thereto, being herein called the "System"), the conservation and application of all funds, the safeguarding of moneys on hand or on deposit and the rights and remedies of the Trustee and the holders of all bonds issued thereunder.

5. The Agreement provides for the issuance of additional Puerto Rico Electric Power Authority Power Revenue Bonds under the conditions and limitations therein set forth.

6. The Bonds are valid and binding special obligations of the Authority, payable solely from the Puerto Rico Electric Power Authority Power Revenue Bonds Interest and Sinking Fund established under the Agreement, to the credit of which Fund the Authority has covenanted to deposit a sufficient amount of revenues of the System, over and above the expenses of repair, maintenance and operation, to pay the principal of and interest on all bonds issued under the provisions of the Agreement (including the Bonds) as the same become due and payable and to create a reserve for such purpose, which Fund is pledged to and charged with the payment of the principal of and the interest on all bonds issued under the Agreement (including the Bonds).

7. The Agreement provides for the fixing and collecting by the Authority of rates and charges for the use of the services and facilities of the System sufficient for the payment of the expenses of the Authority incurred in the repair, maintenance and operation of the System and for the payment of the principal of and the interest on all bonds issued under the provisions of the Agreement (including the Bonds) as the same become due and payable including reserves for such purposes.

8. The bonds issued under the provisions of the Agreement do not constitute a debt of the Commonwealth of Puerto Rico or of any of its municipalities or other political subdivisions, and neither the Commonwealth of Puerto Rico nor any such municipality or other political subdivision is liable thereon, and such bonds are payable only out of the revenues of the System, to the extent provided in the Agreement.

9. Under the provisions of the Acts of Congress now in force and under existing regulations and judicial decisions, (i) subject to compliance with the covenant referred to below and requirements of the Internal Revenue Code of 1986, as amended (the "Code"), 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 the computation of the alternative minimum 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 the Bonds or (b) the inclusion in certain computations (including, without limitation, those related to the corporate alternative minimum tax) of interest that is not included in gross income.

The Authority 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 Authority from complying with the requirements of the Code.

Respectfully submitted,

[To be signed "Brown & Wood LLP"]

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 _____

MBIA Insurance Corporation

Resident Licensed Agent

City, State

STD-RCS-6
4/95

President

Attest:

Assistant Secretary

SPECIMEN

[This page intentionally left blank]

[This page intentionally left blank]

