

\$410,665,000
PUERTO RICO PUBLIC FINANCE CORPORATION
2012 Series A Bonds
(Commonwealth Appropriation Bonds)

Puerto Rico Public Finance Corporation (the "Corporation") is issuing its 2012 Series A Bonds (Commonwealth Appropriation Bonds) (the "2012 Series A Bonds") for the purpose of refunding a portion of its outstanding bonds (as further described herein). The 2012 Series A Bonds will be issued under the Trust Agreement dated as of June 1, 2004 (the "Trust Agreement") by and between the Corporation and U.S. Bank National Association, as trustee. The 2012 Series A Bonds are limited obligations of the Corporation payable solely from payments of principal of and interest on certain promissory notes (the "Notes") issued by certain departments, agencies, instrumentalities and public corporations (the "Authorized Debtors") of the Commonwealth of Puerto Rico (the "Commonwealth" or "Puerto Rico"). The Notes are payable solely from budgetary appropriations to be made by the Legislature of Puerto Rico pursuant to legislation adopted by the Legislature of Puerto Rico (the "Appropriation Acts"). The Appropriation Acts require the Office of Management and Budget of the Commonwealth (the "OMB") to include in the annual operating budget of the Commonwealth amounts required to pay debt service on the Notes and certain other notes of the Authorized Debtors. If these budgetary appropriations are made on a timely basis by the Legislature of Puerto Rico, payments required to be made under the Notes will at all times be sufficient to pay the principal of and interest on the 2012 Series A Bonds as they become due. The Legislature of Puerto Rico is not legally bound to appropriate funds for such payments.

The 2012 Series A Bonds will have the following characteristics:

- The 2012 Series A Bonds will be dated their date of delivery.
- The 2012 Series A Bonds will be registered under The Depository Trust Company's book-entry only system. Purchasers of the 2012 Series A Bonds will not receive definitive 2012 Series A Bonds.
- The inside cover page of this Official Statement contains information concerning the maturities, interest rates and prices or yields of the 2012 Series A Bonds.
- Interest on the 2012 Series A Bonds will be payable monthly on the first day of each month, commencing on August 1, 2012.
- The 2012 Series A Bonds will be issued in denominations of \$5,000 principal amount and integral multiples thereof.
- In the opinion of O'Neill & Borges LLC, Special Puerto Rico Tax Counsel, interest on the 2012 Series A Bonds will be exempt from Puerto Rico and United States taxes to residents of Puerto Rico. Interest on the 2012 Series A Bonds is not excludable from gross income for federal income tax purposes under Section 103(a) of the United States Internal Revenue Code. See *Tax Matters* in this Official Statement.
- It is expected that settlement for the 2012 Series A Bonds will occur on or about June 28, 2012.

The 2012 Series A Bonds will not constitute an obligation of the Commonwealth or any of its political subdivisions or public instrumentalities (other than the Corporation), and neither the Commonwealth nor any of its political subdivisions or public instrumentalities (other than the Corporation) will be liable thereon. The Corporation has no taxing power.

The 2012 Series A Bonds are offered by the Underwriters when, as and if issued by the Corporation and received by the Underwriters, subject to prior sale, withdrawal or modification of the offer without notice, and the approval of legality by Squire Sanders (US) LLP, Miami, Florida, Bond Counsel to the Corporation. Certain legal matters will be passed upon for the Underwriters by O'Neill & Borges LLC, San Juan, Puerto Rico, as Underwriters' Counsel. O'Neill & Borges LLC will also act as Special Puerto Rico Tax Counsel.

UBS FS Puerto Rico

BofA Merrill Lynch

Popular Securities

Santander Securities

Barclays

BBVAPR MSD

Citigroup

FirstBank PR Securities

Oriental Financial Services

Ramirez & Co. Inc

Raymond James | Morgan Keegan

Scotia MSD

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Puerto Rico Public Finance Corporation
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(Commonwealth Appropriation Bonds)

\$267,865,000 Serial Bonds

Maturity Date August 1	Principal Amount	Interest Rate	Price	CUSIP*
2015	\$36,285,000	3.10%	100%	745291UZ5
2016	29,435,000	3.45	100	745291VA9
2017	30,450,000	3.75	100	745291VB7
2018	31,590,000	4.00	100	745291VC5
2019	32,855,000	4.15	100	745291VD3
2020	34,215,000	4.35	100	745291VE1
2021	35,705,000	4.55	100	745291VF8
2022	37,330,000	4.75	100	745291VG6

\$142,800,000 Term Bonds

\$94,490,000	5.10% Term Bond due August 1, 2026	Price 100%	CUSIP* 745291VH4
\$48,310,000	5.35% Term Bond due August 1, 2031	Price 100%	CUSIP* 745291VJ0

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In connection with this offering, the Underwriters may over-allot or effect transactions that stabilize or maintain the market price of the 2012 Series A Bonds at a level above that which might otherwise prevail in the open market. Such stabilizing, if commenced, may be discontinued at any time. The Underwriters may offer and sell the 2012 Series A Bonds to certain dealers and dealer banks and others at a price lower than the public offering price stated on the inside cover page and said offering price may be changed from time to time by the Underwriters.

The information set forth herein has been obtained from sources which are believed to be reliable but, as to information from other than Puerto Rico Public Finance Corporation (the "Corporation") or the Commonwealth of Puerto Rico (the "Commonwealth"), is not guaranteed as to accuracy or completeness, and is not to be construed as a representation, by the Corporation or the Underwriters. The information and expressions of opinion herein are subject to change without notice, and neither the delivery of the 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 Corporation or the Commonwealth since the date hereof. The various tables may not add due to rounding of figures.

The Underwriters have reviewed the information in this Official Statement in accordance with, and as part of, their respective responsibilities to investors under the federal and Commonwealth securities laws as applied to the facts and circumstances of this transaction, but the Underwriters do not guarantee the accuracy or completeness of such information.

No dealer, broker, sales representative or other person has been authorized by the Corporation or the Underwriters to give any information or to make any representations, other than those contained in this Official Statement in connection with the offering described herein, and if given or made, such other information or representations must not be relied upon as having been authorized by any of the foregoing. 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 2012 Series A Bonds, by any person in any jurisdiction in which it is unlawful for such person to make such offer, solicitation or sale.

All quotations from and summaries and explanations of provisions of laws, resolutions, the 2012 Series A Bonds and other documents herein do not purport to be complete. Reference is made to said laws, resolutions, the 2012 Series A Bonds and other documents for full and complete statement of their provisions. Copies of the above are available for inspection at the offices of the Corporation or the Trustee.

CAUTIONARY STATEMENT REGARDING FORWARD-LOOKING STATEMENTS IN THIS OFFICIAL STATEMENT

Certain statements included or incorporated by reference in this Official Statement constitute projections or estimates of future events, generally known as forward-looking statements. These statements are generally identifiable by the words "estimates," "projects," "anticipates," "expects," "intends," "believes" and similar expressions. The achievement of certain results or other expectations contained in such forward-looking statements involves known and unknown risks, uncertainties and other factors which may cause actual results, performance or achievements described to be materially different from any future results, performance or achievements expressed or implied by these forward-looking statements. The Corporation does not plan to issue any updates or revisions to those forward-looking statements if or when changes in their expectations, or events, conditions or circumstances on which such statements are based, occur.

The projections set forth in this Official Statement were not prepared with a view toward complying with the guidelines established by the American Institute of Certified Public Accountants with respect to prospective financial information, but, in the view of the Commonwealth's responsible officers, were prepared on a reasonable basis, reflect the best currently available estimates and judgments, and present, to the best of such officers' knowledge and belief, the expected course of action and the expected future financial performance of the Commonwealth. However, this information is not fact and should not be relied upon as being necessarily indicative of future results, and readers of this Official Statement are cautioned not to place undue reliance on the prospective financial information. Neither the Commonwealth's independent auditors, nor any other independent auditors, have compiled, examined, or performed any procedures with respect to the prospective financial information contained herein, nor have they expressed any opinion or any other form of assurance on such information or its achievability and disclaim any association with the prospective financial information. Neither the Commonwealth's independent auditors, nor any other independent auditors, have been consulted in connection with the preparation of the prospective financial information set forth in this Official Statement, which is solely the product of the Commonwealth, and the independent auditors assume no responsibility for its content.

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\$410,665,000
Puerto Rico Public Finance Corporation
2012 Series A Bonds
(Commonwealth Appropriation Bonds)

INTRODUCTORY STATEMENT

This Official Statement of Puerto Rico Public Finance Corporation (the “Corporation”), a subsidiary of Government Development Bank for Puerto Rico (“Government Development Bank” or “GDB”), provides certain information in connection with the sale by the Corporation of \$410,665,000 aggregate principal amount of its 2012 Series A Bonds (Commonwealth Appropriation Bonds) (the “2012 Series A Bonds”). The 2012 Series A Bonds are being issued pursuant to a Trust Agreement dated as of June 1, 2004 (the “Trust Agreement”) by and between the Corporation and U.S. Bank National Association, as trustee (the “Trustee”).

This Official Statement includes the following documents: (i) the Commonwealth’s Financial Information and Operating Data Report, dated June 8, 2012 (the “Commonwealth Report”), attached hereto as *Appendix I*, (ii) the Comprehensive Annual Financial Report of the Commonwealth of Puerto Rico (the “Commonwealth” or “Puerto Rico”), for the fiscal year ended June 30, 2011, prepared by the Department of the Treasury of the Commonwealth (“Treasury Department”) (the “Commonwealth’s Annual Financial Report”), which was filed with the Municipal Securities Rulemaking Board (“MSRB”) through the Electronic Municipal Market Access system (“EMMA”) (<http://emma.msrb.org>) on April 30, 2012, and is incorporated herein by reference; and (iii) the Trust Agreement, attached hereto as *Appendix IV*.

The Commonwealth Report includes important operating and financial information about the Commonwealth, including information about its economy, historical revenues and expenditures of its General Fund, the year-end results of fiscal years 2010 and 2011 and the first nine months of fiscal year 2012, the projected fiscal year 2012 deficit, preliminary General Fund revenues for the first ten months of fiscal year 2012, the budget for fiscal year 2012, the proposed budget for fiscal year 2013, the debt of the Commonwealth’s public sector, the financial situation of the Government’s retirement systems and certain litigation involving the Commonwealth. Purchasers of the 2012 Series A Bonds should read the Commonwealth Report in its entirety.

The Commonwealth’s Annual Financial Report includes the basic financial statements of the Commonwealth as of and for the fiscal year ended June 30, 2011, together with the independent auditors’ report thereon (which report expresses an unqualified opinion and includes an emphasis of matter paragraph regarding the unfunded actuarial accrued liability and funded ratio of the Employees Retirement System, Teachers Retirement System and Judiciary Retirement System (the “Retirement Systems”) as of June 30, 2011), dated April 27, 2012, of Deloitte & Touche LLP, certified public accountants. Deloitte & Touche LLP did not audit the financial statements of certain activities, funds, and component units separately identified in its report. Those financial statements were audited by other auditors whose reports have been furnished to Deloitte & Touche LLP, and its opinion as to the basic financial statements, insofar as it relates to the amounts included in the basic financial statements pertaining to such activities, funds and component units, is based solely on the reports of the other auditors.

Any appendix of an Official Statement or other disclosure document of the Commonwealth or of any instrumentality of the Commonwealth containing any revision to the Commonwealth Report that is filed with the MSRB through EMMA, or any new or revised Commonwealth Report or other document containing information that modifies or supersedes the information contained in the Commonwealth Report that is filed with the MSRB through EMMA, in each case after the date hereof shall be deemed to be incorporated by reference into this Official Statement and to be part of this Official Statement from the date of filing of such document. Any statement contained in the Commonwealth Report or elsewhere herein shall also be deemed to be modified or superseded to the extent that a statement contained in any such subsequently filed document modifies or supersedes such statement. Any such statement so modified or superseded shall not be deemed, except as so modified or superseded, to constitute a part of this Official Statement. Any filing with the MSRB through EMMA by the Commonwealth of a document generally containing the same information set forth in its continuing disclosure reports or financial statements, after the date hereof and prior to the termination of any offering of the 2012 Series A Bonds, shall also

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.

The Commonwealth has entered into a number of continuing disclosure undertakings required under Rule 15c2-12, as amended (the "Rule"), promulgated by the Securities and Exchange Commission ("SEC") in connection with previously issued bonds. Under its existing continuing disclosure undertakings, the Commonwealth is obligated to file on or before May 1 in each year updates of its financial, operational and macroeconomic information through the end of the prior fiscal year. Pursuant to these continuing disclosure undertakings, the Commonwealth files annual updates of the Commonwealth Report and files the Commonwealth's Annual Financial Report. Although the Commonwealth has filed all such reports, these filings were made after the May 1 deadline between 2006 and 2010 (and also in certain years before that period), and therefore did not comply with the undertakings. In 2011, the Commonwealth complied with its continuing disclosure undertakings relating to fiscal year 2010 by filing the Commonwealth Report and the Commonwealth's Annual Financial Report before the filing deadline. For more information regarding the Commonwealth's compliance with its continuing disclosure obligation, see "Prior Continuing Disclosure Non-Compliance" under CONTINUING DISCLOSURE UNDERTAKING herein.

The Commonwealth will provide without charge to any person to whom this Official Statement is delivered, on the written or oral request of such person, a copy of the Commonwealth's Annual Financial Report or the Trust Agreement. Requests should be directed to Executive Vice President, Government Development Bank for Puerto Rico, 135 West 50th Street, 22nd Floor, New York, New York 10020, telephone number (212) 333-0364, or to Vice President - General Obligations Division, Government Development Bank for Puerto Rico, PO Box 42001, San Juan, Puerto Rico 00940, telephone number (787) 722-7060.

A copy of the Commonwealth's Annual Financial Report may also be obtained through EMMA at <http://emma.msrb.org> or by visiting the Government Development Bank's website at www.gdbpr.com. No additional information on the Government Development Bank's website is deemed to be part of or incorporated by reference in this Official Statement.

Capitalized terms not defined elsewhere in this Official Statement are defined in the *Trust Agreement*.

RECENT DEVELOPMENTS

Recent Rating Action

On June 6, 2012, Standard & Poor's Rating Services, a Standard & Poor's Financial Services LLC company, ("S&P"), affirmed its "BBB" rating on the Commonwealth of Puerto Rico's general obligation debt and revised its outlook on the Commonwealth of Puerto Rico's general obligation debt ratings from stable to negative. S&P assigned a rating of "BBB-" to the 2012 Series A Bonds, with a negative outlook.

For additional information on the ratings of the general obligation bonds of the Commonwealth, see "Overview of Economic and Fiscal Condition - Ratings of Commonwealth General Obligation Bonds" under INTRODUCTION in the Commonwealth Report. For additional information on the ratings of the 2012 Series A Bonds, see RATINGS herein.

Preliminary General Fund Revenues for the First Ten Months of Fiscal Year 2012

Preliminary General Fund net revenues for the first ten months of fiscal year 2012 (from July 1, 2011 to April 30, 2012) were \$6.846 billion, an increase of \$455 million, or 7.1%, from \$6.391 billion of net revenues for the same period in the prior fiscal year. These revenues represent 79% of budgeted revenues of \$8.650 billion for the fiscal year, and are \$141 million, or 2.0%, less than budgeted for the period.

Preliminary sales and use tax collections for the first ten months of fiscal year 2012 were \$954 million, an increase of \$27 million, or 2.9%, from the sales and use tax collections for the same period in the prior fiscal year.

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

OVERVIEW OF ECONOMIC AND FISCAL CONDITION OF THE COMMONWEALTH

Economic Condition

Gross National Product. Puerto Rico's economy entered a recession in the fourth quarter of fiscal year 2006. For fiscal years 2007, 2008, 2009, 2010 and 2011 Puerto Rico's real gross national product decreased by 1.2%, 2.9%, 3.8%, 3.4% and 1.5%, respectively. According to the latest projections of the Puerto Rico Planning Board (the "Planning Board") made in April 2012, real gross national product for fiscal years 2012 and 2013 is expected to increase by 0.9% and 1.1%, respectively.

Employment. According to the Household Survey, total employment fell by 2.3% in fiscal year 2011 and grew by 0.5% in the first ten months of fiscal year 2012. The unemployment rate for fiscal year 2011 and for the first ten months of fiscal year 2012 was 15.9% and 15.2%, respectively. According to the Establishment Survey, total payroll employment fell by 2.0% in fiscal year 2011 and was virtually unchanged, decreasing by 0.2%, during the first ten months of fiscal year 2012. April 2012 year-over-year total payroll employment decreased by 0.7%.

Economic Activity Index. The Government Development Bank – Economic Activity Index (the "EAI") prepared by GDB declined 2.7% in fiscal year 2011, after declining 5.6% for fiscal year 2010. For the first nine months of fiscal year 2012, the EAI showed a year-over-year decline of 0.4%, compared to a decline of 2.9% for the same period of fiscal year 2011. For the third quarter of fiscal year 2012 (January 2012 through March 2012), the EAI increased 0.3%, when compared to the third quarter of fiscal year 2011, which increase represents the first quarterly positive growth rate since the third quarter of fiscal year 2006 (January 2006 to March 2006).

Fiscal Condition

Fiscal Imbalance. Since 2000, the Commonwealth has faced a number of fiscal challenges, including an imbalance between its General Fund total revenues and expenditures. The imbalance reached its highest level in fiscal year 2009, when the deficit was \$3.306 billion. The following table shows total revenues from non-financing sources (which are revenues from taxes, licenses and other internal or external sources received by virtue of existing laws, but excluding proceeds from financings), total expenditures (including debt service payments) and the ensuing imbalance for the last three fiscal years. Total revenues and expenditures, as shown in the table, include non-recurring revenues from temporary revenue raising measures taken by the Commonwealth to address this fiscal imbalance and non-recurring expenditures resulting from the implementation of various expense-reduction measures. Accordingly, the amount of the Commonwealth's so called "structural deficit," or the difference between recurring government revenues and recurring expenditures, may exceed the amount of the deficit shown below. Depending on the assumptions made as to what should be considered "recurring" for purposes of this computation, such difference may be significant.

Revenues from the electronic and traditional lotteries (shown in footnote 1 to the table below) are available to the General Fund, but for accounting purposes are included in the Commonwealth's audited financial statements as a separate fund from the General Fund.

Deficit
Fiscal Years ended June 30,
(in millions)

	<u>Total Revenues⁽¹⁾</u>	<u>Total Expenditures</u>	<u>Deficit</u>
2009	\$7,583	\$10,890 ⁽³⁾	\$(3,306)
2010	\$7,593	\$10,369 ⁽³⁾	\$(2,775)
2011	\$8,056 ⁽²⁾	\$ 9,897 ^{(3) (4)}	\$(1,841)

⁽¹⁾ Excludes General Fund revenues attributable to the electronic and traditional lotteries in the amount of \$126.7 million, \$122.8 million and \$101.9 million for fiscal years 2009, 2010 and 2011, respectively.

⁽²⁾ Includes approximately \$103.0 million of moneys transferred to the General Fund during fiscal year 2011 from the Puerto Rico Sales Tax Financing Corporation consisting principally of sales and use tax collections remaining after providing for debt service on its bonds for that fiscal year.

⁽³⁾ Includes debt service of \$159.6 million, \$517.8 million and \$638.7 million for fiscal years 2009, 2010 and 2011, respectively, on the Commonwealth's general obligation bonds and guaranteed bonds of Public Buildings Authority that were refinanced through the issuance of refunding bonds.

⁽⁴⁾ Excludes approximately \$123 million of non-recurring expenses that had been budgeted for fiscal year 2010 but were incurred in fiscal year 2011 principally related to the fiscal stabilization plan described below.

Source: Commonwealth of Puerto Rico Comprehensive Annual Financial Report and Department of the Treasury.

In January 2009, the Government of Puerto Rico (the "Government") began to implement a multi-year plan designed to achieve fiscal balance, restore sustainable economic growth and safeguard the investment-grade ratings of the Commonwealth bonds. This plan included certain expense reduction measures that, together with various temporary and permanent revenue raising measures, have allowed the government to reduce the deficit. These measures are discussed in "Fiscal Stabilization and Economic Reconstruction" under THE ECONOMY in the Commonwealth Report.

As shown in the table above, during the last three fiscal years, the Commonwealth has been able to reduce the deficit by both increasing its revenues and reducing its expenditures. The Commonwealth's ability to continue reducing the deficit will depend in part on its ability to continue increasing revenues and reducing expenditures, which in turn depends on a number of factors, including improvements in general economic conditions.

For more detailed information with respect to the revenues and expenses of the Commonwealth's General Fund for fiscal years 2009 through 2011, see "Summary and Management's Discussion of General Fund Results" under PUERTO RICO TAXES, OTHER REVENUES, AND EXPENSES in the Commonwealth Report.

Preliminary Results for the First Nine Months of Fiscal Year 2012 and Projected Fiscal Year 2012 Deficit. Preliminary General Fund net revenues for the first nine months of fiscal year 2012 (from July 1, 2011 to March 31, 2012) were \$5.639 billion, an increase of \$599 million, or 11.9%, from \$5.040 billion of net revenues for the same period in the prior fiscal year. These revenues represent 65% of budgeted revenues of \$8.650 billion for the fiscal year, and are \$78 million, or 1.4%, less than budgeted for the period.

The increase in General Fund net revenues is mainly due to the collection of \$1.379 billion under a new temporary excise tax enacted pursuant to Act 154 of October 25, 2010 ("Act 154"), which amount exceeds the Government's projection of collections from the excise tax during this period. The increase in Act 154 excise tax collections was partially offset by (i) decreases in individual income tax collections of \$146 million, corporate income tax collections of \$63 million, and withholdings from non-residents of \$77 million, all of which were primarily a result of the tax relief provided to individual and corporate taxpayers as part of the tax reform, (ii) a decrease of \$172 million in property taxes as a result of the March 2011 expiration of the 2009 temporary special property tax imposed on residential and commercial real estate as part of the fiscal stabilization plan, and (iii) decreases in miscellaneous non-tax revenues, excise taxes on tobacco products and other items due to current economic conditions. These results are consistent with the Government's expectation that the decrease in General Fund net revenues as a result of the implementation of the tax reform would be more than offset by the temporary excise tax imposed on certain foreign persons by Act No. 154.

Preliminary sales and use tax collections for the first nine months of fiscal year 2012 were \$855.9 million, an increase of \$20.5 million, or 2.5%, from the sales and use tax collections for the same period in the prior fiscal year. A portion of the sales and use tax is allocated to COFINA and, thus, is not available to the General Fund.

Preliminary General Fund total expenses (on a cash basis) for the first nine months of fiscal year 2012 amounted to \$6.191 billion. This amount excludes an estimated \$223 million in expenses related to the Department of Education Schoolwide Program that have not yet been registered in the central government accounting system. If these Schoolwide Program expenses had been included, preliminary General Fund total expenses (on a cash basis) for the first nine months of fiscal year 2012 would have amounted to \$6.414 billion, or 69% of budgeted expenditures for fiscal year 2012, which are \$9.260 billion.

The deficit for fiscal year 2012 is projected to be approximately \$610 million, excluding principal and interest payments on Commonwealth general obligation bonds and Commonwealth guaranteed bonds of the Puerto Rico Public Buildings Authority (the "Authority") that were refinanced through GDB financings, which financings were, or are expected to be, repaid from the proceeds of the Commonwealth general obligation bonds and bonds of the Authority. The Office of Management and Budget ("OMB") has indicated that no budget overruns are anticipated and that total expenses for fiscal year 2012 are not expected to exceed the budgeted amount of \$9.260 billion.

Budget for Fiscal Year 2012. The fiscal year 2012 budget (adopted in July of 2011) provides for General Fund total revenues and other resources and total expenditures of \$9.260 billion. The budgeted General Fund total revenues and other resources of \$9.260 billion includes estimated revenues of \$8.650 billion and \$610.0 million in additional resources from proceeds of COFINA bond issues and other sources. The fiscal year 2012 budgeted expenditures exclude certain debt service payments on the Commonwealth's general obligation bonds and Commonwealth guaranteed bonds of the Authority which have been, or are expected to be, refinanced during fiscal year 2012.

Proposed Budget for Fiscal Year 2013. On April 24, 2012, the Governor submitted to the Legislature a proposed budget for fiscal year 2013. The proposed budget provides for General Fund total revenues and other resources (including proceeds from COFINA) and total expenditures of \$9.083 billion, which is \$177 million, or 1.9%, lower than projected General Fund total revenues and other resources and total expenditures of \$9.260 billion for fiscal year 2012. General Fund total revenues and other resources in the proposed budget include estimated revenues of \$8.750 billion and \$333 million of additional resources from COFINA and other sources, compared to \$8.650 billion of projected revenues and \$610 million of additional resources from COFINA and other sources for fiscal year 2012. The additional resources of \$333 million to cover the fiscal year 2013 deficit consist of the release of approximately \$233 million deposited in a contingency fund created in 2010 to cover potential collateral postings on the Commonwealth's outstanding swap portfolio and an additional \$100 million from the projected issuance of COFINA capital appreciation bonds. The release of moneys from the contingency fund results from the significant reduction in the Commonwealth's outstanding swap portfolio (from \$9.2 billion as of June 30, 2008 to \$4.6 billion as of March 31, 2012) due to the refinancing of variable rate debt and mandatory tender bonds and the termination of the associated swaps.

During fiscal year 2013, the Government expects to refinance approximately \$575 million of principal due in and interest to accrue during such fiscal year on the Commonwealth's general obligation bonds and approximately \$170 million of principal due in and interest to accrue during such fiscal year on Commonwealth guaranteed Authority bonds.

The fiscal year 2013 proposed expenditures exclude certain debt service payments on the Commonwealth's general obligation bonds and Commonwealth guaranteed bonds of the Authority in the aggregate amount of \$745 million, which are expected to be refinanced during fiscal year 2013. The fiscal year 2013 proposed expenditures also exclude certain expenditures that were due in fiscal year 2013 related to central government accounts payable with public corporations that were being paid through a multi-year payment plan established in calendar year 2009 but that are expected to be paid during fiscal year 2012 from available moneys resulting from the refinancing of approximately \$148.3 million of debt service on the Commonwealth's general obligation bonds in excess of the \$537.7 million originally contemplated as part of the fiscal year 2012 budget. This payment eliminates the accounts payable to Puerto Rico Electric Power Authority and Puerto Rico Aqueduct and Sewer Authority under the multi-year payment plan and substantially reduces the amounts remaining to be paid under the plan.

Unfunded Pension and Non-Pension Post-Employment Benefit Obligations and Funding Shortfalls of the Retirement Systems.

As of June 30, 2011, the date of the latest actuarial valuations of the three Government-funded retirement systems, the unfunded actuarial accrued liability (including basic and system administered benefits) for the Employees Retirement System, the Teachers Retirement System and the Judiciary Retirement System was \$23.7 billion, \$9.1 billion and \$319 million, respectively, and the funded ratios were 6.8%, 20.8% and 16.7%, respectively.

Based on current employer and member contributions to the retirement systems, the unfunded actuarial accrued liability will continue to increase significantly, with a corresponding decrease in the funded ratio, since the annual contributions are not sufficient to fund pension benefits, and thus, are also insufficient to amortize the unfunded actuarial accrued liability. Because annual benefit payments and administrative expenses of the retirement systems have been significantly larger than annual employer and member contributions, the retirement systems have been forced to use investment income, borrowings and sale of investment portfolio assets to cover funding shortfalls. The funding shortfall (basic system benefits, administrative expenses and debt service in excess of contributions) for fiscal year 2011 for the Employees Retirement System, the Teachers Retirement System and the Judiciary Retirement System was approximately \$693 million, \$268 million and \$6.5 million, respectively. For fiscal year 2012, the funding shortfall is expected to be \$741 million, \$287 million and \$8.5 million, respectively. As a result, the assets of the retirement systems are expected to continue to decline.

Based on the assumptions used in the latest actuarial valuations, including the expected continued funding shortfalls, and considering the increases in employer contributions to the Employees Retirement System and the Teachers Retirement System: (i) the Employees Retirement System, the largest of the three retirement systems, would deplete its net assets (total assets less liabilities, including the principal amount of certain pension obligation bonds) by fiscal year 2014 and its gross assets by fiscal year 2020; (ii) the Teachers Retirement System would deplete its net and gross assets by fiscal year 2022; and (iii) the Judiciary Retirement System would deplete its net and gross assets by fiscal year 2019. The estimated years for depletion of the assets could vary depending on how actual results differ from the assumptions used in the actuarial valuations, as well as based on any future changes to the contribution and benefits structures of the retirement systems.

Since the Commonwealth and other participating employers are ultimately responsible for any funding deficiency in the three retirement systems, the depletion of the assets available to cover retirement benefits will require the Commonwealth and other participating employers to cover annual funding deficiencies. It is estimated that the Commonwealth would be responsible for approximately 64% of any such funding deficiency of the Employee Retirement System and approximately 74% of the combined annual funding deficiency of the three retirement systems, with the balance being the responsibility of the municipalities and participating public corporations.

The Commonwealth also provides non-pension post-employment benefits that consist of a medical insurance plan contribution. These benefits, which amounted to \$114.2 million for fiscal year 2010 and \$125.4 million for fiscal year 2011, are funded on a pay-as-you-go basis from the General Fund and are valued using actuarial principles similar to those used in calculating pension benefits. Based on the latest actuarial valuations, as of June 30, 2011, the aggregate unfunded actuarial accrued liability of these benefits for the three retirement systems was \$2.7 billion.

Because of its multi-year fiscal imbalances previously mentioned, the Commonwealth has been unable and is currently unable to make the actuarially recommended contributions to the retirement systems. If the Commonwealth fails to take action in the short-term to address the retirement systems' funding deficiency, the continued use of investment assets to pay benefits as a result of funding shortfalls and the resulting depletion of assets could adversely affect the ability of the retirement systems to meet the rates of return assumed in the actuarial valuations, which could in turn result in an earlier depletion of the retirement systems' assets and a significant increase in the unfunded actuarial accrued liability. Ultimately, since the Commonwealth's General Fund is required to cover a significant amount of the funding deficiency, the Commonwealth would have difficulty funding the annual required contributions unless it implements significant reforms to the retirement systems, obtains additional revenues, or takes other budgetary measures. For more information regarding the retirement systems and the measures being taken by the Government to address the situation of the retirement systems, see RETIREMENT SYSTEMS in the Commonwealth Report.

Economic Development Plan

The Government has developed the Strategic Model for a New Economy, which is a comprehensive long-term economic development plan aimed at improving Puerto Rico's overall competitiveness and business environment and increasing private-sector participation in the Puerto Rico economy. As part of this plan, the Government enacted legislation which overhauled the permitting and licensing process in Puerto Rico in order to provide for a leaner and more efficient process that fosters economic development, and legislation which provided a new energy policy that seeks to lower energy costs and reduce energy-price volatility by reducing Puerto Rico's dependence on fuel oil and the promotion of diverse, renewable-energy technologies.

The Government has also enacted legislation establishing a clear public policy and legal framework for the establishment of public-private partnerships ("PPP") to finance and develop infrastructure projects and operate and manage certain public assets. The Government has already completed the concession of toll roads PR-22 and PR-5 and has short-listed proponents for the procurement process leading to the award of an administrative concession of the Luis Muñoz Marín International Airport and school infrastructure projects.

Tax Reform

Commencing in 2010, the Commonwealth enacted comprehensive tax reform legislation directed at promoting economic growth and job creation within the framework of preserving the administration's path towards achieving fiscal stability.

The tax reform was intended to be revenue positive. It consisted of two phases focused on providing tax relief to individuals and corporations, promoting economic development and job creation, simplifying the tax system and reducing tax evasion through enhanced tax compliance measures. The first phase was expected to provide individual and corporate taxpayers with aggregate savings of \$309 million for taxable year 2010. The second phase was projected to provide individual and corporate taxpayers aggregate annual average savings of \$1.2 billion for the next six taxable years, commencing in taxable year 2011. Consistent with the objective of maintaining the path towards fiscal stability, the tax relief provisions applicable to individuals and corporations for taxable years 2014 through 2016 become effective only if certain expense control, revenue and gross domestic product targets are met.

The Government expects that the reduction in income tax revenues resulting from the implementation of the tax reform should be fully offset by the additional revenues produced by (i) enhanced tax compliance measures, (ii) the elimination of certain incentives and tax credits, (iii) a new temporary excise tax enacted pursuant to Act 154 imposed on a controlled group member's acquisition from another group member of certain personal property manufactured or produced in Puerto Rico and certain services performed in Puerto Rico (at a declining rate from 4% for 2011 to 1% for 2016), and (iv) an expansion of taxation rules that characterize certain income of non-resident corporations, partnerships and individuals as effectively connected with the conduct of a trade or business in Puerto Rico and therefore subject to Puerto Rico income tax, which was also adopted under Act 154. The Government estimates that this excise tax will affect foreign corporations or partnerships that are principally engaged in the manufacturing of pharmaceuticals and electronics. The Government expected to raise approximately \$1.4 billion from the excise tax during the first year of implementation of the excise tax and expects to raise \$5.6 billion for the six-year period that the excise tax is in place. Act 154 may have a long-term impact on local manufacturing activity.

The first monthly excise tax payment was due in February 2011. For fiscal year 2011 (from February 2011 through June 2011), the collections from the excise tax were \$677.6 million. For the first nine months of fiscal year 2012, the collections from the excise tax were \$1.379 billion. These amounts have exceeded the Government's projection of collections from the excise tax and are consistent with the Government's expectation that the revenues therefrom would be sufficient to offset the reduction in income tax revenues expected from other aspects of the tax reform.

For a summary of the principal provisions of the tax reform, the expansion of the income tax source rules to certain nonresident alien individuals, foreign corporations and foreign partnerships, and the new temporary excise tax, see "Major Sources of General Fund Revenues — Tax Reform" and "Major Sources of General Fund Revenues — Income Taxes," respectively, under PUERTO RICO TAXES, OTHER REVENUES AND EXPENDITURES in the Commonwealth Report.

PLAN OF FINANCING

On December 19, 2001, the Corporation issued \$771,274,288.85 aggregate principal amount of its 2001 Series C Bonds (Commonwealth Appropriation Bonds) (the “2001 Series C Bonds”) under a Trust Agreement dated as of December 19, 2001 (the “Act 164 Trust Agreement”) between the Corporation and The Bank of New York Mellon Trust Company, N.A., as trustee (the “Act 164 Trustee”). The Act 164 Trust Agreement provided for the issuance of bonds under Act Number 164 of December 17, 2001 (“Act 164”).

On June 21, 2002, the Corporation issued \$580,071,037.40 aggregate principal amount of its 2002 Series A Bonds (Commonwealth Appropriation Bonds) (the “2002 Series A Bonds”) under the Act 164 Trust Agreement.

On July 2, 2003, the Corporation issued \$47,935,000 aggregate principal amount of its 2003 Series A Bonds (Commonwealth Appropriation Bonds) (the “2003 Series A Bonds”) and \$272,560,000 aggregate principal amount of its 2003 Series B Refunding Bonds (Commonwealth Appropriation Bonds) (the “2003 Series B Refunding Bonds”). The 2003 Series A Bonds were issued under the Act 164 Trust Agreement and the 2003 Series B Refunding Bonds were issued under a Trust Agreement dated June 30, 1995 (the “Act 113 Trust Agreement”) between the Corporation and Banco Santander Puerto Rico, as trustee (the “Act 113 Trustee”). The Act 113 Trust Agreement provided for the issuance of bonds under Act Number 113 of September 27, 1994 (“Act 113”).

On June 11, 2004, the Corporation issued \$146,895,000 aggregate principal amount of its 2004 Series B Bonds (Commonwealth Appropriation Bonds) (the “2004 Series B Bonds”) under the Trust Agreement.

The 2012 Series A Bonds are being issued under the Trust Agreement for the purpose of (i) current refunding all of the outstanding 2001 Series C Bonds, all of the outstanding 2002 Series A Bonds, all of the outstanding 2003 Series A Bonds, all of the outstanding 2003 Series B Refunding Bonds and all of the outstanding 2004 Series B Bonds listed below under the caption Refunded Bonds (all such bonds being refunded with the 2012 Series A Bonds are collectively referred to as the “Refunded Bonds”), plus accrued interest to the redemption date, (ii) paying capitalized interest on the 2012 Series A Bonds through August 1, 2015, and (iii) paying the costs of issuing the 2012 Series A Bonds. Upon the issuance of the 2012 Series A Bonds, any moneys on deposit with the Trustee, the Act 113 Trustee and the Act 164 Trustee allocable to the Refunded Bonds will be released to the Corporation.

REFUNDED BONDS

Refunded Bonds

The bonds listed below are being refunded in their entirety with the proceeds of the 2012 Series A Bonds.

<u>Bonds</u>	<u>Principal Amount to be Refunded</u>	<u>Interest Rate</u>	<u>Maturity Date</u>	<u>Redemption Price</u>	<u>CUSIP</u>
<u>2001 Series C</u>					
	\$ 2,011,675.60*	6.05%	08/01/2013	100%	745291NH3
	2,119,504.50*	6.05	08/01/2014	100	745291NJ9
	1,563,225.95*	6.05	08/01/2015	100	745291NK6
	1,426,695.00*	6.05	08/01/2016	100	745291NL4
	1,421,136.00*	6.05	08/01/2017	100	745291NM2
	49,430,000.00	6.05	08/01/2017	100	745291UM4
	34,545,000.00	6.10	08/01/2021	100	745291ML5

* Capital appreciation bond. Principal amount refers to the initial principal amount of such capital appreciation bond.

<u>Bonds</u>	<u>Principal Amount to be Refunded</u>	<u>Interest Rate</u>	<u>Maturity Date</u>	<u>Redemption Price</u>	<u>CUSIP</u>
<u>2002 Series A</u>					
	\$ 3,298,454.10*	6.05%	08/01/2013	100%	745291PG3
	3,287,664.00*	6.10	08/01/2014	100	745291PH1
	2,262,000.00*	6.15	08/01/2015	100	745291PJ7
	1,743,691.95*	6.15	08/01/2016	100	745291PK4
	80,930,000.00	6.10	08/01/2017	100	745291UQ5
	2,818,838.10*	6.20	08/01/2017	100	745291PL2
	2,170,882.00*	6.20	08/01/2018	100	745291PM0
	1,478,904.00*	6.20	08/01/2019	100	745291PN8
	1,325,080.00*	6.20	08/01/2020	100	745291PP3
<u>2003 Series A</u>					
	\$ 1,895,000.00	4.60%	08/01/2013	101%	745291QG2
	10,975,000.00	5.05	08/01/2018	101	745291QH0
<u>2003 Series B</u>					
	\$12,945,000.00	4.60%	08/01/2013	101%	745291QP2
	68,905,000.00	5.05	08/01/2018	101	745291QQ0
	22,345,000.00	5.15	08/01/2025	101	745291QR8
<u>2004 Series B</u>					
	\$ 5,765,000.00	5.10%	08/01/2013	101%	745291RY2
	3,280,000.00	5.25	08/01/2014	101	745291RZ9
	6,345,000.00	5.35	08/01/2015	101	745291SA3
	3,930,000.00	5.45	08/01/2016	101	745291SB1
	3,625,000.00	5.55	08/01/2017	101	745291SC9
	10,075,000.00	5.80	08/01/2029	101	745291SE5

* Capital appreciation bond. Principal amount refers to the initial principal amount of such capital appreciation bond.

Upon the issuance of the 2012 Series A Bonds, a portion of the proceeds thereof will be deposited with the Trustee (acting as an escrow agent) under three escrow deposit agreements (one relating to the Refunded Bonds issued under the Act 113 Trust Agreement, one relating to the Refunded Bonds issued under the Act 164 Trust Agreement and one relating to the Refunded Bonds issued under the Trust Agreement). The amounts deposited under the escrow deposit agreements will be sufficient to redeem the Refunded Bonds on their respective redemption dates at the principal amounts thereof, and to pay interest thereon to their respective redemption dates. Upon the deposit with the Trustee of monies sufficient to redeem the Refunded Bonds on their respective redemption dates, the Refunded Bonds will no longer be deemed to be outstanding or entitled to the benefit of the pledge and lien established by the Act 113 Trust Agreement, the Act 164 Trust Agreement and the Trust Agreement, as applicable, or to payment from the budgetary appropriations described below.

Upon the foregoing deposits with the Trustee, acting as escrow agent, Bond Counsel is expected to deliver its opinion that the Refunded Bonds will no longer be deemed to be outstanding under the provisions of the Act 113 Trust Agreement, the Act 164 Trust Agreement, and the Trust Agreement, as applicable, and the Refunded Bonds will thereupon be defeased. In rendering such opinion, Bond Counsel will rely on the report of Causey, Demgen and Moore, Inc. as to the accuracy of certain mathematical computations with respect to the moneys deposited with the escrow agent under the terms of the escrow deposit agreements and the sufficiency thereof to pay the principal of and redemption premium, if any, and interest on the Refunded Bonds on their respective redemption dates.

SOURCES AND USES OF FUNDS

The sources and uses of bond proceeds are set forth below (rounded to the nearest dollar):

Sources	
Principal Amount of the 2012 Series A Bonds	\$410,665,000
Total Sources	\$410,665,000
Uses	
Deposit to the Escrow Fund relating to the Act 164 Trust Agreement.	\$229,345,394
Deposit to the Escrow Fund relating to the Act 113 Trust Agreement.	106,107,940
Deposit to the Escrow Fund relating to the Trust Agreement	33,651,099
Capitalized Interest	36,189,495
Underwriters' Discount and Other Costs of Issuance ⁽¹⁾	5,371,073
Total Uses ⁽²⁾	\$410,665,000

(1) Includes legal, printing and other financing expenses.

(2) Total does not add due to rounding.

PUERTO RICO PUBLIC FINANCE CORPORATION

The Corporation is a subsidiary corporation of Government Development Bank created pursuant to Resolution No. 5044 of the Board of Directors of Government Development Bank, as amended (“Resolution No. 5044”), adopted pursuant to the authority granted under Act No. 17 of the Legislature of Puerto Rico, approved September 23, 1948, as amended. The Corporation is exempt from the payment of any Commonwealth taxes on its revenues and properties and constitutes an independent governmental instrumentality of the Commonwealth separate and apart from Government Development Bank. The obligations of the Corporation are not obligations of Government Development Bank. For additional information regarding the Corporation and Government Development Bank, see “Public Corporations - Government Development Bank for Puerto Rico” in the Commonwealth Report.

The Board of Directors of the Corporation consists of the same members of the Board of Directors of Government Development Bank consisting of a seven member Board of Directors appointed by the Governor with the approval of the Council of Secretaries. The Board of Directors consists of the following members serving terms as indicated:

Member	Commencement of Term	Expiration Date
Marcos Rodríguez-Ema, Chairman	January 15, 2009	September 23, 2015
Juan Carlos Batlle, Vice Chairman	March 2, 2011	September 23, 2012
Manuel H. Dubón, Esq.	February 2, 2009	September 23, 2012
Juan E. Rodríguez Díaz, Esq.	February 20, 2009	September 23, 2012
Eduardo R. Emanuelli	May 11, 2011	September 23, 2015
Jesús F. Méndez	May 18, 2011	September 23, 2014
Eugenio L. Torres	July 5, 2011	September 23, 2014

The following individuals are currently officers of the Corporation:

Juan Carlos Batlle, President of the Corporation, has been the President of Government Development Bank since March 2, 2011. Prior to his appointment, Mr. Batlle served 14 years as a top executive for Santander Group in Puerto Rico. He initially joined Santander in 1997. As part of the Investment Banking Group of Santander Securities Corporation, he served consecutively as Assistant Vice President in 1999, Vice President in 2001, and Senior Vice President and Director in 2003. In 2005, Mr. Batlle was named First Senior Vice President of Banco Santander Puerto Rico and President and Chief Executive Officer of Santander Asset Management Corporation. He

served as Managing Director of Santander Securities Corporation in 2008. Prior to joining Santander, Mr. Batlle was with Popular Securities. Mr. Batlle has also been a member of the Boards of Directors of Santander Securities Corporation, Santander Asset Management Corporation and the First Puerto Rico Family of Funds. In addition, he has been a member of the Boards of Directors of the Puerto Rico Tourism Company, the Convention Center District Authority and the Hotel Development Corporation. He holds a degree in Economics from the College of Literature, Science and the Arts of the University of Michigan.

José R. Otero-Freiria, Executive Vice President of the Corporation, has been Executive Vice President of Government Development Bank and Director of Financing since March 2, 2011. Throughout his professional career, Mr. Otero-Freiria has held various top positions in the financial field, including Manager of Procter & Gamble's Finance Department in San Juan, Finance Manager for Guidant Corporation (later Boston Scientific) in Santa Clara, California, and Director of Institutional Investment Consulting Services at UBS Financial Services in San Juan, Puerto Rico. Most recently, he served in the Office of the Governor as Advisor for Economic Development and Finance, and as Deputy Chief of Staff for Public Policy. Mr. Otero-Freiria earned his bachelor's degree in Economics with a major in Finance and Accounting from the Wharton School of Business at the University of Pennsylvania. He later earned his Masters in Business Administration from Stanford University. He is a Certified Public Accountant.

Zulema Martínez-Alvarez, General Counsel of the Corporation, has been Senior Vice President, General Counsel and Secretary of the Board of Directors of Government Development Bank since July 13, 2011. Before being named General Counsel of Government Development Bank, Ms. Martínez-Alvarez served as Legal Counsel of Government Development Bank, the Energy Affairs Administration and the Solid Waste Management Authority. She also served as an Assistant Solicitor General for the Solicitor General's Office at the Department of Justice and as a Law Clerk for the Puerto Rico Court of Appeals. Ms. Martínez-Alvarez holds a Juris Doctor degree from the University of Puerto Rico School of Law, a Master of Public Health from the University of Puerto Rico Public Health Graduate School and a bachelor's degree from the University of Puerto Rico.

Pursuant to Resolution No. 5044, the Corporation has the authority, among other things, to issue bonds and other obligations for borrowed money payable out of all or any part of funds received in payment of the principal of and interest on securities of governmental instrumentalities of Puerto Rico purchased by the Corporation or any other funds or assets of the Corporation as provided by the resolution or trust agreement authorizing the issuance of its bonds.

THE 2012 SERIES A BONDS

General

The 2012 Series A Bonds are being issued as registered bonds without coupons and will be initially registered only in the name of Cede & Co., as nominee of The Depository Trust Company, New York, New York, ("DTC") which will act as securities depository for the 2012 Series A Bonds. The 2012 Series A Bonds will be available to purchasers in denominations of \$5,000 or any integral multiple thereof only under the book-entry system maintained by DTC through brokers and dealers who are, or act through, DTC Participants (as defined herein). Purchasers will not receive physical delivery of the 2012 Series A Bonds. So long as any purchaser is the Beneficial Owner (as defined herein) of a 2012 Series 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 2012 Series A Bonds. See "Book-Entry Only System" below.

The 2012 Series A Bonds are being issued pursuant to a resolution of the Corporation (the "Resolution") and the Trust Agreement. The 2012 Series A Bonds will be issued in the aggregate principal amount shown on the cover page of this Official Statement and will mature as shown on the inside front cover page.

Interest

The 2012 Series A Bonds will bear interest at the rates shown on the inside front cover page until their respective maturity dates. Interest will accrue from the date of issue of the 2012 Series A Bonds, and will be payable monthly, on the first day of each month, commencing on August 1, 2012. Interest will be calculated on the basis of a 360-day year consisting of twelve 30-day months.

Mandatory Redemption

The 2012 Series A Bonds maturing on August 1, 2026 shall be redeemed in part in the principal amount equal to the Amortization Requirements as set forth below from moneys in the Sinking Fund in the following years:

Year (August 1)	Amortization Requirement
2023	\$39,105,000
2024	16,095,000
2025	18,420,000
2026*	20,870,000

*Final Maturity

There are no Amortization Requirements for the 2012 Series A Bonds constituting term bonds maturing August 1, 2031. Instead, the full maturity amount of \$48,310,000 shall be due and payable on August 1, 2031.

Optional Redemption

At the option of the Corporation, and upon at least 30 days' notice, the 2012 Series A Bonds maturing on and after August 1, 2022 are subject to redemption from any moneys available for that purpose (other than moneys set aside with respect to an Amortization Requirement) prior to maturity, in whole or in part, on any date not earlier than August 1, 2022, as directed by the Corporation, at a redemption price equal to the par amount to be redeemed, plus accrued interest to the redemption date, without premium.

Notice and effect of Redemption; Partial Redemption

Any redemption of the 2012 Series A Bonds, either in whole or in part, shall be made upon at least 30 days' notice by mail to DTC or, if the book-entry only system as described below has been discontinued, by first class mail, postage prepaid, to all registered owners in the manner and under the terms and conditions provided in the Trust Agreement. On the date designated for redemption, notice having been given as provided in the Trust Agreement and moneys for payment of the principal of and redemption premium, if any, and the interest on the 2012 Series A Bonds or portions thereof so called for redemption being held by the Trustee, interest on the 2012 Series A Bonds or portions thereof so called for redemption shall cease to accrue. Subject to certain provisions of the Trust Agreement, the 2012 Series A Bonds and portions thereof which have been duly called for redemption under the provisions of the Trust Agreement, or with respect to which irrevocable instructions to call for redemption or to pay at maturity have been given, and for which sufficient moneys or Government Obligations permitted by the Trust Agreement are held in a separate account for the payment of the principal of and redemption premium, if any, and the interest on the 2012 Series A Bonds or portions thereof to be paid or redeemed, such 2012 Series A Bonds shall not be deemed to be Outstanding under the Trust Agreement, and the registered owners thereof shall have no rights with respect thereto, except to receive payment of the principal thereof and redemption premium, if any, and the interest thereon from such separate account.

Each notice of redemption shall contain, among other things, the CUSIP identification number of the 2012 Series A Bonds (or portions thereof) being called for redemption, the redemption date and price and the address at which such 2012 Series A Bonds are to be surrendered for payment of the redemption price. Any defect in such

notice or the failure to mail any such notice to DTC will not affect the validity of the proceedings for the redemption of any other 2012 Series A Bond.

If less than all the 2012 Series A Bonds of any maturity are called for redemption, the particular 2012 Series A Bonds so called for redemption shall be selected by the Trustee by such method as it deems fair and appropriate, except that so long as the book-entry only system remains in effect, in the event of any such partial redemption, DTC shall reduce the credit balances of the applicable DTC Participants with respect to the 2012 Series A Bonds and such DTC Participants shall in turn select those Beneficial Owners (as defined herein) whose ownership interests are to be extinguished by such partial redemption, each by such method as DTC or such DTC Participant, as the case may be, in its sole discretion, deems fair and appropriate.

Book-Entry Only System

The Depository Trust Company (“DTC”), New York, NY, will act as securities depository for the 2012 Series A Bonds. The 2012 Series A Bonds will be issued as fully-registered securities registered in the name of Cede & Co. (DTC’s partnership nominee) or such other name as may be requested by an authorized representative of DTC. One fully-registered 2012 Series A Bond certificate will be issued for each stated maturity of the 2012 Series A Bonds, each in the aggregate principal amount of such maturity, and will be deposited with DTC. SO LONG AS CEDE & CO. IS THE REGISTERED OWNER OF THE 2012 SERIES A BONDS, AS NOMINEE FOR DTC, REFERENCES HEREIN TO BONDHOLDERS OR OWNERS OF THE 2012 SERIES A BONDS (OTHER THAN UNDER THE CAPTION “TAX MATTERS”) SHALL MEAN CEDE & CO. AND SHALL NOT MEAN THE BENEFICIAL OWNERS OF THE 2012 SERIES A BONDS.

DTC, the world’s largest securities depository, is a limited-purpose trust company organized under the New York Banking Law, a “banking organization” within the meaning of the New York Banking Law, a member of the Federal Reserve System, a “clearing corporation” within the meaning of the New York Uniform Commercial Code, and a “clearing agency” registered pursuant to the provisions of Section 17A of the Securities Exchange Act of 1934, as amended. DTC holds and provides asset servicing for over 3.5 million issues of U.S. and non-U.S. equity issues, corporate and municipal debt issues, and money market instruments (from over 100 countries) that DTC’s participants (“Direct Participants”) deposit with DTC. DTC also facilitates the post-trade settlement among Direct Participants of sales and other securities transactions in deposited securities, through electronic computerized book-entry transfers and pledges between Direct Participants’ accounts. This eliminates the need for physical movement of securities certificates. Direct Participants include both U.S. and non-U.S. securities brokers and dealers, banks, trust companies, clearing corporations, and certain other organizations. DTC is a wholly-owned subsidiary of The Depository Trust & Clearing Corporation (“DTCC”). DTCC is the holding company for DTC, National Securities Clearing Corporation and Fixed Income Clearing Corporation, all of which are registered clearing agencies. DTCC is owned by the users of its regulated subsidiaries. Access to the DTC system is also available to others such as both U.S. and non-U.S. securities brokers and dealers, banks, trust companies, and clearing corporations that clear through or maintain a custodial relationship with a Direct Participant, either directly or indirectly (“Indirect Participants”). DTC has a S&P rating of AA+. The DTC Rules applicable to its Participants are on file with the Securities and Exchange Commission. More information about DTC can be found at www.dtcc.com.

Purchases of the 2012 Series A Bonds under the DTC system must be made by or through Direct Participants, which will receive a credit for the 2012 Series A Bonds on DTC’s records. The ownership interest of each actual purchaser of the 2012 Series A Bonds (“Beneficial Owner”) is in turn to be recorded on the Direct and Indirect Participants’ records. Beneficial Owners will not receive written confirmation from DTC of their purchase. Beneficial Owners are, however, expected to receive written confirmations providing details of the transaction, as well as periodic statements of their holdings, from the Direct or Indirect Participant through which the Beneficial Owner entered into the transaction. Transfers of ownership interests in the 2012 Series A Bonds are to be accomplished by entries made on the books of Direct and Indirect Participants acting on behalf of Beneficial Owners.

Beneficial Owners will not receive certificates representing their ownership interests in the 2012 Series A Bonds, except in the event that use of the book-entry system for the 2012 Series A Bonds is discontinued.

To facilitate subsequent transfers, the 2012 Series A Bonds deposited by Direct Participants with DTC are registered in the name of DTC's partnership nominee, Cede & Co., or such other name as may be requested by an authorized representative of DTC. The deposit of the 2012 Series A Bonds with DTC and their registration in the name of Cede & Co. or such other DTC nominee do not effect any change in beneficial ownership. DTC has no knowledge of the actual Beneficial Owners of the 2012 Series A Bonds; DTC's records reflect only the identity of the Direct Participants to whose accounts such 2012 Series A Bonds are credited, which may or may not be the Beneficial Owners. The Direct and Indirect Participants will remain responsible for keeping account of their holdings on behalf of their customers.

Conveyance of notices and other communications by DTC to Direct Participants, by Direct Participants to Indirect Participants, and by Direct Participants and Indirect Participants to Beneficial Owners will be governed by arrangements among them, subject to any statutory or regulatory requirements as may be in effect from time to time. Beneficial Owners of 2012 Series A Bonds may wish to take certain steps to augment the transmission to them of notices of significant events with respect to the 2012 Series A Bonds, such as redemptions, tenders, defaults, and proposed amendments to the 2012 Series A Bonds documents. For example, Beneficial Owners of 2012 Series A Bonds may wish to ascertain that the nominee holding the 2012 Series A Bonds for their benefit has agreed to obtain and transmit notices to Beneficial Owners. In the alternative, Beneficial Owners may wish to provide their names and addresses to the registrar and request that copies of notices be provided directly to them.

Redemption notices shall be sent to DTC. If less than all of the 2012 Series A Bonds within a maturity are being redeemed, DTC's practice is to determine by lot the amount of the interest of each Direct Participant in such maturity to be redeemed.

Neither DTC nor Cede & Co. (nor any other DTC nominee) will consent or vote with respect to bonds unless authorized by a Direct Participant in accordance with DTC's MMI Procedures. Under its usual procedures, DTC mails an Omnibus Proxy to the Corporation 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 2012 Series A Bonds will be made to Cede & Co., or such other nominee as may be requested by an authorized representative of DTC. DTC's practice is to credit Direct Participants' accounts upon DTC's receipt of funds and corresponding detail information from the Corporation or the Trustee on payable dates in accordance with their respective holdings shown on DTC's records. Payments by Participants to Beneficial Owners will be governed by standing instructions and customary practices, as is the case with securities held for the accounts of customers in bearer form or registered in "street name," and will be the responsibility of such Participant and not of DTC, the Trustee, or the Corporation, 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 on the 2012 Series A Bonds to Cede & Co. (or such other nominee as may be requested by an authorized representative of DTC) is the responsibility of the Corporation or the Trustee, disbursement of such payments to Direct Participants will be the responsibility of DTC, and disbursement of such payments to the Beneficial Owners will be the responsibility of Direct and Indirect Participants.

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

The Corporation cannot and does not give any assurances that DTC, DTC Direct or Indirect Participants will distribute to the Beneficial Owners of the 2012 Series A Bonds: (i) payments of principal and interest payments (including redemption payments) with respect to the 2012 Series A Bonds; (ii) confirmation of ownership interest in the 2012 Series A Bonds; or (iii) notices sent to DTC or Cede & Co., its nominee, as the registered owner of the 2012 Series A Bonds, or that they will do so on a timely basis, or that DTC or the DTC Participants will serve and act in the manner described in this Official Statement.

The Corporation, the Trustee, and the Underwriters will have no responsibility or obligation to DTC Participants, Beneficial Owners or other nominees of such Beneficial Owners for: (i) sending transaction statements; (ii) maintaining, supervising or reviewing the accuracy of any records maintained by DTC or any

DTC Participant or other nominees of such Beneficial Owners; (iii) payment or the timeliness of payment by DTC to any DTC Participant, or by any DTC Participant or other nominees of Beneficial Owners to any Beneficial Owner, of any amount due with respect to the principal of or interest on 2012 Series A Bonds; (iv) delivery or timely delivery by DTC to any DTC Participant, or by any DTC Participant or other nominees of Beneficial Owners to any Beneficial Owners, of any notice or other communication which is required or permitted under the terms of the Trust Agreement to be given to the registered owners of 2012 Series A Bonds; or (v) any consent given or any action taken by DTC or its nominee as the registered owner of the 2012 Series A Bonds.

Discontinuance of the Book-Entry Only System

DTC may discontinue providing its services as securities depository with respect to the 2012 Series A Bonds at any time by giving reasonable notice to the Corporation or the Trustee. Under such circumstances, in the event that a successor securities depository is not obtained, definitive 2012 Series A Bonds will be printed and delivered.

The Corporation, in its sole discretion and without the consent of any other person, may terminate the services of DTC as securities depository with respect to the 2012 Series A Bonds. In such event, definitive 2012 Series A Bonds will be printed and delivered.

In the event that such book-entry only system is discontinued or the Corporation terminates the services of DTC as securities depository, the following provisions will apply: (i) payments of the principal of and the interest on the 2012 Series A Bonds will be made in lawful money of the United States of America; (ii) payments of principal will be made at the principal corporate trust office of the Trustee in New York, New York; (iii) interest on the 2012 Series A Bonds will be paid by check mailed to the respective addresses of the registered owners thereof as of the fifteenth day of the month immediately preceding the interest payment date as shown on the registration books of the Corporation maintained by the Trustee; (iv) the 2012 Series A Bonds will be issued only as registered bonds without coupons in denominations of \$5,000 or any multiple thereof; and (v) the transfer of the 2012 Series A Bonds will be registrable and the 2012 Series A Bonds may be exchanged at the principal corporate trust office of the 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.

SOURCE OF PAYMENT AND SECURITY FOR THE 2012 SERIES A BONDS

General

The Trust Agreement provides for the refunding of eligible bonds of the Corporation issued prior to 2004 (the "Pre-2004 Bonds"), including the 2001 Series C Bonds, the 2002 Series A Bonds, the 2003 Series A Bonds and the 2003 Series B Refunding Bonds. In 2004, the Corporation issued \$1,206,130,000 aggregate principal amount of its 2004 Series A Bonds (Commonwealth Appropriation Bonds) (the "2004 Series A Bonds") and the 2004 Series B Bonds under the Trust Agreement for the purpose of providing the Corporation with the funds to restructure and refund a portion of the Corporation's Pre-2004 Bonds. The Pre-2004 Bonds were issued for the purpose of providing the Corporation with the necessary funds to purchase from Government Development Bank several promissory notes (the "Pre-2004 Notes") issued in connection with the restructuring and refinancing of certain loans made by Government Development Bank to certain departments, agencies, instrumentalities and public corporations of the Commonwealth (the "Authorized Debtors") pursuant to the terms of legislation enacted by the Legislature of Puerto Rico (the "Appropriation Acts"). The Pre-2004 Bonds had been issued under several different trust agreements relating to several different Appropriation Acts.

The Pre-2004 Notes were amended in 2004 to permit the execution and delivery of new notes to provide for the payment of principal of and interest on the 2004 Series A Bonds and the 2004 Series B Bonds. Upon the issuance and delivery of the 2012 Series A Bonds, the Puerto Rico Department of Health will issue a new note to provide for the payment of principal of and interest on its corresponding portion of the 2012 Series A Bonds. The new notes issued in 2004 and the new note to be issued by the Puerto Rico Department of Health in connection with the issuance and delivery of the 2012 Series A Bonds are hereinafter collectively referred to as the "Notes". The Corporation's \$242,430,000 aggregate principal amount of 2011 Series A Bonds, the Corporation's \$437,645,000

aggregate principal amount of 2011 Series B Bonds and the 2012 Series A Bonds, together with all other bonds hereafter issued by the Corporation under the Trust Agreement (collectively, the “Bonds”), will be payable on a parity basis solely from payments of principal and interest on the Notes. The Notes are payable solely from budgetary appropriations made by the Legislature of Puerto Rico pursuant to the Appropriation Acts.

The Authorized Debtors consist of the Puerto Rico Hotel Development Corporation, the Puerto Rico Department of Health, the Puerto Rico Housing Finance Authority, the Puerto Rico Aqueduct and Sewer Authority, the Puerto Rico Infrastructure Financing Authority, the Puerto Rico Solid Waste Authority, the Puerto Rico Sugar Corporation, the Puerto Rico Department of Treasury, the Puerto Rico Maritime Shipping Authority, the Puerto Rico Land Authority and the Puerto Rico Office of School Improvements.

The Appropriation Acts consist of (i) Act No. 113 approved and signed by the Governor of the Commonwealth on September 27, 1994, (ii) Act No. 85 approved and signed by the Governor of the Commonwealth on June 13, 1998, (iii) Joint Resolution No. 523 approved and signed by the Governor of the Commonwealth on August 24, 2000, and (iv) Act No. 164 approved and signed by the Governor of the Commonwealth on December 17, 2001.

Additional Bonds may be issued under the Trust Agreement only to (i) refund any Bonds outstanding under the Trust Agreement or any other bonds payable from budgetary appropriations made under the Appropriation Acts, (ii) fund a Reserve Account, if applicable, (iii) pay capitalized interest with respect to any such additional Bonds, and (iv) pay the cost of issuance of such additional Bonds. The Corporation may not issue additional Bonds under the Trust Agreement unless the amount of principal and interest payable under the Notes and any other promissory notes of Authorized Debtors issued in connection with such additional Bonds, are sufficient to pay the principal of and interest on all Bonds outstanding after the issuance of such additional Bonds. See “*Source of Payment and Security for the 2012 Series A Bonds - Limitation on Additional Bonds.*”

The Bonds (including the 2012 Series A Bonds) are limited obligations of the Corporation payable solely from Pledged Revenues (as defined in the Trust Agreement), consisting of payments of principal of and interest on the Notes and other amounts deposited to the credit of the “Puerto Rico Public Finance Corporation Restructuring Sinking Fund” (the “Sinking Fund”) established under the Trust Agreement, including the investment earnings thereon. Under the Trust Agreement, the Corporation has pledged the Notes (and any other notes that may in the future be delivered to the Corporation to secure the Bonds) to the Trustee and created a first lien on the Pledged Revenues for the benefit of the holders of the Bonds, including the 2012 Series A Bonds.

Payments of principal and interest under the Notes will be made solely from budgetary appropriations made by the Legislature of Puerto Rico pursuant to the Appropriation Acts (such budgetary appropriations which relate to the Notes are referred to as the “Legislative Appropriations”). The Appropriation Acts require the OMB to include in the Commonwealth’s operating budget submitted annually to the Legislature of Puerto Rico the amounts necessary, up to certain specified maximums in some cases, to pay the principal of and interest on the Notes and certain other notes of the Authorized Debtors as they become due. If the Legislative Appropriations are made on a timely basis each year and in the required amounts, payments of principal and interest required to be made under the Notes will at all times be sufficient to pay the principal of and interest on the Bonds, including the 2012 Series A Bonds, as they become due and payable. The Legislature of Puerto Rico is not legally bound to appropriate funds for such payments.

After giving effect to the issuance of the 2012 Series A Bonds and the refunding of the Refunded Bonds, the aggregate principal par amount of the outstanding bonds of the Corporation payable from Pledged Revenues will be \$1.091 billion. The Corporation may from time to time issue additional bonds and notes, which would be authorized and issued pursuant to trust indentures or authorizing resolutions separate from and unrelated to the Resolution and the Trust Agreement and would be secured with revenues other than the Pledged Revenues.

Descriptions of the Corporation, the Commonwealth, the 2012 Series A Bonds, the Trust Agreement, the Notes, and certain other documents are included in this Official Statement. Such descriptions do not purport to be comprehensive or definitive. All references herein to the Trust Agreement and other documents are qualified in their entirety by reference to each such document. References herein to the 2012 Series A Bonds are qualified in their entirety by reference to the form thereof. The Resolution of the Corporation authorizing the issuance of the 2012

Series A Bonds and each of the aforesaid documents are available for inspection at the offices of the Corporation, located at Roberto Sánchez Vilella Government Center, De Diego Avenue, San Juan, Puerto Rico 00940.

The Bonds do not constitute an obligation of the Commonwealth or any of its political subdivisions or public instrumentalities (other than the Corporation), and neither the Commonwealth nor any of its political subdivisions or public instrumentalities (other than the Corporation) shall be liable thereon. The Corporation has no taxing power.

The Appropriation Acts and the Notes

Each of the Appropriation Acts provides that the Commonwealth, through budgetary appropriations during a number of fiscal years specified in each such Appropriation Act, will pay the principal of and interest on the Notes. Some of the Appropriation Acts provide that such budgetary appropriations shall not exceed specified dollar amounts per Commonwealth fiscal year. The aggregate principal and interest installments required to be paid under the Notes is sufficient to cover the aggregate principal amount of and the aggregate annual amount of interest payable on the Bonds, including the 2012 Series A Bonds, issued from time to time under the Trust Agreement, together with fees, expenses and other amounts payable by the Corporation or the Trustee. The Notes are a combination of the Act 164 Notes, the Act 85 Notes, the Joint Resolution 523 Notes and the Act 113 Notes described below. Below is a brief summary of each of the Appropriation Acts.

Act 164 of December 17, 2001. Act 164 provides that the Commonwealth, through budgetary appropriations during a 30 fiscal year period, commencing with fiscal year 2001-2002, will pay the principal of and interest on all notes covered under Act 164 (the “Act 164 Notes”). Act 164 provides, however, that such budgetary appropriations shall not exceed \$225 million per fiscal year. The Act 164 Notes are payable solely from budgetary appropriations to be made pursuant to Act 164. Act 164 provides that (i) the Commonwealth shall honor, by means of budgetary appropriations, the payment of principal of and interest on the Act 164 Notes, (ii) OMB shall include in the operating budget of the Commonwealth submitted annually to the Legislature of Puerto Rico in each of the succeeding thirty fiscal years, commencing with fiscal year 2001-02, the amounts necessary to pay the principal of and interest on the Act 164 Notes, up to a maximum annual amount of \$225 million per fiscal year, and (iii) the budgetary appropriations made thereunder may be used only for the payment of principal of and interest on the Act 164 Notes and related costs, and are not subject to third party claims.

Act 85 of June 13, 1998. Act 85 provides that the Commonwealth, through budgetary appropriations during a 28 fiscal year period, commencing with fiscal year 1998-1999, will pay the principal of and interest on all notes covered under Act 85 (the “Act 85 Notes”). Act 85 provides that the Act 85 Notes may not exceed \$425 million in principal amount, may not bear interest at an annual rate in excess of 8% and may not have a final maturity later than August 1, 2026. The Act 85 Notes are payable solely from budgetary appropriations to be made pursuant to Act 85. Act 85 provides that (i) the Commonwealth shall honor, by means of budgetary appropriations, the payment of principal of and interest on the Act 85 Notes, (ii) OMB shall include in the operating budget of the Commonwealth submitted annually to the Legislature of Puerto Rico in each of the 28 fiscal years commencing with fiscal year 1998-1999, the amounts necessary to pay the principal of and interest on the Act 85 Notes, and (iii) the budgetary appropriations made thereunder may be used only for the payment of principal of and interest on the Act 85 Notes and related costs, and are not subject to third party claims.

Joint Resolution 523 of August 24, 2000. Joint Resolution 523 provides that the Commonwealth, through budgetary appropriations in each fiscal year, commencing with fiscal year 2001-2002 and ending with fiscal year 2031-2032, will pay the principal of and interest on all notes covered under Joint Resolution 523 (the “Joint Resolution 523 Notes”). Joint Resolution 523 provides, however, that such budgetary appropriations shall not exceed \$34,900,000 per fiscal year. Joint Resolution 523 also provides that the Joint Resolution 523 Notes may not bear interest at an annual rate in excess of 8%. The Joint Resolution 523 Notes are payable solely from budgetary appropriations to be made pursuant to Joint Resolution 523. Joint Resolution 523 provides that (i) the Commonwealth shall include in the operating budget of the Commonwealth in each of the fiscal years commencing with fiscal year 2001-2002 and ending with fiscal year 2031-2032, the amounts necessary to pay the principal of and interest on the Joint Resolution 523 Notes, up to the maximum annual amount specified above, and (ii) the budgetary appropriations made thereunder may be used only for the payment of principal of and interest on the Joint Resolution 523 Notes and related costs, and are not subject to third party claims.

Act 113 of September 27, 1994. Act 113 provides that the Commonwealth, through budgetary appropriations made each fiscal year, commencing with fiscal year 1995-1996, will pay the principal of and interest on all notes covered under Act 113 (the “Act 113 Notes”). Act 113 provides that the Act 113 Notes may not exceed \$310 million in principal amount. The Act 113 Notes are payable solely from budgetary appropriations to be made pursuant to Act 113. Act 113 provides that (i) the Commonwealth shall honor, by means of budgetary appropriations, the payment of principal of and interest on the Act 113 Notes, (ii) OMB shall include in the operating budget of the Commonwealth submitted annually to the Legislature of Puerto Rico in each fiscal year commencing with fiscal year 1995-1996, the amounts necessary to pay the principal of and interest on the Act 113 Notes, and (iii) the budgetary appropriations made thereunder may be used only for the payment of principal of and interest on the Act 113 Notes and related costs, and are not subject to third party claims.

The funds to be provided by the Commonwealth to make the payments required under the Notes are subject to and conditioned upon the appropriation of such funds by the Legislature of Puerto Rico in the annual budget of the Commonwealth. If all annual budgetary appropriations provided by the Appropriation Acts are made in full and all payments of principal and interest due under the Notes are timely paid, such payments will be sufficient to pay the principal of and interest on the Bonds issued from time to time under the Trust Agreement, as the same become due and payable, together with all amounts payable under the Trust Agreement. **The failure to make annual budgetary appropriations in the amounts required would cause a shortfall in the moneys available under the Notes to pay principal and interest due on the Bonds.**

In the event the budgetary appropriations made under the Appropriation Acts are insufficient in any fiscal year to pay in full the amounts due and payable on the Notes in such fiscal year, to the extent any amounts representing the budgetary appropriations are received by the Corporation, such amounts shall be applied

first: to the payment of interest ratably, according to the amount of interest then due and payable under the Notes; and

second: to the payment of principal ratably, according to the amount of principal then due and payable under the Notes.

Special Considerations - Bonds are Limited Obligations; Legislature Not Legally Bound to Appropriate; Investment of Funds

The principal of and redemption premium, if any, and interest on the Bonds will be payable solely from the Legislative Appropriations made pursuant to the Appropriation Acts and other sources described above. **The Legislature of Puerto Rico is not legally bound to appropriate sufficient amounts to timely pay the principal of and redemption premium, if any, and interest due on the Bonds. There is no assurance that sufficient funds will be appropriated or otherwise made available to make such payments on the Bonds.** For a discussion of Puerto Rico’s budgetary process, see “Budgetary Process and Payment of Commonwealth Obligations” below and in the Commonwealth Report.

Bondholders have no legal recourse to require the Legislature of Puerto Rico to appropriate the funds necessary to timely pay the principal of and redemption premium, if any, and interest due on the Bonds.

Neither the Corporation nor the Commonwealth has ever defaulted on the payment of principal of or interest on any of its debt.

Pending their application for the payment of principal of and interest on the Bonds on the dates required, funds on deposit in the Sinking Fund (including funds representing the Legislative Appropriations) shall be invested by the Trustee as required by the Trust Agreement. Pursuant to the Trust Agreement, such funds may be invested, among other investments, in an investment agreement with a financial institution which has a long term debt rating in one of the three highest rating categories by Moody’s and S&P (without regards to any gradations within such categories). Losses incurred in connection with such investments may result in a shortfall in the moneys available to pay principal and interest due on the Bonds. See the caption entitled “Investment of Moneys” in the Trust Agreement.

Letter of Credit

Under the Commonwealth's Constitution, if the annual budget of capital expenditures and operating expenses of the Commonwealth for a fiscal year has not been adopted by the last day of the preceding fiscal year (June 30), the budget for such preceding fiscal year is automatically renewed for the ensuing fiscal year, until a new budget for such succeeding fiscal year is approved by the Legislature of Puerto Rico and the Governor. This means that if the debt service on the Notes for any fiscal year and, therefore, the annual budgetary appropriation for such fiscal year is less than the debt service on the Notes in the immediately succeeding fiscal year, then in the case of a delay in the approval of the budget for such succeeding fiscal year, pending approval of the new budget, the budgetary appropriation that would carry over and be available to meet debt service on the Notes for such succeeding fiscal year would be insufficient to meet the debt service on the Notes, and consequently on the Bonds, including the 2012 Series A Bonds. See "Budgetary Process and Payment of Commonwealth Obligations" below.

To cover the risk that in any year until the final maturity date of the 2012 Series A Bonds (the "Maturity Date") the budget is not adopted prior to June 30 and the Legislative Appropriation that automatically carries over from the prior fiscal year may be insufficient to cover fully the debt service payments on the 2012 Series A Bonds during the ensuing Bond Year, on the date of delivery of the 2012 Series A Bonds, Government Development Bank will issue an irrevocable, transferable standby letter of credit (the "Letter of Credit") in favor of the Trustee solely for the benefit of the owners of the 2012 Series A Bonds. The Letter of Credit will be in a stated amount at any time equal to the estimated maximum increase from each fiscal year thereafter to the next fiscal year, until the Maturity Date, in the aggregate debt service on the 2012 Series A Bonds. The Letter of Credit enables the Trustee to draw up to the full amount thereof unless: (i) on or prior to the third Business Day immediately preceding August 1 of each fiscal year until the Maturity Date it receives written notice from the Corporation to the effect that the operating budget of the Commonwealth for such fiscal year has been adopted, or (ii) the Trustee has otherwise received funds representing the full stated amount of the principal and interest due with respect to the 2012 Series A Bonds for the Bond Year commencing within such fiscal year.

The Letter of Credit will expire on August 2, 2031.

The stated amount of the Letter of Credit will be reduced by the amount of any drawing thereunder. The amount of any such drawing will be reinstated upon receipt by Government Development Bank of reimbursement of the full amount due to it with respect to such drawing. Such reimbursement would occur if the Legislature of Puerto Rico subsequently appropriates the full amount required to pay debt service on the Notes. If such appropriation is not made, the Corporation would not have sufficient funds to reimburse Government Development Bank, and the amount of the drawing under the Letter of Credit would not be reinstated. In such event, holders of the 2012 Series A Bonds would no longer have the protection intended to be afforded by the Letter of Credit. The Letter of Credit is not intended to and does not cover the risk that no appropriation is made by the Legislature of Puerto Rico under any Appropriation Act for any particular fiscal year, or that an appropriation is made in an amount lower than the amount of debt service on the Notes due with respect to any fiscal year. If the budget for any fiscal year is adopted but no appropriation for the payment of the Notes is included in such budget, or an appropriation is made in an amount lower than the amount of debt service on the Notes, the Trustee may not make a drawing under the Letter of Credit.

For information with respect to Government Development Bank, the issuer of the Letter of Credit, please see the Official Statement dated February 1, 2012, for the \$1,000,000,000 Government Development Bank for Puerto Rico Senior Notes, 2012 Series A, which was filed with the MSRB through EMMA.

The Trust Agreement permits the Corporation to substitute the Letter of Credit or any successor letter of credit for a letter of credit in the same stated amount, for a term at least as long as the remaining term of the Letter of Credit or the successor letter of credit being replaced, containing administrative provisions substantially similar to those of the Letter of Credit and reasonably acceptable to the Trustee and issued by a bank, banking association or trust company whose long-term debt obligations are rated at the time of issuance of such letter of credit in one of the three highest rating categories (without regard to any gradations within any such category) by S&P and Moody's.

Flow of Funds

Under the Trust Agreement the Corporation agrees to cause the Secretary of Treasury to transfer to the Trustee, no later than July 15 of each fiscal year while the Bonds are Outstanding, funds representing the portion of the budgetary appropriations needed for the payment of all amounts due in respect of the Notes (including principal of and interest on the Bonds) for the immediately succeeding Bond Year (referred to herein as the “Legislative Appropriation”) for deposit in the Sinking Fund as described below.

Any Legislative Appropriation (or funds received in substitution therefor or with respect to the Notes, including any moneys received pursuant to a draw under the Letter of Credit) and other funds received by the Trustee, including any Hedge Counterparty Swap Payments (other than moneys received from draws made under any Credit Facility or Liquidity Facility, other than the Letter of Credit, which moneys will be deposited in special subaccounts as provided in the Trust Agreement) for the payment of principal of and interest on the Bonds shall be deposited in the Sinking Fund in the following order:

first, to the credit of the Bond Service Account, such amount as may be required to make the total amount then to the credit of the Bond Service Account equal to the sum of (i) the amount of interest then or to become due and payable on the Bonds of each Series then Outstanding during the Bond Year commencing within the fiscal year with respect to which such Legislative Appropriation is made or such funds are received; and (ii) the amount of principal then or to become due and payable not later than July 31 of such Bond Year on the Serial Bonds of each Series then Outstanding;

second, to the credit of the Redemption Account, such amount as may be required to make the total amount then to the credit of the Redemption Account in the Bond Year commencing within the fiscal year with respect to which such Legislative Appropriation is made or such funds are received equal to the Amortization Requirement for such Bond Year for the Term Bonds of each Series then Outstanding; and

third, to the credit of the Surplus Account, any remaining amount.

Under the Trust Agreement, the Trustee is required to make a draw under the Letter of Credit on the second Business Day immediately preceding August 1 of any Bond Year unless it receives written notice from the Corporation prior to such date to the effect that a budget for the fiscal year commencing on the preceding July 1 has been adopted or it has otherwise received funds representing the full amount of principal and interest due with respect to the Bonds for such Bond Year.

No Acceleration of the Bonds

The Bonds are not subject to acceleration upon the occurrence of an event of default or otherwise.

Limitation on Additional Bonds

No additional Bonds may be issued under the Trust Agreement except (i) to refund any Bonds issued under the Trust Agreement or any other bonds of the Corporation payable from the budgetary appropriations made under the Appropriation Acts, (ii) to fund a Reserve Account, if applicable, (iii) to pay capitalized interest with respect to such additional Bonds, or (iv) to pay the costs of issuance of such additional Bonds. All such additional Bonds will be issued on a parity basis with all Bonds previously issued under the Trust Agreement, including the 2012 Series A Bonds, and will be entitled to the same benefit and security under the Trust Agreement.

No additional Bonds may be issued unless the amounts of principal and interest payable under the Notes pledged to the Trustee (assuming timely payments under such Notes) after the issuance of such additional Bonds are sufficient to pay the principal of and interest on all Bonds outstanding after the issuance of such additional Bonds as the same become due, together with other amounts required to be paid by the Corporation with respect to the Bonds, any outstanding Credit or Liquidity Facility, if applicable, or under the Trust Agreement.

Budgetary Process and Payment of Commonwealth Obligations

The fiscal year of the Commonwealth begins on July 1 and ends on June 30 (references herein to a particular fiscal year are based on the year in which such fiscal year ends). The Governor is constitutionally required to submit to the Legislature of Puerto Rico an annual budget of capital improvements and operating expenses of the Commonwealth for the ensuing fiscal year. The annual budget is prepared by OMB, working with the Planning Board, the Treasury Department, Government Development Bank and other government offices and agencies. Section 7 of Article VI of the Commonwealth's Constitution provides: "The appropriations made for any fiscal year shall not exceed the total revenues, including available surplus, estimated for said fiscal year unless the imposition of taxes sufficient to cover said appropriations is provided by law."

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

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

During any fiscal year in which the resources available to the Commonwealth are insufficient to cover the appropriations approved for such year, the Governor may take administrative measures necessary to balance the budget, or make recommendations to the Legislature of Puerto Rico for new taxes, or take any other necessary action to meet the estimated deficiency, or authorize borrowings under provisions of existing legislation, or take action which involves a combination of such steps. Any such proposed adjustments shall give effect to the "priority norms" established by law for the disbursement of public funds in the following order of priority:

first, the payment of the interest on, and amortization requirements for, public debt (Commonwealth general obligation and guaranteed debt);

second, the fulfillment of obligations arising out of legally binding contracts, court decisions on eminent domain and certain commitments to protect the name, credit and good faith of the Commonwealth government;

third, current expenditures in the areas of health, protection of persons and property, education, welfare and retirement systems; and

fourth, all other purposes.

The Commonwealth's Constitution provides that the public debt of the Commonwealth will constitute a first claim on available Commonwealth revenues. Public debt of the Commonwealth includes general obligation bonds and notes of the Commonwealth to which the full faith, credit and taxing power of the Commonwealth are pledged and, according to opinions rendered by the Attorney General of the Commonwealth, also any payments required to be made by the Commonwealth under its guarantees of bonds and notes issued by its public instrumentalities. **The Bonds do not constitute public debt of the Commonwealth for purposes of the constitutional provision described above.**

For a description of the public debt of the Commonwealth and a more detailed discussion of the Commonwealth budget, see the Commonwealth Report.

AGGREGATE DEBT SERVICE REQUIREMENTS

The following table sets forth the debt service schedule for the year ending August 1 of each year shown for the 2012 Series A Bonds and the other outstanding bonds of the Corporation payable from Legislative Appropriations made pursuant to the Appropriation Acts:

Year Ending August 1	Annual Debt Service of Other Bonds of the Corporation ⁽¹⁾	2012 Series A Bonds ⁽²⁾			Total Annual Debt Service
		Principal	Interest	Debt Service	
2012	\$ 9,019,998	-	-	-	\$ 9,019,998
2013	15,757,950	-	-	-	15,757,950
2014	15,757,950	-	-	-	15,757,950
2015	32,223,576	\$ 36,285,000	\$ 18,198,980	\$ 54,483,980	86,707,556
2016	40,203,350	29,435,000	17,074,145	46,509,145	86,712,495
2017	40,203,350	30,450,000	16,058,637	46,508,637	86,711,987
2018	40,203,350	31,590,000	14,916,762	46,506,762	86,710,112
2019	40,203,350	32,855,000	13,653,162	46,508,162	86,711,512
2020	40,203,350	34,215,000	12,289,680	46,504,680	86,708,030
2021	40,203,350	35,705,000	10,801,328	46,506,328	86,709,678
2022	40,203,350	37,330,000	9,176,750	46,506,750	86,710,100
2023	40,203,350	39,105,000	7,403,575	46,508,575	86,711,925
2024	65,203,350	16,095,000	5,409,220	21,504,220	86,707,570
2025	63,703,350	18,420,000	4,588,375	23,008,375	86,711,725
2026	62,188,350	20,870,000	3,648,955	24,518,955	86,707,305
2027	227,439,250	-	2,584,585	2,584,585	230,023,835
2028	215,868,875	-	2,584,585	2,584,585	218,453,460
2029	103,160,500	-	2,584,585	2,584,585	105,745,085
2030	103,305,500	-	2,584,585	2,584,585	105,890,085
2031	35,817,250	48,310,000	2,584,585	50,894,585	86,711,835
Total	<u>\$1,271,072,699</u>	<u>\$410,665,000</u>	<u>\$146,142,495</u>	<u>\$556,807,495</u>	<u>\$1,827,880,194</u>

* These amounts exclude debt service on the Refunded Bonds.

(1) Excludes capitalized interest during fiscal year 2012.

(2) Excludes capitalized interest during fiscal years 2012 – 2015.

TAX MATTERS

The following is a summary of the opinion of O’Neill & Borges LLC, Special Puerto Rico Tax Counsel, regarding certain Puerto Rico and United States federal tax consequences of the ownership of the 2012 Series A Bonds by Puerto Rico residents.

This section does not purport to cover all of the Puerto Rico and United States federal tax consequences arising from the purchase and ownership of the 2012 Series A Bonds. The following is based upon laws, regulations, judicial decisions and administrative pronouncements now in effect and subject to change, and any change may apply retroactively and affect the accuracy of the opinions, statements and conclusions set forth in this discussion. You should consult your independent tax advisor as to the application to your particular situation of the tax discussion described below, as well as the effect of any foreign, state or other laws.

An opinion of counsel represents only such counsel’s best legal judgment and is not binding on the Puerto Rico Treasury Department, any municipality or agency of Puerto Rico, the United States Internal Revenue Service (the “IRS”) or the courts. Accordingly, there can be no assurance that the opinions set forth herein, if challenged,

would be sustained. Moreover, this section is not to be construed as a substitute for careful tax planning. Prospective investors are urged to consult their own tax advisors with specific reference to their own tax situations, including the application and effect of other tax laws and any possible changes in the tax laws after the date of this Official Statement. The following discussion does not address all of the tax consequences to entities that are classified as partnerships or other pass-through entities under the PR Code or the US Code and other entities subject to special tax regimes under the PR Code or the US Code (such as life insurance companies, retirement plans, registered or regulated investment companies, tax exempt organizations, etc.). Said entities should consult their tax advisors regarding the Puerto Rico and United States tax consequences of investment in the 2012 Series A Bonds.

In the opinion of O’Neill & Borges LLC, under the provisions of the Acts of Congress and the laws of Puerto Rico in force as of the date of issuance of the 2012 Series A Bonds:

1. Interest on the 2012 Series A Bonds is:
 - (a) exempt from Puerto Rico income taxes under Section 1031.02(a)(3)(B) of the Internal Revenue Code for a New Puerto Rico, Act No. 1-2011 of the Legislature of Puerto Rico, approved January 31, 2011, as amended (the “PR Code”);
 - (b) excluded under Section 1022.04(b)(2) of the PR Code from the “adjusted net book income” of a corporation for purposes of computing the alternative minimum tax imposed by Section 1022.03(a) of the PR Code;
 - (c) exempt from the Puerto Rico alternative basic tax under Section 1021.02(a)(2) of the PR Code; and
 - (d) exempt from Puerto Rico municipal license taxes under Section 9(25) of the Puerto Rico Municipal License Tax Act of 1974, as amended.
2. The 2012 Series A Bonds are exempt from Puerto Rico personal property tax pursuant to Section 3.11 of the Puerto Rico Municipal Property Tax Act of 1991, as amended, and Section 3 of the Puerto Rican Federal Relations Act.
3. The 2012 Series A Bonds are exempt from Puerto Rico (i) gift tax with respect to donors who are residents of Puerto Rico at the time the gift is made and (ii) estate tax with respect to estates of decedents who are residents of Puerto Rico at the time of death and who acquired their United States citizenship solely by reason of birth or residence in Puerto Rico.
4. The 2012 Series A Bonds will be considered an obligation of an instrumentality of Puerto Rico for purposes of: (i) the non-recognition of gain rules under Section 1034.04(f)(2)(A) of the PR Code applicable to certain involuntary conversions; and (ii) the exemption from the surtax imposed by Section 1022.05 of the PR Code available to corporations that have a certain percentage of their net income invested in obligations of instrumentalities of Puerto Rico and certain other investments pursuant to Section 1022.05(g) of the PR Code.
5. Interest on the 2012 Series A Bonds constitutes industrial development income under Section 2(j) of the Economic Incentives for the Development of Puerto Rico Act, or under analogous provisions of similar prior acts (collectively referred to as the “Acts”), when received by a holder of a grant of tax exemption issued under any of the Acts that acquired the 2012 Series A Bonds with eligible funds, as such term is defined in the Acts.
6. Gain recognized from the sale or exchange of the 2012 Series A Bonds will be subject to income tax under the PR Code to taxpayers subject to Puerto Rico income tax on such gains, including individuals residing in Puerto Rico and corporations organized under the laws of Puerto Rico.

The PR Code does not contain any provisions regarding the treatment of the excess of a 2012 Series A Bond’s redemption price at maturity over its initial issue price (original issue discount). However, under the administrative practice followed by the Treasury Department with respect to the repealed Puerto Rico Internal Revenue Code of 1994, original issue discount was treated as interest.

Prospective owners of the 2012 Series A Bonds, including but not limited to financial institutions, should be aware that, pursuant to Sections 1033.17(a)(5), 1033.17(a)(10) and 1033.17(f) of the PR Code, ownership of the 2012 Series A Bonds may, under certain circumstances, result in a disallowance, for regular and alternative

minimum Puerto Rico income tax purposes, of interest expense and other expenses related to an investment in the 2012 Series A Bonds.

IRS Circular 230 Disclosure: The following U.S. tax discussion is general in nature and is not intended to be a tax opinion or tax advice. The U.S. tax discussion was prepared to support the promotion and marketing of the 2012 Series A Bonds. No taxpayer can rely on the U.S. tax discussion to avoid penalties that may be imposed on the taxpayer by the IRS. Each prospective purchaser should seek advice from an independent tax advisor about the tax consequences under its own particular circumstances of investing in the 2012 Series A Bonds.

The following discussion is limited to 2012 Series A Bonds held as capital assets and does not purport to address interest or gain on the 2012 Series A Bonds that is effectively connected with a Puerto Rico trade or business. Based upon the provisions of the United States Internal Revenue Code of 1986, as amended (the "US Code"), now in force and the rules and regulations thereunder, in the opinion of O'Neill & Borges LLC:

1. Interest or original issue discount on the 2012 Series A Bonds owned by an individual is excludable from the gross income of the individual for United States federal income tax purposes under Section 933 of the US Code if (a) the individual is a bona fide resident of Puerto Rico during the entire taxable year in which such interest or original issue discount is to be recognized for purposes of the US Code and (b) such interest or original issue discount is not, and is not treated as, income effectively connected with, or attributable to, the conduct of a trade or business within the United States by such individual under the US Code. In addition, for U.S. federal income tax purposes, no deduction or credit will be allowed that is allocable to or chargeable against amounts so excluded from the Puerto Rico individual's gross income.

2. Interest or original issue discount on the 2012 Series A Bonds derived by a corporation organized under the laws of Puerto Rico or by any foreign corporation for purposes of the US Code is not subject to United States federal income tax under the US Code if: (a) such interest or original issue discount is not, and is not treated as, income effectively connected with, or attributable to, the conduct of a trade or business in the United States by such corporation under the US Code; (b) such corporation is not a controlled foreign corporation or a passive foreign investment company under the US Code; and (c) such corporation is not treated as a domestic corporation for purposes of the US Code.

3. United States taxpayers, other than individuals who comply with the requirements set forth below, may be subject to federal income tax on any gain realized upon sale of the 2012 Series A Bonds. Pursuant to Notice 89-40, issued by the United States Internal Revenue Service on March 27, 1989, and the regulations issued under Section 937 of the US Code, the gain from the sale of the 2012 Series A Bonds by an individual who is a bona fide resident of Puerto Rico will constitute Puerto Rico source income, and therefore will qualify for exclusion from gross income under Section 933 of the US Code, provided (i) said 2012 Series A Bonds do not constitute inventory in the hands of such individual, (ii) such gain is not attributable to an office or fixed place of business of the individual located outside of Puerto Rico and (iii) the individual has been a bona fide resident of Puerto Rico for the shorter of (1) the full period during which the individual has owned the 2012 Series A Bonds or (2) each of the ten years preceding the year of the sale. In the case the individual is a bona fide resident of Puerto Rico for the tax year for which the source of income must be determined and the individual was a United States citizen or resident (other than a bona fide resident of Puerto Rico) for any of the ten years preceding said year, the individual may elect to treat as gain from sources within Puerto Rico the portion of the gain attributable to the individual's holding period in Puerto Rico.

4. Puerto Rico corporations generally will not be subject to income or withholding tax under the US Code on gain recognized on the sale or exchange of the 2012 Series A Bonds, unless the gain is effectively connected, or treated as effectively connected, with the conduct by the Puerto Rico corporation of a trade or business in the United States.

The opinion of Special Puerto Rico Tax Counsel regarding the tax consequences under Puerto Rico law and the US Code arising from the ownership of, receipt or accrual of interest on or disposition of the 2012 Series A Bonds is limited to the above. Special Puerto Rico Tax Counsel does not express any other opinion regarding the Puerto Rico or United States federal tax consequences arising from ownership or disposition of the 2012 Series A Bonds or as to the tax consequences under the laws of any state or any other taxing jurisdictions. Each Purchaser of the 2012 Series A Bonds should consult his, her or its tax advisor as to such tax consequences.

Prospective owners of the 2012 Series A Bonds should consult their tax advisors with respect to the precise determination of the Puerto Rico and United States federal tax consequences arising from ownership or disposition of the 2012 Series A Bonds.

CONTINUING DISCLOSURE UNDERTAKING

In accordance with the requirements of Rule 15c2-12, as amended (the “Rule”), promulgated by the Securities and Exchange Commission (“SEC”), the Corporation and the Commonwealth have agreed for the benefit of the Beneficial Owners to provide or cause to provide as follows:

1. to file, within 305 days after the end of each fiscal year commencing with the fiscal year ending June 30, 2012, with the MSRB through EMMA, core financial information and operating data for the prior fiscal year, including (i) the Commonwealth’s audited financial statements, prepared in accordance with generally accepted accounting principles in effect from time to time, and (ii) material historical quantitative data (including financial information and operating data) on the Commonwealth and its revenues, expenditures, financial operations and indebtedness, in each case generally found in this Official Statement; and
2. to file in a timely manner, not in excess of ten business days after the occurrence of the event, with the MSRB through EMMA, notice of the occurrence of any of the following events with respect to the 2012 Series A Bonds:
 - a. principal and interest payment delinquencies;
 - b. non-payment related defaults, if material;
 - c. unscheduled draws on debt service reserves reflecting financial difficulties;
 - d. unscheduled draws on credit enhancements reflecting financial difficulties;
 - e. substitution of credit or liquidity facility providers, or their failure to perform;
 - f. adverse tax opinions, the issuance by the IRS of proposed or final determinations of taxability, Notices of Proposed Issue (IRS Form 5701-TEB) or other material notices or determinations with respect to the tax status of the 2012 Series A Bonds, or other material events affecting the tax status of the 2012 Series A Bonds;
 - g. modifications to rights of the holders (including Beneficial Owners) of the 2012 Series A Bonds, if material;
 - h. bond calls, if material;
 - i. defeasances;
 - j. release, substitution, or sale of property securing repayment of the 2012 Series A Bonds, if material;
 - k. rating changes;
 - l. tender offers;
 - m. bankruptcy, insolvency, receivership, or similar proceeding of the Commonwealth;
 - n. the consummation of a merger, consolidation or acquisition involving the Corporation or the sale of substantially all of the assets of the Corporation, other than in the ordinary course of business, the entry into a definitive agreement to undertake such action or the termination of a definitive agreement relating to any such actions, other than pursuant to its terms, if material; and
 - o. the appointment of a successor or additional trustee, or the change of name of a trustee, if material.

The Corporation will also file, in a timely manner, with the MSRB through EMMA, notice of a failure by the Commonwealth to provide the financial and operating information required under paragraph 1 on or before the specified period.

Event (c) is included pursuant to a letter from the SEC staff to the National Association of Bond Lawyers, dated September 19, 1995. However, event (c) may not be applicable since the terms of the 2012 Series A Bonds do not provide for “debt service reserves.” In addition, with respect to the following events:

Events (d) and (e). The Corporation and the Commonwealth do not undertake to provide any notice with respect to credit enhancement added after the primary offering of the 2012 Series A Bonds, unless the Commonwealth applies for or participates in obtaining the enhancement.

Event (f). For information on the tax status of the 2012 Series A Bonds, see “*Tax Matters.*”

Event (h). The Corporation 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 (i) the terms, dates and amounts of redemption are set forth in detail in this Official Statement, (ii) the only open issue is which 2012 Series A Bonds will be redeemed in the case of a partial redemption, (iii) notice of redemption is given to the Bondholders as required under the terms of the 2012 Series A Bonds, and (iv) 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 2012 Series A Bond purchases.

Event (m). According to the Rule, the event is considered to occur when any of the following occur: the appointment of a receiver, fiscal agent or similar officer for an obligated person in a proceeding under the U.S. Bankruptcy Code or in any other proceeding under state or federal law in which a court or governmental authority has assumed jurisdiction over substantially all of the assets or business of the obligated person, or if such jurisdiction has been assumed by leaving the existing governing body and officials or officers in possession but subject to the supervision and orders of a court or governmental authority, or the entry of an order confirming a plan of reorganization, arrangement or liquidation by a court or governmental authority having supervision or jurisdiction over substantially all of the assets or business of the obligated person.

The Corporation and the Commonwealth expect to provide the information described in paragraph 1 above by filing the first bond official statement that includes such information for the preceding fiscal year or, if no such official statement is issued by the 305-day deadline, by filing the Commonwealth’s Financial Information and Operating Report or a separate document containing such information.

The Corporation and the Commonwealth may from time to time choose to provide notice of the occurrence of certain other events in addition to those listed above if, in the judgment of the Commonwealth, such other events are material with respect to the 2012 Series A Bonds, but neither the Corporation nor the Commonwealth undertake to provide any such notice of the occurrence of any material event except those events listed above.

The Commonwealth and the Corporation acknowledge that their undertaking pursuant to the Rule described under this heading is intended to be for the benefit of the holders of the 2012 Series A Bonds, including Beneficial Owners, and shall be enforceable by any such holders or Beneficial Owners; provided that the right to enforce the provisions of this undertaking shall be limited to a right to obtain specific enforcement of the Corporation’s or the Commonwealth’s obligations hereunder, and any failure by the Corporation or the Commonwealth to comply with the provisions of this undertaking shall not be an event of default with respect to the 2012 Series A Bonds under the Trust Agreement.

No bondholder or Beneficial Owner may institute any suit, action or proceeding at law or in equity (“Proceeding”) for the enforcement of the foregoing covenants (the “Covenants”) or for any remedy for breach thereof, unless such bondholder or Beneficial Owner shall have filed with the Corporation and the Commonwealth written notice of any request to cure such breach, and the Corporation or the Commonwealth, as applicable, shall have refused to comply within a reasonable time. All Proceedings shall be instituted only in a Commonwealth court located in the Municipality of San Juan for the equal benefit of all bondholders or Beneficial Owners of the outstanding 2012 Series A Bonds benefited by the Covenants, and no remedy shall be sought or granted other than specific performance of any of the Covenants at issue. Notwithstanding the foregoing, no challenge to the adequacy of the information provided in accordance with the filings mentioned above may be prosecuted by any bondholder or Beneficial Owner except in compliance with the remedial and enforcement provisions contained in the Trust Agreement. Moreover, Proceedings filed by bondholders or Beneficial Owners against the Commonwealth may be subject to the sovereign immunity provisions of Article 2 of Law No. 104 of June 29, 1955, as amended (32 L.P.R.A. Section 3077), which governs the scope of legal actions against the Commonwealth and substantially limits the amount of monetary damages that may be granted against the Commonwealth.

The Covenants may only be amended if:

- i. 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 Corporation or the Commonwealth, or type of business conducted; the Covenants, as amended, would have complied with the requirements of the Rule at the time of award of the 2012 Series A Bonds, after taking into account any amendments or change in circumstances; and the amendment does not materially impair the interests of bondholders or Beneficial Owners, as determined by parties unaffiliated with the Corporation or the Commonwealth; or
- ii. all or any part of the Rule, as interpreted by the staff of the Securities and Exchange Commission at the date of the adoption of such Rule, ceases to be in effect for any reason, and the Corporation or the Commonwealth, as applicable, elects that the Covenants shall be deemed amended accordingly.

The Corporation and the Commonwealth have 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 in complying with the Rule.

Prior Continuing Disclosure Non-Compliance

The Commonwealth has made similar continuing disclosure undertakings in connection with prior bond issuances. Although the Commonwealth has filed all the reports and financial statements required to be filed, some of these filings have been made after the Commonwealth's May 1 filing deadline.

The Commonwealth's audited financial statements for the fiscal years ended June 30, 2006, 2007 and 2008 were filed after the Commonwealth's filing deadlines, because various governmental agencies did not submit their audited financial statements to the central government's external auditors on time, thereby delaying submission of the Commonwealth's audited financial statements. The Commonwealth's audited financial statements for the fiscal year ended June 30, 2009 was also filed after the Commonwealth's filing deadline due to delays in the engagement and transition of new external auditors, the implementation of new government accounting pronouncements, and the restatement of the financial statements of certain discretely presented component units.

The Commonwealth Report for the fiscal year ended June 30, 2008 containing the information described in paragraph 1(ii) above, was filed after the Commonwealth's filing deadline. Except for that Commonwealth Report, the Commonwealth has timely filed the Commonwealth Report for all other fiscal years.

In 2011 and 2012, the Commonwealth complied with its continuing disclosure undertaking relating to fiscal years 2010 and 2011, respectively.

The Commonwealth has established new policies and procedures that it believes will ensure full and timely compliance with all continuing disclosure obligations in the future. Such new policies and procedures include: (i) the assignment of additional resources from local and international audit firms to those component units whose financial statements have not been timely provided to the Commonwealth; (ii) the assignment of dedicated external and internal resources to (a) assist the Central Accounting Division at Treasury in the preparation of complex financial information that has historically delayed the audit and (b) provide periodic and consistent follow up on component unit financial statement deliverables and deadlines; (iii) the execution of a memorandum of understanding between Treasury, OMB and Government Development Bank for the coordination of all financial statement related tasks and the designation of Government Development Bank, in its role as fiscal agent, to review and monitor the progress of certain component units; and (iv) the establishment of an Audit Oversight Committee comprised of Treasury and Government Development Bank personnel in order to continuously monitor the status of the audit and the Commonwealth's financial statements.

UNDERWRITING

The 2012 Series A Bonds are being purchased from the Corporation by the underwriters set forth on the cover page hereof (the “Underwriters”) at an aggregate discount of \$4,045,819.88 from the initial offering prices of the Bonds set forth or derived from information set forth on the inside cover hereof. Pursuant to a Contract of Purchase by and between the Corporation and the Underwriters (the “Contract of Purchase”), the Underwriters agree to accept delivery of and pay for all of the 2012 Series A Bonds if any are delivered. The obligation to make such purchase is subject to certain terms and conditions set forth in the Contract of Purchase, the approval of certain legal matters by counsel and certain other conditions.

The Underwriters and their respective affiliates are full service financial institutions engaged in various activities, which may include securities trading, commercial and investment banking, financial advisory, investment management, principal investment, hedging, financing and brokerage activities. Certain of the Underwriters and their respective affiliates have, from time to time, performed, and may in the future perform, various investment banking services for the Corporation, for which they received or will receive customary fees and expenses.

In the ordinary course of their various business activities, the Underwriters and their respective affiliates may make or hold a broad array of investments and actively trade debt and equity securities (or related derivative securities) and financial instruments for their own account and for the accounts of their customers and may at any time hold long and short positions in such securities and instruments. Such investment and securities activities may involve securities and instruments of the Corporation.

Santander Securities LLC (“Santander Securities”) and Merrill Lynch, Pierce, Fenner & Smith Incorporated (“Merrill”) have entered into an agreement pursuant to which they will provide services and advice to each other related to the structuring and execution of certain municipal finance transactions for the Commonwealth’s governmental entities in the global capital markets and in the United States market and in the Puerto Rico market if issued in connection with such global or U.S. issuances. Santander Securities and Merrill will be entitled to receive a portion of each other’s revenues from the underwriting of the 2012 Series A Bonds as consideration for their professional services.

Oriental Financial Services Corp. (“Oriental”) and Raymond James & Associates, Inc. (“Raymond James”) have entered into an agreement under which the parties provide services and advice to each other to assist the Commonwealth and its issuers in the structuring and execution of their municipal securities offerings. As part of the agreement, Oriental and Raymond James share in the risk from the underwriting of the 2012 Series A Bonds as part of the consideration for their professional services.

On April 2, 2012, Raymond James Financial, Inc. (“RJF”), the parent company of Raymond James, acquired all of the stock of Morgan Keegan & Company, Inc. (“Morgan Keegan”) from Regions Financial Corporation. Morgan Keegan and Raymond James are each registered broker-dealers. Both Morgan Keegan and Raymond James are wholly owned subsidiaries of RJF and, as such, are affiliated broker-dealer companies under the common control of RJF, utilizing “Raymond James | Morgan Keegan” as their trade name. It is anticipated that the businesses of Raymond James and Morgan Keegan will be combined. Raymond James has entered into a distribution arrangement with Morgan Keegan for the distribution of the 2012 Series A Bonds at the original issue prices. Such arrangement generally provides that Raymond James will share a portion of its underwriting compensation or selling concession with Morgan Keegan.

LEGAL MATTERS

The proposed form of opinion of Squire Sanders (US) LLP, Bond Counsel, is attached as *Appendix II* to this Official Statement. Certain legal matters will be passed upon for the Underwriters by O’Neill & Borges LLC, San Juan, Puerto Rico. O’Neill & Borges LLC will also act as Special Puerto Rico Tax Counsel.

LEGAL INVESTMENT

The 2012 Series A Bonds will be eligible for deposit by banks in Puerto Rico to secure public funds and will be approved investments for domestic insurance companies.

VERIFICATION OF MATHEMATICAL COMPUTATIONS

Causey, Demgen & Moore, Inc., (the “Verification Agent”), will perform and verify, from the information provided to them, the sufficiency of the uninvested cash to pay principal of and redemption premium, if any, and interest on the Refunded Bonds on their respective redemption dates. The Verification Agent will express no opinion on the assumptions provided to them.

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 Corporation in connection with the 2012 Series A Bonds offered hereby. As financial advisor, Government Development Bank participated in the selection of the Underwriters of the 2012 Series A Bonds. 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. The Underwriters or their respective affiliates participate in other financial transactions with Government Development Bank.

RATINGS

Moody’s and S&P have assigned the 2012 Series A Bonds ratings of “Baa2” and “BBB-,” respectively. These ratings reflect only the respective views of the rating agencies and an explanation of the significance of each rating may be obtained only from the respective rating agency. There is no assurance that such ratings will remain in effect for any given period of time or that they will not be revised downward or withdrawn entirely by either or both of such rating agencies, if in the judgment of either or both, circumstances so warrant. Any such downward revision or withdrawal of either of such ratings may have an adverse effect on the market prices of the 2012 Series A Bonds.

Such rating agencies were provided with materials relating to the Commonwealth and the 2012 Series A Bonds and other relevant information, and no application has been made to any other rating agency for the purpose of obtaining a rating on the 2012 Series A Bonds.

MISCELLANEOUS

The foregoing summaries of or references to the various acts, the 2012 Series A Bonds, the Trust Agreement, the Resolution, the Notes, the Letter of Credit, the Appropriation Acts and the summaries of or references to the various acts contained in the Commonwealth Report are made subject to all the detailed provisions thereof to which reference is hereby made for further information and do not purport to be complete statements of any or all of such provisions.

Appended to and constituting a part of this Official Statement are (i) the Commonwealth Report (*Appendix I*); (ii) the proposed form of opinion of Bond Counsel (*Appendix II*); (iii) the proposed form of opinion of Special Puerto Rico Tax Counsel (*Appendix III*); and (iv) the Trust Agreement (*Appendix IV*).

This Official Statement incorporates by reference the Commonwealth’s Annual Financial Report.

The information set forth in this Official Statement and incorporated herein by reference, except for information appearing in “Book-Entry Only System” and in UNDERWRITING herein, was supplied by certain officials of Government Development Bank, the Corporation and the Commonwealth, in their respective official capacities, or was obtained from publications of Government Development Bank or certain of its agencies or instrumentalities, and is included or incorporated by reference in this Official Statement on the authority of such

officials or the authority of such publications as official documents. The information pertaining to DTC and the Underwriters was supplied by DTC and the Underwriters, respectively.

This Official Statement will be filed with the MSRB through EMMA.

PUERTO RICO PUBLIC FINANCE CORPORATION

By: /s/ Ignacio Canto
Executive Vice President

COMMONWEALTH OF PUERTO RICO
Financial Information and Operating Data Report
June 8, 2012

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COMMONWEALTH OF PUERTO RICO
Financial Information and Operating Data Report
June 8, 2012

INTRODUCTION

General

The financial and operating information about the Commonwealth of Puerto Rico (the “Commonwealth” or “Puerto Rico”) included in this Report has been updated as of March 31, 2012, except as otherwise provided herein. The Commonwealth’s fiscal year runs from July 1 through June 30 of the following year. References in this Report to a particular fiscal year are to the year in which such fiscal year ends.

Forward-Looking Statements

The information included in this Report contains certain “forward-looking” statements. These forward-looking statements may relate to the Commonwealth’s fiscal and economic condition, economic performance, plans, and objectives. All statements contained herein that are not clearly historical in nature are forward-looking, and the words “anticipates,” “believes,” “continues,” “expects,” “estimates,” “intends,” “aims,” “projects,” and similar expressions, and future or conditional verbs such as “will,” “would,” “should,” “could,” “might,” “can,” “may,” or similar expressions, are generally intended to identify forward-looking statements.

These statements are not guarantees of future performance and involve certain risks, uncertainties, estimates, and assumptions by the Commonwealth that are difficult to predict. The economic and financial condition of the Commonwealth is affected by various financial, social, economic, environmental, and political factors. These factors can be very complex, may vary from one fiscal year to the next, and are frequently the result of actions taken or not taken, not only by the Commonwealth and its agencies and instrumentalities, but also by entities such as the government of the United States of America or other nations that are not under the control of the Commonwealth. Because of the uncertainty and unpredictability of these factors, their impact cannot, as a practical matter, be included in the assumptions underlying the Commonwealth’s projections.

The projections set forth in this Report were not prepared with a view toward complying with the guidelines established by the American Institute of Certified Public Accountants with respect to prospective financial information, but, in the view of the Commonwealth’s responsible officers, were prepared on a reasonable basis, reflect the best currently available estimates and judgments, and present, to the best of such officers’ knowledge and belief, the expected course of action and the expected future financial performance of the Commonwealth. However, this information is not fact and should not be relied upon as being necessarily indicative of future results, and readers of this Report are cautioned not to place undue reliance on the prospective financial information. Neither the Commonwealth’s independent auditors, nor any other independent auditors, have compiled, examined, or performed any procedures with respect to the prospective financial information contained herein, nor have they expressed any opinion or any other form of assurance on such information or its achievability and disclaim any association

with the prospective financial information. Neither the Commonwealth's independent auditors, nor any other independent auditors, have been consulted in connection with the preparation of the prospective financial information set forth in this Report, which is solely the product of the Commonwealth, and the independent auditors assume no responsibility for its content.

Overview of Economic and Fiscal Condition

Economic Condition

Gross National Product. Puerto Rico's economy is closely linked to the United States economy. In recent fiscal years, however, the performance of Puerto Rico's economy has not been consistent with the performance of the United States economy. Puerto Rico's economy entered a recession in the fourth quarter of fiscal year 2006. For fiscal years 2007, 2008, 2009, 2010 and 2011 Puerto Rico's real gross national product decreased by 1.2%, 2.9%, 3.8%, 3.4% and 1.5%, respectively, while the United States real gross national product grew at rates of 1.7% and 2.5% during fiscal years 2007 and 2008, respectively, contracted by 3.5% during fiscal year 2009, and grew by 0.4% and 2.9% during fiscal years 2010 and 2011. According to the Puerto Rico Planning Board's (the "Planning Board") latest projections made in April 2012, which take into account the preliminary results for fiscal year 2011, the estimated effect on the Puerto Rico economy of the Government's tax reform enacted in fiscal year 2011, the significant increase in public and private construction and fixed investment, and other economic factors, it is projected that the real gross national product for fiscal year 2012 will increase by 0.9%. The real gross national product for fiscal year 2013 is forecasted to grow by 1.1%.

Employment. According to the Household Survey, total employment fell by 2.3% in fiscal year 2011 and grew by 0.5% in the first ten months of fiscal year 2012. The unemployment rate for fiscal year 2011 and for the first ten months of fiscal year 2012 was 16.0% and 15.2%, respectively. In April 2012, the unemployment rate fell to 14.8%. According to the Establishment Survey, total payroll employment fell by 2.0% in fiscal year 2011 and was virtually unchanged, decreasing by 0.2%, during the first ten months of fiscal year 2012. April 2012 year-over-year total payroll employment decreased by 0.7%.

Economic Activity Index. The Government Development Bank – Economic Activity Index (the "EAI") prepared by the GDB reflected a reduction of 2.7% in fiscal year 2011, after a reduction of 5.6% for fiscal year 2010. For the first nine months of fiscal year 2012, the EAI showed a year-over-year reduction of 0.4%, compared to a reduction of 2.9% for the same period of fiscal year 2011. For the third quarter of fiscal year 2012 (January 2012 through March 2012), the EAI showed a year-over-year increase of 0.3%, which represents the first quarterly positive growth rate since the third quarter of fiscal year 2006 (January 2006 to March 2006).

Fiscal Condition

Fiscal Imbalance. Since 2000, the Commonwealth has faced a number of fiscal challenges, including an imbalance between its General Fund total revenues and expenditures. The imbalance reached its highest level in fiscal year 2009, when the deficit was \$3.306 billion, consisting of the difference between total revenues from non-financing sources of \$7.583 billion and total expenditures of \$10.890 billion. The following table shows total revenues from non-

financing sources (which are revenues from taxes, licenses and other internal or external sources received by virtue of existing laws, but excluding proceeds from financings), total expenditures (including debt service payments) and the ensuing imbalance for the last three fiscal years. Total revenues from non-financing sources, as shown in the table, includes revenues from temporary revenue raising measures taken by the Commonwealth to address this fiscal imbalance, some of which are described in “Fiscal Stabilization and Economic Reconstruction” under THE ECONOMY below. Such temporary revenues should not be considered “recurring” revenues beyond the applicable period of such measures. Similarly, total expenditures, as shown in the table, includes expenditures of a non-recurring nature as a result of the implementation of various expense-reduction measures also described in “Fiscal Stabilization and Economic Reconstruction” under THE ECONOMY below. Accordingly, the amount of the Commonwealth’s so called “structural deficit,” or the difference between recurring government revenues and recurring expenditures, may differ from the amount of the deficit shown below. Depending on the assumptions made as to what should be considered “recurring” for purposes of this computation, such difference may be significant.

Revenues from the electronic and traditional lotteries (shown in footnote 1 to the table) are available to the General Fund, but for accounting purposes are included in the Commonwealth’s audited financial statements as a separate fund from the General Fund.

Deficit			
Fiscal Years ended June 30,			
(in millions)			
	Total Revenues⁽¹⁾	Total Expenditures	Deficit
2009	\$7,583	\$10,890	\$(3,306)
2010	\$7,593	\$10,369 ⁽³⁾	\$(2,775)
2011	\$8,056 ⁽²⁾	\$ 9,897 ⁽³⁾⁽⁴⁾	\$(1,841)

⁽¹⁾ Excludes General Fund revenues attributable to the electronic and traditional lotteries in the amount of \$126.7 million, \$122.8 million and \$101.9 million for fiscal years 2009, 2010 and 2011, respectively.

⁽²⁾ Includes approximately \$103.1 million of moneys transferred to the General Fund during fiscal year 2011 from the Puerto Rico Sales Tax Financing Corporation consisting principally of sales and use tax collections remaining after providing for debt service on its bonds for that fiscal year.

⁽³⁾ Includes debt service of \$159.6 million, \$517.8 million and \$638.7 million for fiscal years 2009, 2010 and 2011, respectively, on the Commonwealth’s general obligation bonds and guaranteed bonds of Public Buildings Authority that was refinanced through the issuance of refunding bonds.

⁽⁴⁾ Excludes approximately \$123 million of non-recurring expenses that had been budgeted for fiscal year 2010 but were incurred in fiscal year 2011 principally related to the fiscal stabilization plan described below.

Source: Commonwealth of Puerto Rico Comprehensive Annual Financial Report and Department of the Treasury.

Prior to fiscal year 2009, the Commonwealth bridged such deficit through the use of non-recurring measures, such as borrowing from Government Development Bank for Puerto Rico (“Government Development Bank” or “GDB”) or in the bond market, postponing the payment of various government expenses, such as payments to suppliers and utilities providers, and other one-time measures such as the use of derivatives and borrowings collateralized with government owned real estate and uncollected General Fund revenues.

In January 2009, the Government of Puerto Rico (the “Government”) began to implement a multi-year plan designed to achieve fiscal balance, restore sustainable economic growth and safeguard the investment-grade ratings of the Commonwealth bonds. This plan included certain expense reduction measures that, together with various temporary and permanent revenue raising measures, have allowed the government to reduce the deficit. These measures are briefly discussed below and are discussed in greater detail in “Fiscal Stabilization and Economic Reconstruction” under THE ECONOMY.

As shown in the table above, during the last three fiscal years, the Commonwealth has been able to reduce the deficit by both increasing its revenues and reducing its expenditures. The Commonwealth’s ability to continue reducing the deficit will depend in part on its ability to continue increasing revenues and reducing expenditures, which in turn depends on a number of factors, including improvements in general economic conditions.

Fiscal Stabilization Plan. The fiscal stabilization plan, which was generally contained in Act No. 7 of March 9, 2009, as amended (“Act 7”), sought to achieve budgetary balance, while addressing expected fiscal deficits in the intervening years through the implementation of a number of initiatives, including: (i) a gradual operating expense-reduction plan through reduction of operating expenses, including payroll, which is the main component of government expenditures, and the reorganization of the Executive Branch; (ii) a combination of temporary and permanent revenue raising measures, coupled with additional tax enforcement measures; and (iii) certain financial measures.

The Government estimates that the fiscal stabilization plan’s operating expense reduction measures have resulted in annual savings of approximately \$837 million, and that the tax revenue enforcement measures, and the temporary and permanent revenue raising measures have resulted in additional revenues of \$420 million during fiscal year 2011.

The principal financial measure taken has been a bond issuance program through the Puerto Rico Sales Tax Financing Corporation (“COFINA” by its Spanish-language acronym), to which the Commonwealth allocated a portion of its sales and use tax. The proceeds from the COFINA bond issuance program (such proceeds are deposited in an account (referred to herein as the “Stabilization Fund”) managed by GDB) have been used to repay existing government debt (including debts with GDB), finance government operating expenses for fiscal years 2008 through 2012, including costs related to the implementation of a workforce reduction plan, and fund an economic stimulus plan, as described below. During fiscal years 2009 and 2010, COFINA issued approximately \$5.6 billion and \$3.6 billion, respectively, of revenue bonds payable from sales and use tax collections transferred to COFINA. During fiscal year 2012, COFINA issued approximately \$1.9 billion of revenue bonds payable from sales and use tax collections transferred to COFINA, the proceeds of which were mainly used to finance a portion of the government’s operating expenses for fiscal year 2012, refund outstanding debt obligations payable from Commonwealth appropriations, and refund certain outstanding COFINA bonds.

Another financial measure taken has been the restructuring of a portion of the debt service on the Commonwealth’s general obligation bonds and on bonds of the Public Buildings Authority (“PBA”) that are guaranteed by the Commonwealth and are payable from Commonwealth budget appropriations. During fiscal year 2010, the Commonwealth refinanced

\$512.9 million of interest accrued during such fiscal year on the Commonwealth's general obligation bonds and \$164.5 million of interest accrued during such fiscal year on PBA bonds. During fiscal year 2011, the Commonwealth refinanced \$490.9 million of interest accrued during such fiscal year and principal due on July 1, 2011 on the Commonwealth's general obligation bonds. During fiscal year 2011, PBA also used a line of credit from GDB to make payments of approximately \$147.8 million of interest accrued during such fiscal year on its Commonwealth guaranteed bonds, which line of credit was refinanced with the proceeds of a series of Commonwealth guaranteed bonds issued by PBA.

During fiscal year 2012, the Government expected to refinance approximately \$537.7 million of debt service on the Commonwealth's general obligation bonds, consisting of approximately \$449.9 million of interest to accrue during such fiscal year and approximately \$87.8 million of principal due in such fiscal year. Given favorable market conditions, the Government refinanced an additional \$148.3 million of principal due in such fiscal year to provide additional budgetary relief, allowing the Government to redirect the use of moneys that would have been used for such principal payments. The Government expects to use the available moneys resulting from this additional refinancing to pay during fiscal year 2012 outstanding accounts payable of the central Government with several public corporations, such as PBA, the Puerto Rico Electric Power Authority ("PREPA") and the Puerto Rico Aqueduct and Sewer Authority ("PRASA"), corresponding to fiscal year 2008, which did not have a source of repayment and as to which multi-year payment plans were established during calendar year 2009. These payables resulted from the Government not budgeting for certain rent payments and other services provided during fiscal year 2008. These additional amounts expected to be paid in fiscal year 2012 will pre-pay the amounts that would have been due in fiscal year 2013 pursuant to the multi-year payment plans.

The Government also expects to refinance during fiscal year 2012 approximately \$153.8 million of interest to accrue during such fiscal year on Commonwealth guaranteed PBA bonds.

During fiscal year 2013, the Government expects to refinance approximately \$575 million of principal due in and interest to accrue during such fiscal year on the Commonwealth's general obligation bonds and approximately \$170 million of principal due in and interest to accrue during such fiscal year on Commonwealth guaranteed PBA bonds.

The fiscal stabilization plan is discussed in more detail in "Fiscal Stabilization and Economic Reconstruction" under THE ECONOMY.

Results for Fiscal Year 2009. General Fund total revenues for fiscal year 2009 were \$7.583 billion (\$7.710 billion if you include approximately \$126.7 million of revenues from the electronic and traditional lotteries that are available to the General Fund, but which for accounting purposes are included in the Commonwealth's audited financial statements as a separate fund from the General Fund). General Fund total revenues (including revenues from the lotteries) for fiscal year 2009 decreased by \$648.8 million, or 7.8%, from fiscal year 2008. Total expenditures for fiscal year 2009 were \$10.890 billion (consisting of \$9.927 billion of total expenditures and \$962 million of other financing uses, principally debt service payments) representing an increase of approximately \$1.402 billion, or 14.8%, from original budgeted

expenditures and exceeded General Fund total revenues (including revenues from the lotteries, but excluding other financing sources) by \$3.180 billion, or 41.2%.

During fiscal year 2009, the Government faced an aggregate cash shortfall of \$1.153 billion that, when added to the General Fund deficit, represented approximately \$4.333 billion in excess expenditures and cash shortfall. The difference between General Fund revenues and total expenditures for fiscal year 2009 was principally paid from proceeds of COFINA bond issues and the restructuring of the corpus account of the Puerto Rico Infrastructure Financing Authority (“PRIFA”) pursuant to the fiscal stabilization plan. See “Fiscal Stabilization and Economic Reconstruction – Fiscal Stabilization Plan” under THE ECONOMY.

Results for Fiscal Year 2010. General Fund total revenues for fiscal year 2010 were \$7.593 billion (\$7.716 billion if you include approximately \$122.8 million of revenues from the lotteries). General Fund total revenues (including revenues from the lotteries) for fiscal year 2010 increased by \$6.0 million, or 0.1%, from fiscal year 2009. The principal changes in sources of revenues from fiscal year 2009 included a decrease in the sales and use tax received by the General Fund of \$256.8 million due to the assignment to COFINA of an additional 1.75% of the 5.5% Commonwealth sales and use tax. This decrease in the amount of sales and use taxes allocated to the General Fund was fully offset, however, by increases in property taxes and excise taxes on cigarettes and alcoholic beverages of approximately \$227.8 million and \$60.5 million, respectively, as a result of the temporary and permanent revenue raising measures implemented as part of the Commonwealth’s fiscal stabilization plan. Revenues from income taxes for fiscal year 2010 were approximately the same as in fiscal year 2009, reflecting the continuing impact of the ongoing economic recession.

Total expenditures for fiscal year 2010 were \$10.369 billion (which included \$173 million of expenditures related to a Government local stimulus program described below in “Fiscal Stabilization and Economic Reconstruction – Economic Reconstruction Plan” under THE ECONOMY), consisting of (i) \$9.640 billion of total expenditures and (ii) \$728 million of other financing uses (principally debt service payments). Total expenditures of \$10.369 billion exceeded General Fund total revenues (including revenues from the lotteries, but excluding other financing sources) by \$2.653 billion, or 34.4%. Excluding the debt service amounts that were refinanced, as discussed above, total expenditures for fiscal year 2010 were approximately \$9.692 billion and exceeded General Fund total revenues (including revenues from the lotteries, but excluding other financing sources) by \$1.976 billion, or 25.6%. The difference between revenues and expenses for fiscal year 2010 was covered principally by proceeds from a COFINA bond issue.

Results for Fiscal Year 2011. General Fund total revenues for fiscal year 2011 were \$8.056 billion (\$8.158 billion if you include approximately \$101.9 million of revenues from the lotteries). General Fund total revenues for fiscal year 2011 include approximately \$103.1 million of moneys transferred to the General Fund during fiscal year 2011 from COFINA, consisting principally of sales and use tax collections remaining after providing for debt service on the COFINA bonds for that fiscal year. General Fund total revenues (including revenues from the lotteries) for fiscal year 2011 increased by \$442 million, or 5.7%, from fiscal year 2010.

General Fund total revenues of \$8.056 billion (\$8.158 billion including the lotteries) include certain post-audit adjustments made by the Department of the Treasury (the “Treasury Department”) to the Commonwealth’s audited financial statements for fiscal year 2011 included in the Comprehensive Annual Financial Report of the Commonwealth (“CAFR”). These adjustments, which are deemed not material, consist of a reduction in revenues of \$40.4 million, or less than 1%, from those reported in the CAFR.

The increase in General Fund total revenues for fiscal year 2011, compared to fiscal year 2010, were mainly due to an increase of \$170.1 million in tax withholdings from non-residents and the collection of \$677.6 million as a result of the new temporary excise tax and the expansion of the taxation of certain foreign persons adopted as Act No. 154 of October 25, 2010, as amended (“Act 154”) as part of the tax reform (discussed below under “Tax Reform”), which the Government began collecting in February 2011. This increase was partially offset by a decrease of \$406.5 million in collections from income tax on individuals as a result of the tax relief provided to individual taxpayers as part of the tax reform and current economic conditions. These results are consistent with the Government’s projection that the decrease in General Fund net revenues as a result of the tax relief provided to taxpayers as part of the tax reform would be offset by the temporary excise tax imposed on certain foreign persons by Act 154.

General Fund total expenses for fiscal year 2011 were \$10.020 billion, consisting of \$9.075 billion of total expenditures and \$945 million of other financing uses (principally debt service payments). Total expenditures of \$10.020 billion exceeded General Fund total revenues (including revenues from the lotteries and moneys transferred from COFINA) by \$1.862 billion, or 22.8%. Total expenditures of \$10.020 billion include (i) \$638.7 million of debt service on the Commonwealth’s general obligation bonds and guaranteed bonds of PBA that were refinanced through the issuance of refunding bonds and (ii) approximately \$123 million of non-recurring expenses that had been budgeted for fiscal year 2010 but were incurred in fiscal year 2011 principally related to the fiscal stabilization plan. Excluding the debt service that was refinanced and such non-recurring expenses, General Fund total expenses for fiscal year 2011 were \$9.258 billion and exceeded General Fund total revenues (including revenues from the lotteries and moneys transferred from COFINA, but excluding other financing sources) by \$1.100 billion, or 13.5%. The difference between revenues and expenses for fiscal year 2011 was covered principally from proceeds of COFINA bonds.

Adopted Budget for Fiscal Year 2012. On July 1, 2011, the Governor signed the Commonwealth’s central government budget for fiscal year 2012. The adopted budget provides for General Fund total revenues and other resources and total expenditures of \$9.260 billion. The budgeted General Fund total revenues and other resources of \$9.260 billion include estimated revenues of \$8.650 billion and \$610.0 million in additional resources from proceeds of COFINA bond issues. The fiscal year 2012 budgeted expenditures exclude certain debt service payments on the Commonwealth’s general obligation bonds and Commonwealth guaranteed PBA bonds which were refinanced or are expected to be refinanced during fiscal year 2012. See “Fiscal Stabilization Plan” above.

Preliminary Results for the First Nine Months of Fiscal Year 2012 and Projected Fiscal Year 2012 Deficit. Preliminary General Fund net revenues for the first nine months of fiscal year 2012 (from July 1, 2011 to March 31, 2012) were \$5.639 billion, an increase of \$599 million, or

11.9%, from \$5.040 billion of net revenues for the same period in the prior fiscal year. These revenues represent 65% of budgeted revenues of \$8.650 billion for the fiscal year, and \$78 million, or 1.4%, less than the budget for the period.

The increase in General Fund net revenues is mainly due to the collection of \$1.379 billion as a result of the Act 154 excise tax, which amount exceeds the Government's projection of collections from the excise tax during this period. For the comparable period of fiscal year 2011, collections from the Act 154 excise tax were \$235 million, since Government began collecting the same in February 2011. The increase in Act 154 excise tax collections was partially offset by (i) a decrease in collections of \$146 million from income tax on individuals, \$63 million from income tax on corporations, and \$77 million from withholdings from non-residents, all of which were primarily a result of the tax relief provided to individual and corporate taxpayers as part of the tax reform, (ii) a decrease of \$172 million in property taxes as a result of the expiration in March 2011 of the special property tax imposed on residential and commercial real estate in fiscal year 2009 as part of the temporary revenue raising measures included in the fiscal stabilization plan, and (iii) decreases in miscellaneous non-tax revenues, excise taxes on tobacco products and other items due to current economic conditions. These results are consistent with the Government's expectation that the decrease in General Fund net revenues as a result of the implementation of the tax reform would be offset by the temporary excise tax imposed on certain foreign persons by Act No. 154.

Preliminary sales and use tax collections for the first nine months of fiscal year 2012 were \$855.9 million, an increase of \$20.5 million, or 2.5%, from the sales and use tax collections for the same period in the prior fiscal year. A portion of the sales and use tax is allocated to COFINA and, thus, is not available to the General Fund. See "Major Sources of General Fund Revenues — Sales and Use Taxes" under PUERTO RICO TAXES, OTHER REVENUES AND EXPENDITURES.

Preliminary General Fund total expenses (on a cash basis) for the first nine months of fiscal year 2012 amounted to \$6.191 billion. This amount excludes an estimated \$223 million in expenses related to the Department of Education Schoolwide Program that have not yet been registered in the central government accounting system. These expenses must be allocated by school according to the matching formula approved by the United States federal government before they are reflected in the central government accounting system. If the expenses related to the Department of Education Schoolwide Program are included, preliminary General Fund total expenses (on a cash basis) for the first nine months of fiscal year 2012 amounted to \$6.414 billion, or 69% of budgeted expenditures for fiscal year 2012, which are \$9.260 billion.

The deficit for fiscal year 2012 is projected to be approximately \$610 million, excluding certain principal and interest payments on Commonwealth general obligation bonds and Commonwealth guaranteed PBA Bonds that were refinanced through GDB financings, which financings were, or are expected to be, repaid from the proceeds of Commonwealth general obligation bonds and PBA Bonds. See "Fiscal Stabilization Plan" above. This deficit is the same amount that had been budgeted at the beginning of the fiscal year. The Office of Management and Budget ("OMB") has indicated that no budget overruns are anticipated and that total expenses for fiscal year 2012 are not expected to exceed the budget of \$9.260 billion.

Preliminary General Fund Revenues for the First Ten Months of Fiscal Year 2012. Preliminary General Fund net revenues for the first ten months of fiscal year 2012 (from July 1, 2011 to April 30, 2012) were \$6.846 billion, an increase of \$455 million, or 7.1%, from \$6.391 billion of net revenues for the same period in the prior fiscal year. These revenues represent 79% of budgeted revenues of \$8.650 billion for the fiscal year, and are \$141 million, or 2.0%, less than budgeted for the period.

Preliminary sales and use tax collections for the first ten months of fiscal year 2012 were \$954 million, an increase of \$27 million, or 2.9%, from the sales and use tax collections for the same period in the prior fiscal year.

Proposed Budget for Fiscal Year 2013. On April 24, 2012, the Governor submitted to the Legislature a proposed budget for fiscal year 2013. The proposed budget provides for General Fund total revenues and other resources and total expenditures of \$9.083 billion (including proceeds from COFINA), which is \$177 million, or 1.9%, lower than projected General Fund total revenues and other resources and total expenditures of \$9.260 billion for fiscal year 2012. General Fund total revenues and other resources in the proposed budget includes estimated revenues of \$8.750 billion and \$333 million of additional resources from COFINA and other sources, compared to \$8.650 billion of projected revenues and \$610 million of additional resources from COFINA bond issues for fiscal year 2012. Additional resources of \$333 million to cover fiscal year 2013 deficit consists of the release of approximately \$233 million deposited in a contingency fund created in 2010 to cover potential collateral postings on the Commonwealth's outstanding swap portfolio and an additional \$100 million from the projected issuance of COFINA capital appreciation bonds. The release of moneys from the contingency fund results from the significant reduction in the Commonwealth's outstanding swap portfolio (from \$9.2 billion as of June 30, 2008 to \$4.6 billion as of March 31, 2012) due to the refinancing of variable rate debt and mandatory tender bonds and the termination of the associated swaps.

The fiscal year 2013 proposed expenditures exclude certain debt service payments on the Commonwealth's general obligation bonds and Commonwealth guaranteed PBA bonds in the aggregate amount of \$745 million, which are expected to be refinanced during fiscal year 2013. The fiscal year 2013 proposed expenditures also exclude certain expenditures that were due in fiscal year 2013 related to central government accounts payable with public corporations that were being paid through a multi-year payment plan established in calendar year 2009 but that are expected to be paid during fiscal year 2012 from available moneys resulting from the refinancing of approximately \$148.3 million of debt service on the Commonwealth's general obligation bonds in excess of the \$537.7 million originally contemplated as part of the fiscal year 2012 budget. This payment eliminates the amounts payable to PREPA and PRASA under the multi-year payment plan and substantially reduces the amounts remaining to be paid under the plan. See "Fiscal Stabilization Plan" above.

Unfunded Pension and Non-Pension Post-Employment Benefit Obligations and Funding Shortfalls of the Retirement Systems.

One of the challenges every administration has faced during the past 20 years is how to address the growing unfunded pension benefit obligations and funding shortfalls of the three

Government retirement systems (the Employees Retirement System, the Teachers Retirement System and the Judiciary Retirement System) that are funded principally with budget appropriations from the Commonwealth's General Fund. As of June 30, 2011, the date of the latest actuarial valuations of the retirement systems, the unfunded actuarial accrued liability (including basic and system administered benefits) for the Employees Retirement System, the Teachers Retirement System and the Judiciary Retirement System was \$23.7 billion, \$9.1 billion and \$319 million, respectively, and the funded ratios were 6.8%, 20.8% and 16.7%, respectively.

Based on current employer and member contributions to the retirement systems, the unfunded actuarial accrued liability will continue to increase significantly, with a corresponding decrease in the funded ratio, since the annual contributions are not sufficient to fund pension benefits, and thus, are also insufficient to amortize the unfunded actuarial accrued liability. Because annual benefit payments and administrative expenses of the retirement systems have been significantly larger than annual employer and member contributions, the retirement systems have been forced to use investment income, borrowings and sale of investment portfolio assets to cover funding shortfalls. The funding shortfall (basic system benefits, administrative expenses and debt service in excess of contributions) for fiscal year 2011 for the Employees Retirement System, the Teachers Retirement System and the Judiciary Retirement System was approximately \$693 million, \$268 million and \$6.5 million, respectively. For fiscal year 2012, the funding shortfall is expected to be \$741 million, \$287 million and \$8.5 million, respectively. As a result, the assets of the retirement systems are expected to continue to decline.

Based on the assumptions used in the latest actuarial valuations, including the expected continued funding shortfalls, and considering the increases in employer contributions to the Employees Retirement System and the Teachers Retirement System: (i) the Employees Retirement System, the largest of the three retirement systems, would deplete its net assets (total assets less liabilities, including the principal amount of certain pension obligation bonds) by fiscal year 2014 and its gross assets by fiscal year 2020; (ii) the Teachers Retirement System would deplete its net and gross assets by fiscal year 2022; and (iii) the Judiciary Retirement System would deplete its net and gross assets by fiscal year 2019. The estimated years for depletion of the assets could vary depending on how actual results differ from the assumptions used in the actuarial valuations, as well as based on any future changes to the contribution and benefits structures of the retirement systems.

Since the Commonwealth and other participating employers are ultimately responsible for any funding deficiency in the three retirement systems, the depletion of the assets available to cover retirement benefits will require the Commonwealth and other participating employers to cover annual funding deficiencies. It is estimated that the Commonwealth would be responsible for approximately 74% of the combined annual funding deficiency of the three retirement systems, with the balance being the responsibility of the municipalities and participating public corporations.

The Commonwealth also provides non-pension post-employment benefits that consist of a medical insurance plan contribution. These benefits, which amounted to \$114.2 million for fiscal year 2010 and \$125.4 million for fiscal year 2011, are funded on a pay-as-you-go basis from the General Fund and are valued using actuarial principles similar to the way that pension benefits are calculated. Based on the latest actuarial valuations, as of June 30, 2011, the

aggregate unfunded actuarial accrued liability of these benefits for the three retirement systems was \$2.7 billion.

Because of its multi-year fiscal imbalances previously mentioned, the Commonwealth has been unable and is currently unable to make the actuarially recommended contributions to the retirement systems. If the Commonwealth fails to take action in the short-term to address the retirement systems' funding deficiency, the continued use of investment assets to pay benefits as a result of funding shortfalls and the resulting depletion of assets could adversely affect the ability of the retirement systems to meet the rates of return assumed in the actuarial valuations, which could in turn result in an earlier depletion of the retirement systems' assets and a significant increase in the unfunded actuarial accrued liability. Ultimately, since the Commonwealth's General Fund is required to cover a significant amount of the funding deficiency, the Commonwealth would have difficulty funding the annual required contributions unless it implements significant reforms to the retirement systems, obtains additional revenues, or takes other budgetary measures. For more information regarding the retirement systems, see RETIREMENT SYSTEMS.

In order to address the growing unfunded pension and non-pension benefit obligations and funding shortfalls of the three Government retirement systems, in February 2010, the Governor established a special commission to make recommendations for improving the financial solvency of the retirement systems. The special commission submitted a report to the Governor on October 21, 2010.

As a result of the special commission's report and the Government's analysis, the Governor submitted two bills to the Legislative Assembly to address in part the retirement systems' financial condition. One of such bills was enacted as Act No. 96 of June 16, 2011 ("Act 96"). On June 23, 2011, in accordance with Act 96, \$162.5 million of funds on deposit in the Corpus Account of the Puerto Rico Infrastructure Development Fund (the "Corpus Account"), which is under the custody and control of the Puerto Rico Infrastructure Financing Authority ("PRIFA") (see "Infrastructure Financing Authority" under PUBLIC CORPORATIONS for a description of the Corpus Account), were contributed to the Employees Retirement System and invested in capital appreciation bonds issued by COFINA maturing annually on August 1, 2043 through 2048 and accreting interest at a rate of 7%. The principal amount of the COFINA bonds will grow to an aggregate amount of approximately \$1.65 billion at their maturity dates.

The second bill submitted by the Governor was enacted as Act No. 114 of July 5, 2011 ("Act 114") and Act No. 116 of July 6, 2011 ("Act 116"). These Acts provide an increase in employer contributions to the Employee Retirement System and the Teachers Retirement System of 1% of covered payroll in each of the next five fiscal years and by 1.25% of covered payroll in each of the following five fiscal years. As a result of these increases, the Employee Retirement System and the Teachers Retirement System would receive approximately \$36 million and \$14 million, respectively, in additional employer contributions during fiscal year 2012, and the additional employer contributions are projected to increase gradually each fiscal year (by an average aggregate increase of \$71 million per fiscal year) to approximately \$494 million and \$195 million, respectively, by fiscal year 2021. The additional employer contributions for fiscal year 2012 have been included in the approved budget for such fiscal year. With respect to the

increases in the employer contributions corresponding to the municipalities, Act 116 provides that the increases for fiscal years 2012, 2013 and 2014 will be paid for by the Commonwealth from the General Fund budget, representing approximately \$6.3 million, \$12.8 million and \$19.7 million in fiscal years 2012, 2013 and 2014, respectively.

In addition to these measures, on August 8, 2011, the Board of Trustees of the Employees Retirement System adopted a new regulation regarding the rules relating to the concession of personal loans to its members, which, among other changes, lowers the maximum amount of those loans from \$15,000 to \$5,000. This change is expected to improve gradually the Employees Retirement System's liquidity.

Economic Reconstruction Plan

In fiscal year 2009, the Government began to implement a short-term economic reconstruction plan. The cornerstone of this plan was the implementation of federal and local economic stimulus programs. The Commonwealth was awarded approximately \$7.1 billion in stimulus funds under the American Recovery and Reinvestment Act of 2009 ("ARRA") program, which was enacted by the U.S. government to stimulate the U.S. economy in the wake of the global economic downturn. Approximately \$3.3 billion of the ARRA funds is allocated for consumer and taxpayer relief and the remainder will be used to expand unemployment and other social welfare benefits, and spending in education, healthcare and infrastructure, among others. As of May 11, 2012, approximately \$6.1 billion in ARRA funds had been disbursed, representing approximately 86% of awarded funds.

The Government has complemented the federal stimulus package with additional short and medium-term supplemental stimulus measures that seek to address local economic challenges and provide investment in strategic areas. These measures included a local \$500 million economic stimulus plan to supplement the federal plan.

Economic Development Plan

The Government has also developed the Strategic Model for a New Economy, which is a comprehensive long-term economic development plan aimed at improving Puerto Rico's overall competitiveness and business environment and increasing private-sector participation in the Puerto Rico economy. As part of this plan, the Government enacted Act No. 161 of December 1, 2009, which overhauled the permitting and licensing process in Puerto Rico in order to provide for a leaner and more efficient process that fosters economic development. The Government also enacted Acts No. 82 and 83 of July 19, 2010, which provided a new energy policy that seeks to lower energy costs and reduce energy-price volatility by reducing Puerto Rico's dependence on fuel oil and the promotion of diverse, renewable-energy technologies. Moreover, the Government adopted a comprehensive tax reform (described below) that takes into account the Commonwealth's current financial situation. See "Tax Reform" below.

In addition, to further stimulate economic development and cope with the fiscal crisis, on June 8, 2009, the Legislative Assembly approved Act No. 29 establishing a clear public policy and legal framework for the establishment of public-private partnerships ("PPP") to finance and develop infrastructure projects and operate and manage certain public assets. During fiscal year

2010, the Government engaged various financial advisors to assist it in the evaluation and procurement of various projects in the energy, transportation, water and public school infrastructure sectors. During the fourth quarter of fiscal year 2010, the Government published desirability studies for four public-private partnership priority projects and commenced procurement for such projects. As of September 30, 2011, the Government had completed the concession of toll roads PR-22 and PR-5 and had short-listed proponents for the procurement process leading to the award of an administrative concession of the Luis Muñoz Marín International Airport and school infrastructure projects.

The Government has also identified strategic initiatives to promote economic growth in various sectors of the economy where the Commonwealth has competitive advantages and several strategic/regional projects aimed at fostering balanced economic development throughout the Island. These projects, some of which are ongoing, include tourism and urban redevelopment projects.

The fiscal stabilization plan, the economic reconstruction plan, and the long-term economic development plan are described in further detail below in “Fiscal Stabilization and Economic Reconstruction” under THE ECONOMY.

Tax Reform

In February 2010, the Governor established a committee to review the Commonwealth’s income tax system and propose a comprehensive tax reform directed at promoting economic growth and job creation within the framework of preserving the administration’s path towards achieving fiscal stability. The committee presented its findings to the Governor and, on October 25, 2010, the Governor announced that he was submitting to the Legislative Assembly various bills in order to implement the tax reform.

The tax reform was intended to be revenue positive. It consisted of two phases focused on providing tax relief to individuals and corporations, promoting economic development and job creation, simplifying the tax system and reducing tax evasion through enhanced tax compliance measures. The first phase, enacted as Act No. 171 of November 15, 2010, was expected to provide individual and corporate taxpayers with aggregate savings of \$309 million for taxable year 2010. The second phase, enacted as Act No. 1 of January 31, 2011 (“Act 1 of 2011”), was projected to provide individual and corporate taxpayers aggregate annual average savings of \$1.2 billion for the next six taxable years, commencing in taxable year 2011. Consistent with the objective of maintaining the path towards fiscal stability, the tax relief provisions applicable to individuals and corporations for taxable years 2014 through 2016 become effective only if (i) OMB certifies that the administration’s expense control target has been met, (ii) the Treasury Department certifies that the General Fund revenue target has been met and (iii) the Planning Board certifies a year-over-year target increase in gross domestic product. See “Major Sources of General Fund Revenues—Tax Reform” under PUERTO RICO TAXES, OTHER REVENUES AND EXPENDITURES for a summary of the principal provisions of the tax reform.

As part of structuring the tax reform, the Government utilized a group of economic consultants to project its impact on tax revenues through the use of dynamic economic models

adjusted to the Commonwealth's specific economic conditions. The Government also conducted its own internal analyses of such impact. Based on these analyses, the Government expects that the reduction in income tax revenues resulting from the implementation of the tax reform should be fully offset by the additional revenues produced by (i) enhanced tax compliance measures, (ii) the elimination of certain incentives and tax credits, (iii) a new temporary excise tax imposed on a controlled group member's acquisition from another group member of certain personal property manufactured or produced in Puerto Rico and certain services performed in Puerto Rico (at a declining rate from 4% for 2011 to 1% for 2016), and (iv) an expansion of taxation rules that characterize certain income of non-resident corporations, partnerships and individuals as effectively connected with the conduct of a trade or business in Puerto Rico and therefore subject to Puerto Rico income tax. The temporary excise tax and the expansion of the taxation of certain foreign persons were adopted by Act 154. In circumstances in which the temporary excise tax applies, the expansion of the taxation of nonresident individuals, foreign corporations and foreign partnerships does not apply. The other revenue enhancement measures, which are part of the second phase of the tax reform, are included in Act 1 of 2011. On December 29, 2010, the Treasury Department adopted regulations that provide certain tax credits against the temporary excise tax that lessen its impact on affected taxpayers subject to the temporary excise tax. These regulations became effective on January 1, 2011. The regulations address implementation and interpretation issues and include provisions regarding certain applicable credits against the tax subject to maintaining a baseline employment and other conditions. The Government estimates that this excise tax will affect foreign corporations or partnerships that are principally engaged in the manufacturing of pharmaceuticals and electronics. The Government expected to raise approximately \$1.4 billion from the excise tax during the first year of implementation of Act 154 and expects to raise \$5.6 billion for the six-year period that the excise tax is in place.

The first monthly excise tax payment was due in February 2011. For fiscal year 2011 (from February 2011 through June 2011), the collections from the excise tax were \$677.6 million. For the first nine months of fiscal year 2012, the collections from the excise tax were \$1.379 billion. These amounts have exceeded the Government's projection of collections from the excise tax and are consistent with the Government's expectation that the revenues therefrom would be sufficient to offset the reduction in income tax revenues expected from other aspects of the tax reform.

In connection with the expansion of the taxation of foreign persons by Act 154, the Government obtained a legal opinion regarding the creditability of the excise tax for U.S. federal income tax purposes. The opinion concludes that this excise tax should be creditable against U.S. federal income tax. That conclusion was based in part upon a determination that the expansion of the taxation of foreign persons and the imposition of the excise tax more likely than not satisfy the constitutional requirements of due process and the Commerce Clause of the United States Constitution, for reasons discussed therein. It is the position of the Government that the excise tax is a tax imposed in substitution of the generally imposed income tax and that, as such, under Section 903 of the United States Internal Revenue Code of 1986, as amended, U.S. taxpayers can claim a foreign tax credit for amounts paid.

On March 30, 2011, the United States Internal Revenue Service (the "IRS") issued Notice 2011-29 addressing the creditability of the new excise tax imposed by Act 154. Notice 2011-29 provides that the provisions of the new Puerto Rico excise tax are novel and the

determination of its creditability requires the resolution of a number of legal and factual issues. Pending the resolution of those issues, the IRS will not challenge a taxpayer's position that the excise tax is a tax in lieu of an income tax under Section 903. The IRS also provided that any change in the foregoing tax credit treatment of the excise tax after resolution of the pending issues will be prospective and will apply to excise tax paid or accrued after the date that further guidance is issued.

Act 154 has not been challenged in court. Consequently, no court has passed on the constitutionality of Act 154. There can be no assurance that its constitutionality will not be challenged and that, if challenged, the courts will uphold Act 154. To the extent a court determines that the imposition of the excise tax or the expansion of the income tax or both are unconstitutional, the Government's revenues may be materially adversely affected.

For a summary of the principal provisions of the tax reform, the expansion of the income tax source rules to certain nonresident alien individuals, foreign corporations and foreign partnerships, and the new temporary excise tax, see "Major Sources of General Fund Revenues — Tax Reform" and "Major Sources of General Fund Revenues — Income Taxes," respectively, under PUERTO RICO TAXES, OTHER REVENUES AND EXPENDITURES.

Ratings of Commonwealth General Obligation Bonds

On June 6, 2012, Standard & Poor's Rating Services, a Standard & Poor's Financial Services LLC company ("S&P"), affirmed its "BBB" rating on the Commonwealth of Puerto Rico's general obligation debt and revised its outlook on the Commonwealth of Puerto Rico's general obligation debt ratings from stable to negative. On March 7, 2011, S&P had raised its rating on the Commonwealth's unenhanced general obligation bonds to "BBB" with a stable outlook from "BBB-" with a positive outlook.

On June 5, 2012, Moody's Investors Service ("Moody's") reaffirmed its rating of "Baa1" with a negative outlook on the Commonwealth's unenhanced general obligation bonds. On August 8, 2011, Moody's had lowered its rating on the Commonwealth's unenhanced general obligation bonds to "Baa1" with a negative outlook from "A3". This rating action was a result of Moody's review of the Commonwealth's rating, which had been placed on watchlist on May 3, 2011.

On June 5, 2012, Fitch, Inc. ("Fitch") reaffirmed its rating of "BBB+" with a stable outlook on the Commonwealth's general obligation and appropriation debt. On January 19, 2011, Fitch had assigned a "BBB+" rating to the Commonwealth's general obligation and appropriation debt with a stable outlook.

The ratings reflect only the opinions of such rating agencies and an explanation of the significance of such ratings may be obtained only from the relevant rating agency.

Geographic Location and Demographic Trends

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

According to the United States Census Bureau, the population of Puerto Rico was 3,725,789 in 2010, compared to 3,808,610 in 2000. The population of San Juan, the island's capital and largest city, was 381,931 in 2010 compared to 434,374 in 2000.

Relationship with the United States

Puerto Rico's constitutional status is that of a territory of the United States, and, pursuant to the territorial clause of the U.S. Constitution, the ultimate source of power over Puerto Rico is the U.S. Congress.

Puerto Rico came under United States sovereignty pursuant to the Treaty of Paris, signed on December 10, 1898, which ended the Spanish-American War. Puerto Ricans have been citizens of the United States since 1917. In 1950, after a long evolution toward greater self-government, Congress enacted Public Law 600, which provided that the existing political, economic and fiscal relationship between Puerto Rico and the United States would remain the same, but Puerto Rico would be authorized to draft and approve its own Constitution, guaranteeing a republican form of government. The Constitution was drafted by a popularly elected constitutional convention, approved in a special referendum by the people of Puerto Rico, amended and ratified by the U.S. Congress, and subsequently approved by the President of the United States.

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

The official languages of Puerto Rico are Spanish and English.

Governmental Structure

The Constitution of Puerto Rico provides for the separation of powers of the executive, legislative, and judicial branches of government. The Governor is elected every four years. The Legislative Assembly consists of a Senate and a House of Representatives, the members of which are elected for four-year terms. The highest court within the local jurisdiction is the Supreme Court of Puerto Rico. Decisions of the Supreme Court of Puerto Rico may be appealed to the Supreme Court of the United States under the same conditions as decisions from state courts. Puerto Rico constitutes a District in the federal judiciary and has its own United States District Court. Decisions of this court may be appealed to the United States Court of Appeals for the First Circuit and from there to the Supreme Court of the United States.

Governmental responsibilities assumed by the central government of the Commonwealth are similar in nature to those of the various state governments. In addition, the central

government assumes responsibility for local police and fire protection, education, public health and welfare programs, and economic development.

Principal Officers Responsible for Fiscal Matters

Luis G. Fortuño was sworn in as Governor of Puerto Rico on January 2, 2009. From 2005 until becoming Governor, Mr. Fortuño was Puerto Rico's elected Resident Commissioner in the U.S. House of Representatives. Mr. Fortuño was an attorney in private practice from 1985 to 1993, and again from 1997 to 2003. Mr. Fortuño was the Executive Director of the Tourism Company from 1993 to 1996. From 1994 to 1996, Mr. Fortuño served as the first Secretary of the Department of Economic Development and Commerce. Mr. Fortuño holds a Bachelor's Degree from the Edmund A. Walsh School of Foreign Service at Georgetown University and a Juris Doctor from the University of Virginia School of Law.

Jesús F. Méndez was designated Secretary of the Treasury Department on January 7, 2011 and confirmed by the Senate of Puerto Rico on January 24, 2011. Prior to his appointment, Mr. Méndez served as Executive Vice President and Director of Administration, Operation and Controllorship of GDB and as Executive Director of PBA. From 2005 to 2008, Mr. Méndez held the position of President and Chief Executive Officer of Tresamici Management, Inc., a closely held corporation dedicated to the administration of assisted living facilities. From 1996 to 2004, he held several senior management positions within Banco Santander S.A. operating entities in Puerto Rico, including President of Santander Asset Management and First Senior Vice President and Trust Officer of Banco Santander Puerto Rico and Managing Director of Santander Securities Corporation. Prior to joining Santander Securities, Mr. Méndez served as Chief Financial Officer and Managing Director of BP Capital Markets. He also worked for Credit Suisse First Boston (Puerto Rico, Inc.) as Vice President and Deloitte & Touche as Senior Auditor. In addition, Mr. Méndez also held the position of Assistant Bank Examiner at the Federal Deposit Insurance Corporation in New York City. Mr. Méndez has a Bachelor's Degree in Business Administration from the University of Puerto Rico and is a Certified Public Accountant.

Juan Carlos Pavía was appointed Director of OMB on February 16, 2011. Prior to his appointment as Director of OMB, Mr. Pavía was Executive Vice President and Fiscal Agent of GDB as well as Executive Director of the Fiscal Stabilization and Reconstruction Board, where he was responsible for the compliance, oversight and economic studies areas of GDB. Before being named Executive Vice President and Fiscal Agent of GDB, he was a senior advisor to the President of GDB and Deputy Advisor to the Governor. Prior to entering public service, Mr. Pavía was employed in the commercial banking field. Mr. Pavía earned a bachelor's degree in Business Administration from The George Washington University in Washington D.C.

Juan Carlos Batlle was appointed President of GDB effective March 2, 2011. Prior to his appointment, Mr. Batlle served 14 years as a top executive for Santander Group in Puerto Rico. As part of the Investment Banking Group of Santander Securities Corporation, he served consecutively as Assistant Vice President in 1999, Vice President in 2001, and Senior Vice President and Director in 2003. In 2005, Mr. Batlle was named First Senior Vice President of Banco Santander Puerto Rico and President and Chief Executive Officer of Santander Asset Management Corporation. In 2008, Mr. Batlle was named Managing Director of Santander

Securities Corporation. Prior to joining Santander in 1997, Mr. Batlle was employed by Popular Securities, Inc. Mr. Batlle has also been a member of the Boards of Directors of Santander Securities Corporation, Santander Asset Management Corporation and the First Puerto Rico Family of Funds. In addition, he has been a member of the Boards of Directors of the Puerto Rico Tourism Company, the Convention Center District Authority and the Hotel Development Corporation. He holds a degree in Economics from the College of Literature, Science and the Arts of the University of Michigan.

Political Trends

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

	<u>1992</u>	<u>1996</u>	<u>2000</u>	<u>2004</u>	<u>2008</u>
New Progressive Party	49.9%	51.1%	45.7%	48.2%	52.8%
Popular Democratic Party	45.9%	44.5%	48.6%	48.4%	41.3%
Puerto Rico Independence Party	4.2%	3.8%	5.2%	2.7%	2.0%
Others, Blank or Void	-	0.5%	0.5%	0.6%	3.9%

With the results of the 2008 election, the New Progressive Party gained control of the Executive Branch and retained control of the Legislative Branch. The current membership of the Senate and House of Representatives by political party is as follows:

	<u>Senate</u>	<u>House</u>
New Progressive Party	21	37
Popular Democratic Party	8	17
Total	<u>29</u>	<u>54</u>

The next general election (gubernatorial, municipal, and legislative) in Puerto Rico will be held in November 2012.

THE ECONOMY

General

The Commonwealth in the past has established policies and programs directed principally at developing the manufacturing and service sectors and expanding and modernizing the Commonwealth's infrastructure. Domestic and foreign investments have historically been

stimulated by selective tax exemptions, development loans, and other financial and tax incentives. Infrastructure expansion and modernization have been to a large extent financed by bonds and notes issued by the Commonwealth, its public corporations, and municipalities. Economic progress has been aided by significant increases in the levels of education and occupational skills of the population.

Puerto Rico's economy experienced a considerable transformation during the second half of the twentieth century, from an agriculture economy to an industrial one. Factors contributing to this transformation included government-sponsored economic development programs, increases in the level of federal transfer payments, and the relatively low cost of borrowing. In some years, these factors were aided by a significant rise in construction investment driven by infrastructure projects, private investment, primarily in housing, and relatively low oil prices. Nevertheless, the significant oil price increases experienced from January 2002 to June 2008, the continuous contraction of the manufacturing sector, and the budgetary pressures on government finances triggered a general contraction in the economy.

Puerto Rico's economy entered a recession in the fourth quarter of fiscal year 2006, a fiscal year in which the real gross national product grew by only 0.5% and the government was shut-down during the first two weeks of May. For fiscal years 2007, 2008, 2009 and 2010, the real gross national product contracted by 1.2%, 2.9%, 3.8% and 3.4%, respectively. For fiscal year 2011, preliminary reports indicate that the real gross national product contracted by 1.5%. The Planning Board projects an increase in real gross national product of 0.9% for fiscal year 2012 and an increase of 1.1% for fiscal year 2013.

Nominal personal income, both aggregate and per capita, has shown a positive average growth rate from 1947 to 2011. In fiscal year 2011, aggregate personal income was \$59.4 billion (\$48.9 billion at 2005 prices) and personal income per capita was \$15,995 (\$13,157 in 2005 prices). Personal income includes transfer payments to individuals in Puerto Rico under various social programs. Total U.S. federal transfer payments to individuals amounted to \$15.6 billion in fiscal year 2011 (\$15.4 billion in fiscal year 2010). Entitlements for previously performed services or resulting from contributions to programs such as Social Security, Veterans' Benefits, Medicare, and U.S. Civil Service retirement pensions were \$10.9 billion, or 70% of the transfer payments to individuals in fiscal year 2011 (\$10.6 billion, or 69.2%, in fiscal year 2010). The remainder of the federal transfers to individuals is represented by grants, mostly concentrated in the Nutritional Assistance Program (Food Stamps) and Pell Grant scholarships (higher education).

Total average annual employment (as measured by the Puerto Rico Department of Labor and Human Resources Household Employment Survey, known as the "Household Survey") decreased during the last decade. From fiscal year 2000 to fiscal year 2011, total employment decreased at an average annual rate of 0.6%, from 1,150,291 to 1,077,006. A reduction in total employment began in the fourth quarter of fiscal year 2006 and has continued consistently through fiscal year 2011 due to the current recession and the fiscal adjustment measures. During the first ten months of fiscal year 2012, however, total employment has shown moderate signs of improvement based on an average growth rate of 0.5% as compared to the same period for the prior fiscal year.

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

The following table shows the Puerto Rico gross national product for the five fiscal years ended June 30, 2011, compared to the annual percentage increase in real gross national product in the United States.

**Commonwealth of Puerto Rico
Gross National Product
Fiscal Years Ended June 30,**

	<u>2007</u>	<u>2008</u>	<u>2009</u>	<u>2010</u>	<u>2011⁽¹⁾</u>
Gross national product (PR) – \$ millions ⁽²⁾	\$59,521	\$61,665	\$62,598	\$63,058	\$64,106
Real gross national product (PR) – \$ millions (2005 prices)	\$53,400	\$51,832	\$49,885	\$48,195	\$47,488
Annual percentage increase (decrease) in real gross national product (PR) (2005 prices)	(1.2)%	(2.9)%	(3.8)%	(3.4)%	(1.5)%
U.S. annual percentage increase in real gross national product (2005 prices)	1.7%	2.5%	(3.5)%	0.4%	2.9%

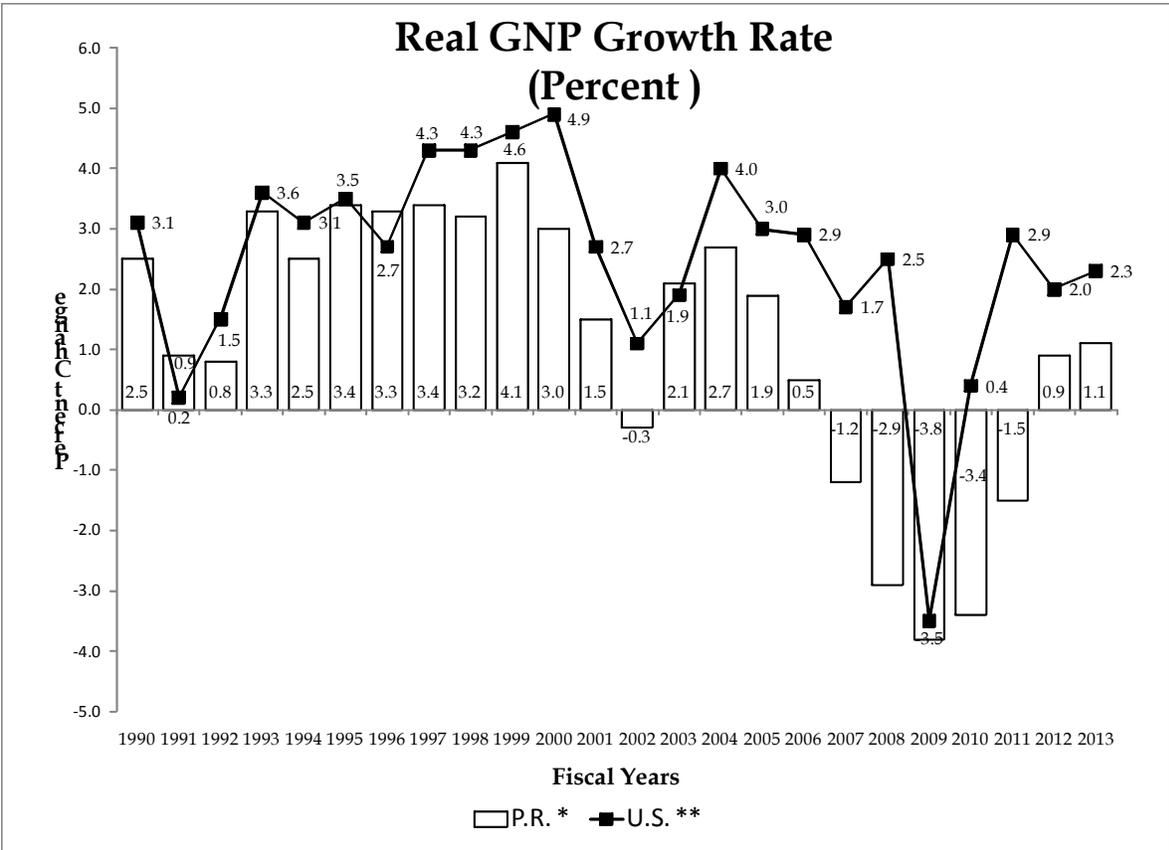
⁽¹⁾ Preliminary.

⁽²⁾ In current dollars.

Sources: Puerto Rico Planning Board and IHS-Global Insight.

The economy of Puerto Rico is closely linked to the United States economy, as most of the external factors that affect the Puerto Rico economy (other than oil prices) are determined by the policies and performance of the mainland economy. These external factors include exports, direct investment, the amount of federal transfer payments, the level of interest rates, the rate of inflation, and tourist expenditures. During fiscal year 2011, approximately 70.7% of Puerto Rico's exports went to the United States mainland, which was also the source of approximately 46.1% of Puerto Rico's imports. In fiscal year 2011, Puerto Rico experienced a positive merchandise trade balance of \$20.2 billion.

The following graph compares the growth rate of real gross national product for the Puerto Rico and U.S. economies since fiscal year 1990, and the forecast of the growth rate for fiscal years 2012 and 2013.



* Estimate for Puerto Rico from the Puerto Rico Planning Board (Apr-2012).

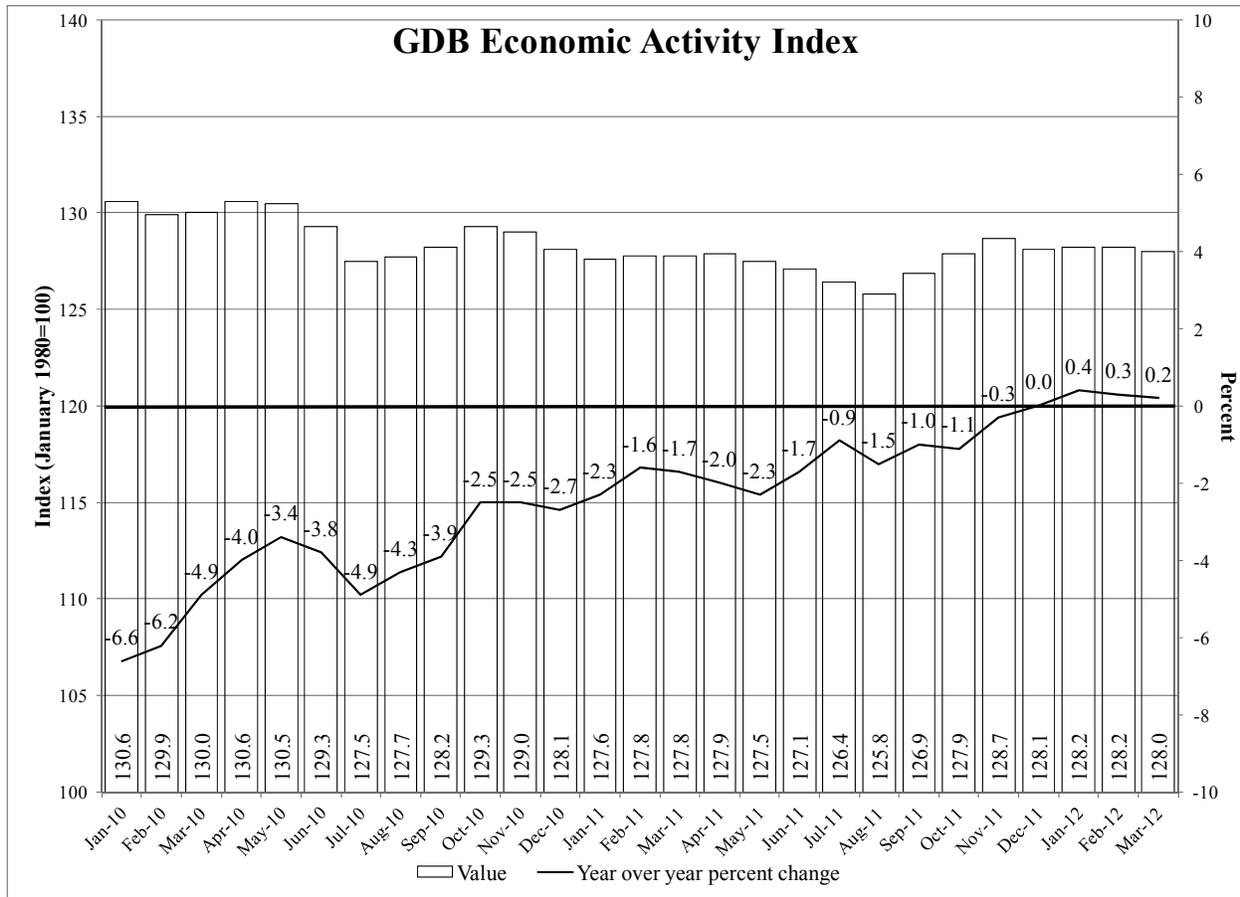
** Estimate for U.S. from IHS-Global Insight (Apr-2012).

Sources: Puerto Rico Planning Board & IHS-Global Insight.

Since the 1950s, the Planning Board has prepared a complete set of macroeconomic measures like those prepared for the United States by the Bureau of Economic Analysis (“BEA”) of the Department of Commerce, as part of the National Income and Product Accounts (“NIPA”). In contrast with the BEA, which computes the economic accounts on a quarterly basis, the Planning Board computes Puerto Rico’s NIPA on an annual basis. Like the BEA, the Planning Board revises its statistics on a regular basis. The Planning Board classifies its statistics as preliminary until they are revised and made final in conjunction with the release of new data each year. Thus, all macroeconomic accounts for fiscal year 2011 shown in this Report are preliminary until the revised figures for fiscal year 2011 and the preliminary figures of fiscal year 2012 are released and the forecast for fiscal year 2013 is revised.

Certain information regarding current economic activity, however, is available in the form of the Government Development Bank – Economic Activity Index (the “EAI”), a coincident indicator of ongoing economic activity. This index, shown in the following table and published by GDB since October 2009, is composed of several variables (total payroll employment based on the Establishment Survey, total electric power consumption, cement sales and consumption of gasoline) that highly correlate to Puerto Rico’s real gross national product. The average contraction rate of the index for fiscal year 2011 was 2.7%, after a reduction of 5.6% for fiscal year 2010. For the first three quarters of fiscal year 2012, the EAI decreased by 0.4%. In the third quarter of fiscal year 2012, however, the EAI increased at an average rate of

0.3% compared to the same period for the prior fiscal year. This increase is the first quarterly increase since the third quarter of fiscal year 2006.



Economic Forecast for Fiscal Years 2012 and 2013

On April 2012, the Planning Board released its revised gross national product forecast for fiscal year 2012 and its gross national product forecast for fiscal year 2013. The Planning Board revised its gross national product forecast for fiscal year 2012 from a projected growth of 0.7% to 0.9%, both in constant dollars. The Planning Board’s revised forecast for fiscal year 2012 took into account the estimated effects on the Puerto Rico economy of the Government’s fiscal stabilization plan, the impact of the initial phase of the tax reform, the disbursement of funds from ARRA, the continuation of the fiscal stabilization plan, and the activity expected to be generated from the Government’s local stimulus package (particularly in public construction investment). The revised forecast also considered the effect on the Puerto Rico economy of general and global economic conditions, the U.S. economy, the volatility of oil prices, interest rates and the behavior of local exports, including expenditures by visitors. The Planning Board’s forecast for fiscal year 2013 projects an increase in gross national product of 1.1% in constant dollars. The Planning Board’s forecast for fiscal year 2013 took into account the estimated effect of the projected growth of the U.S. economy, tourism activity, personal consumption expenditures, federal transfers to individuals and the acceleration of investment in construction

due to the Government's local stimulus package (particularly in public construction investment) and the establishment of public-private partnerships. It also took into account the disbursement of the remaining ARRA funds, and the continuation of the implementation of the tax reform.

Fiscal Year 2011

The Planning Board's preliminary reports on the performance of the Puerto Rico economy for fiscal year 2011 indicate that real gross national product decreased 1.5% (an increase of 1.7% in current dollars) over fiscal year 2010. Nominal gross national product was \$64.1 billion in fiscal year 2011 (\$47.5 billion in 2005 prices), compared to \$63.1 billion in fiscal year 2010 (\$48.2 billion in 2005 prices). Aggregate personal income increased from \$58.9 billion in fiscal year 2010 (\$49.2 billion in 2005 prices) to \$59.4 billion in fiscal year 2011 (\$47.5 billion in 2005 prices), and personal income per capita increased from \$15,790 in fiscal year 2010 (\$13,177 in 2005 prices) to \$15,995 in fiscal year 2011 (\$13,157 in 2005 prices).

According to the Household Survey, total employment for fiscal year 2011 averaged 1,077,006, a decrease of 25,700, or 2.3%, from the previous fiscal year. The unemployment rate for fiscal year 2011 was 15.9%, a slight reduction from 16.0% for fiscal year 2010.

Among the variables that contributed to the decrease in gross national product were the continuous contraction of the manufacturing sector and the significant increase in the average price of the West Texas Intermediate (WTI) oil barrel, which went up from \$75.2/bbl in fiscal year 2010 to \$89.4/bbl, a rise of 18.9%. On the other hand, the interest rates at historically low levels were not enough incentive to jumpstart private investment.

Fiscal Year 2010

The Planning Board's reports on the performance of the Puerto Rico economy for fiscal year 2010 indicate that real gross national product decreased 3.4% (an increase of 0.7% in current dollars) over fiscal year 2009. Nominal gross national product was \$63.1 billion in fiscal year 2010 (\$48.2 billion in 2005 prices), compared to \$62.6 billion in fiscal year 2009 (\$49.9 billion in 2005 prices). Aggregate personal income increased from \$58.0 billion in fiscal year 2009 (\$49.3 billion in 2005 prices) to \$58.9 billion in fiscal year 2010 (\$48.2 billion in 2005 prices), and personal income per capita increased from \$15,467 in fiscal year 2009 (\$13,137 in 2005 prices) to \$15,790 in fiscal year 2010 (\$13,177 in 2005 prices).

According to the Household Survey, total employment for fiscal year 2010 averaged 1,102,700, a decrease of 65,500, or 5.6%, from the previous fiscal year. The unemployment rate for fiscal year 2010 was 16.0%, an increase from 13.4% for fiscal year 2009.

Among the variables contributing to the decrease in gross national product was the continuous contraction of the manufacturing and construction sectors. Due to the Commonwealth's dependence on oil for power generation and gasoline (in spite of some recent improvements in power-production diversification), the high level of oil prices accounted for an increased outflow of local income in fiscal year 2008, when the average price of the WTI increased by 53.1% to reach an average of \$97.0/bbl. Although the situation improved significantly during fiscal year 2009, with a decline of 28.1% in the price of the WTI, oil prices remained at relatively high levels, at an average of \$69.7/bbl, and the impact of the increases of

previous years were still felt in fiscal year 2009. Nevertheless, during fiscal year 2010, the average price of the WTI increased by 7.9% to \$75.2/bbl, which put more pressure on internal demand. Although the continuation of the difficulties associated with the financial crisis kept short-term interest rates at historically low levels, such low interest rates did not translate into a significant improvement in the construction sector due in part to the high level of inventory of residential housing units.

Fiscal Stabilization and Economic Reconstruction

In January 2009, the Government began to implement a multi-year Fiscal Stabilization Plan (the “Fiscal Plan”) and Economic Reconstruction Plan (the “Economic Plan”) that sought to achieve fiscal balance and restore economic growth. The Fiscal Plan was central to safeguarding the Commonwealth’s investment-grade credit rating and restoring Puerto Rico’s economic growth and development.

In addition, the administration designed and began to implement the *Strategic Model for a New Economy*, a series of economic development initiatives which aim to enhance Puerto Rico’s competitiveness and strengthen specific industry sectors. These economic development initiatives were intended to support the prospects of long-term and sustainable growth.

Fiscal Stabilization Plan

The Fiscal Plan had three main objectives: (i) stabilize the short-term fiscal situation, (ii) safeguard and strengthen the Commonwealth’s investment-grade credit rating, and (iii) achieve budgetary balance. The Fiscal Plan, which was generally contained in Act 7, included operating expense-reduction measures, tax revenue enforcement measures, temporary and permanent revenue raising measures, and financial measures, as discussed below.

Expense Reduction Measures. A significant portion of Puerto Rico’s budget deficit is attributable to the accumulated effect of high operating expenses in the government. The Fiscal Plan sought to reduce the government’s recurring expense base to make it consistent with the level of government revenues. The Fiscal Plan established a government-wide operating expense-reduction program aimed at reducing operating expenses, including payroll.

Payroll expense is the most significant component of the government’s recurring expense base. The reduction in payroll expenses contemplated by the Fiscal Plan was implemented in three phases and included certain benefits conferred to participating employees, as follows:

- *Phase I: Incentivized Voluntary Resignation and Voluntary Permanent Workday Reduction Programs:* The Incentivized Voluntary Resignation Program offered public employees a compensation incentive based on the time of service in the government. The Voluntary Permanent Workday Reduction Program was available to public employees with 20 or more years of service. The Workday Reduction Program consisted of a voluntary reduction of one regular workday every fifteen calendar days, which is equivalent to approximately a 10% reduction in annual workdays. Phase I commenced in March 2009 and public employees had until April 27, 2009 to submit the required information to participate in the voluntary programs available under Phase I and be eligible for the Public

Employees Alternatives Program. Under Phase I, 2,553 employees resigned under the Incentivized Voluntary Resignation Program and 27 employees took advantage of the Voluntary Permanent Workday Reduction Program. Based on the number of employees who agreed to participate in these programs, the administration estimates that expenses for fiscal year 2010 were reduced by \$90.9 million.

- Phase II: Involuntary Layoff Plan: As provided in Act 7, Phase II went into effect because the objective of reducing \$2 billion in expenses was not achieved after implementation of Phase I and Phase III (see below). Under Phase II, subject to certain exceptions, employees with transitory or non-permanent positions were terminated. As a result, 1,986 positions were eliminated, representing an estimated savings of \$44.6 million annually. In addition, Phase II provided for one or more rounds of involuntary layoffs and applied to most central government public employees unless excluded pursuant to Act 7, strictly according to seniority in public service, starting with employees with the least seniority. The plan excluded certain employees providing “essential” services, certain employees paid by federal funds, those on military leave, and political appointees and their trust employees (political appointees and their trust employees, who do not hold a permanent or career position in the government, are referred to herein as “non-career employees”). Employees in Phase II received a severance package that included health coverage payment for up to a maximum of six months or until the former public employee became eligible for health insurance coverage at another job. As of September 30, 2010, total government employees dismissed under Phase II (excluding the 1,986 transitory or non-permanent positions eliminated) was approximately 12,505, representing an estimated savings of \$322.8 million annually. This amount excludes approximately 1,784 employees rehired by the Department of Education as a result of an agreement with the union providing for certain salary and workday reductions and the inclusion of additional service requirements, among other things. The negotiation of this agreement by the administration resulted in annual savings of \$51 million, an increase of \$25 million over the estimated savings achievable through the termination of such employees.
- Phase III: Temporary Suspension of Certain Provisions of Laws, Collective Bargaining Agreements, and Other Agreements: Phase III went into effect on March 9, 2009 and imposed a temporary freeze on salary increases and other economic benefits included in laws, collective bargaining agreements, and any other agreements. Phase III remained in effect for a period of two years. The administration estimates that savings from the implementation of these measures was approximately \$186.9 million for fiscal year 2010.
- Public Employees Alternatives Program: The employees that elected to participate in the Incentivized Voluntary Resignation Program under Phase I or that were subject to involuntary layoffs under Phase II, were eligible to participate in the Public Employees Alternatives Program. This program assists public employees in their transition to other productive alternatives, and offers vouchers

for college education, technical education, and professional training, as well as for establishing a business and for relocation.

Act 7 extended the term of collective bargaining agreements with public employees that had expired at the time of its enactment or that expire while it is in effect for a period of two years (until March 9, 2011) and provided that during this period such collective bargaining agreements may not be renegotiated or renewed. Act No. 73 of May 17, 2011 (“Act 73”) extended the term of the non-economic clauses of such collective bargaining agreements for an additional period of two years (until March 9, 2013) and provided that the economic clauses may be negotiated considering primarily the fiscal condition of the applicable agency and the Government and the safeguarding of services to the people. Act 73 further provides that for the negotiation of any economic clauses, OMB must evaluate the current and projected fiscal condition of the applicable agency and the Government and issue a certification as to the available resources, if any, for such negotiations.

The following table summarizes the amount of employees affected by the workforce and labor related expense reduction measures included in Act 7 and the expected annual savings in operational expenses from the implementation of Phases I through III of the Fiscal Plan. The implementation of the workforce and labor related expense reduction measures included in Act 7 concluded on June 30, 2010.

Phase	Affected Employees	Savings (in millions)
Phase I: Voluntary Resignation	2,553	\$90.9
Phase II: Involuntary Layoffs		
Termination of transitory and non-permanent employees	1,986	44.6
Layoffs (as of April 30, 2010)	12,505	322.8
Phase III: Suspension of Certain Benefits	-	186.9
Total	17,044	\$645.2

The second element of the expense-reduction measures, which pertains to other operating expenses, was conducted through an austerity program in combination with other expense reduction measures. The austerity program mandated a 10% reduction in other operational expenses, including cellular phone use, credit cards, and official vehicles.

In July 2010, the Governor renewed an executive order issued in September 2009 requiring all agencies and public corporations to reduce, modify or cancel service contracts to achieve a cost reduction of at least 15%. The executive order covers advertising, consulting, information technology, accounting, legal and other services (except for direct services to the public), and grants the Fiscal Restructuring and Stabilization Board created under Act 7 (the “Fiscal Board”) the power to monitor agencies and public corporations in order to ensure the required 15% minimum cost reduction. Each agency or public corporation had 30 days to report the following to the Fiscal Board: (i) all service contracts currently in effect, (ii) all canceled and/or modified contracts and the corresponding savings, (iii) justification for any remaining contracts in light of the mission of the agency or public corporation, and (iv) the reasonableness of the fees or compensation terms for each remaining contract.

In July 2010, the Governor also renewed another executive order issued in September 2009 requiring all agencies and public corporations to report the following to the Fiscal Board within 30 days: (i) all lease contracts currently in effect, (ii) the uses of leased premises, (iii) the needs for such premises, (iv) the terms and conditions of each lease, and (v) budgeted amounts for rent and other related expenses. During fiscal year 2010, the administration achieved savings by, among other things, consolidating operations of one or more agencies or public corporations and renegotiating leases to obtain more favorable terms. The administration estimates annual savings as a result of the revision of all leases of at least 15% of rent and related expenses, or approximately \$22 million annually.

Tax Revenue Enforcement Measures. The Fiscal Plan also sought to increase tax revenues by implementing a more rigorous and ongoing tax enforcement and compliance strategy. Specific tax enforcement initiatives included: (i) enhancements to the administration of federal grants and fund receipts, (ii) stronger collections and auditing efforts on Puerto Rico's sales and use tax, and (iii) a voluntary tax compliance program.

Revenue Raising Measures. The goal of achieving fiscal and budgetary balance required a combination of measures that included the introduction of permanent and temporary tax increases. The Fiscal Plan included six temporary and four permanent revenue increasing measures. The temporary revenue increasing measures consisted of: (i) a 5% surtax on income of certain individuals, (ii) a 5% surtax on income of certain corporations, (iii) a 5% income tax on credit unions (commonly known as "cooperativas" in Puerto Rico), (iv) a 5% income tax on Puerto Rico international banking entities, (v) a special property tax on residential and commercial real estate, and (vi) a moratorium on certain tax credits. The temporary measures were initially set to be in effect for up to three fiscal years beginning in fiscal year 2010. Act 1 of 2011, however, limited the duration of the 5% surtax on income derived by certain individuals and corporations and the special property tax to two years. The permanent measures include (i) modifications to the alternative minimum tax for individuals and corporations, (ii) an increase in the excise tax on cigarettes, (iii) a new excise tax on motorcycles, and (iv) an increase in the excise tax on alcoholic beverages. The total revenues from these temporary and permanent measures for fiscal year 2010 were \$428 million. The total preliminary revenues from these temporary and permanent measures for fiscal year 2011 were \$450 million.

Financial Measures. The administration has also carried out several financial measures designed to achieve fiscal stability throughout the Fiscal Plan implementation period. These measures included, among others, (i) a financing or bond issuance program, the proceeds of which were used to bridge the budgetary imbalance during the Fiscal Plan implementation period and fund some of the Economic Plan initiatives, (ii) the restructuring of the securities held in the Corpus Account of the Infrastructure Development Fund and (iii) the restructuring of a portion of the Commonwealth's debt service.

These financial measures were anchored on the bond-issuance program of COFINA. Act 7, in conjunction with Act No. 91 of May 13, 2006, as amended ("Act 91 of 2006"), and Act No. 1 of January 14, 2009 ("Act 1 of 2009"), allocated to COFINA, commencing on July 1, 2009, 2.75% (one-half of the tax rate of 5.5%) of the sales and use tax imposed by the central government, thus increasing COFINA's financing capacity and allowing the Commonwealth to achieve fiscal stability throughout the implementation period of the Fiscal Plan.

During fiscal years 2009 and 2010, COFINA issued approximately \$5.6 billion and \$3.6 billion, respectively, of revenue bonds payable from sales and use tax collections transferred to COFINA. The proceeds from these bond issues were used for, among other uses, paying approximately \$1.9 billion of Commonwealth obligations that did not have a designated source of repayment, paying or financing approximately \$4.8 billion of operational expenses constituting a portion of the Commonwealth's deficit, and funding the Local Stimulus Fund (described below) and the Stabilization Fund for fiscal year 2011 with approximately \$500 million and \$1.0 billion, respectively. During fiscal year 2012, COFINA expects to issue approximately \$2 billion of revenue bonds payable from sales and use tax collections transferred to COFINA, the proceeds of which will be mainly used to finance a portion of the government's operating expenses for fiscal year 2012 and refund outstanding bonds payable from Commonwealth appropriations.

Act No. 3, approved by the Legislative Assembly of the Commonwealth on January 14, 2009 ("Act 3"), authorized the sale of the securities held in the Corpus Account. PRIFA sold the securities in January 2009 and used the proceeds to, among other things, make a deposit to the General Fund of approximately \$319 million, which was applied to cover a portion of the Commonwealth's budget deficit and make a transfer to GDB of approximately \$159 million as a capital contribution. The gross proceeds resulting from the sale were approximately \$884 million.

Another financial measure taken has been the restructuring of a portion of the Commonwealth's debt service on the Commonwealth's general obligation bonds and bonds of PBA that are guaranteed by the Commonwealth and are payable from Commonwealth budget appropriations. During fiscal year 2009, the Commonwealth refinanced \$159.6 million of interest accrued during such fiscal year on the Commonwealth's general obligation bonds and PBA bonds. During fiscal year 2010, the Commonwealth refinanced \$353.3 million of interest accrued during such fiscal year on the Commonwealth's general obligation bonds and \$164.5 million of interest accrued during such fiscal year on PBA bonds. During fiscal year 2011, the Commonwealth refinanced \$490.9 million of interest accrued during such fiscal year and principal due on July 1, 2011 on the Commonwealth's general obligation bonds. During fiscal year 2011, PBA also used a line of credit from GDB to make payments of approximately \$147.8 million of interest accrued during such fiscal year on its Commonwealth guaranteed bonds, which line of credit was refinanced with the proceeds of a series of Commonwealth guaranteed bonds issued by PBA. During fiscal year 2012, the Government refinanced approximately \$686.0 million of principal due in and interest to accrue during such fiscal year on the Commonwealth's general obligation bonds. The Government also expects to refinance during fiscal year 2012 approximately \$153.8 million of interest to accrue during such fiscal year on Commonwealth guaranteed PBA bonds.

During fiscal year 2013, the Government expects to refinance approximately \$575 million of principal due in and interest to accrue during such fiscal year on the Commonwealth's general obligation bonds and approximately \$170 million of principal due in and interest to accrue during such fiscal year on Commonwealth guaranteed PBA bonds.

The Fiscal Plan has provided more fiscal stability, thereby safeguarding and strengthening Puerto Rico's credit. The fiscal structure resulting from the full implementation of the plan will be sustainable and conducive to economic growth and development.

Economic Reconstruction Plan

To balance the impact of the Fiscal Plan, the administration developed and is implementing an economic reconstruction program designed to stimulate growth in the short term and lay the foundation for long-term economic development. The Economic Plan consists of two main components: (i) two economic stimulus programs, and (ii) a supplemental stimulus plan.

Economic Stimulus Programs. The cornerstone of Puerto Rico's short-term economic reconstruction plan was the implementation of two economic stimulus programs aimed at reigniting growth and counterbalancing any adverse effects associated with the Fiscal Plan. The economic stimulus programs consisted of Puerto Rico's participation in ARRA (also referred to herein as the "Federal Stimulus") and a local plan (the "Local Stimulus") designed to complement the Federal Stimulus.

- ***Federal Stimulus Program:*** Puerto Rico was awarded \$7.1 billion in stimulus funds from ARRA. The funds are distributed in four main categories: relief to individuals, budgetary and fiscal relief, taxpayers' relief, and capital improvements. In terms of government programs, the Federal Stimulus allocates funds to education, agriculture and food assistance, health, housing and urban development, labor, and transportation, among others. As of May 11, 2012, PRIFA, which is responsible for the administration of ARRA in Puerto Rico, reported that approximately \$6.1 billion in ARRA funds had been disbursed, representing approximately 86% of awarded funds.
- ***Local Stimulus Program:*** The administration formulated the Local Stimulus to supplement the Federal Stimulus and address specific local challenges associated with the local mortgage market, the availability of credit, and the infrastructure and construction sectors. Despite the fact that the Local Stimulus amounted to a \$500 million investment by the government, it is estimated that its effect would be greater due to certain lending programs, which are being coordinated in collaboration with commercial banks in Puerto Rico. The administration has been disbursing funds under the \$500 million local stimulus program. Most municipalities have received disbursements earmarked to pay outstanding debts and fund local projects. The administration has also disbursed funds allocated towards job training programs, a strategic water distribution project in a southern municipality and the revamping of the Puerto Rico permits system. It is estimated that approximately \$400 million of Local Stimulus funds will be used for infrastructure projects. As of April 30, 2012, approximately \$416 million of Local Stimulus funds had been disbursed.

Supplemental Stimulus Plan. The Supplemental Stimulus Plan was designed to provide investment in strategic areas with the objective of laying the foundations for long-term growth in

Puerto Rico. The coordinated implementation of the Supplemental Stimulus Plan is expected to reinforce continuity in reigniting economic growth while making key investments for long-term development.

The Supplemental Stimulus Plan is being conducted through a combination of direct investments and guaranteed lending. Specifically, the Supplemental Stimulus Plan targets critical areas such as key infrastructure projects, public capital improvement programs, private sector lending to specific industries, and the export and research-and-development knowledge industries. The Supplemental Stimulus Plan takes into account the strategic needs that Puerto Rico must fulfill in order to become a more competitive player in its region and in the global economy.

On September 1, 2010 the Governor signed Act No. 132, also known as the Real Estate Market Stimulus Act of 2010 (“Act 132”), which provides certain incentives to help reduce the existing housing inventory. The incentives provided by Act 132 were effective from September 1, 2010 through June 30, 2011, and were subsequently extended until October 31, 2011 by Act No. 115 of July 5, 2011. On November 1, 2011, the Government approved Act 216, which provides incentives similar to the ones available under Act 132 and establishes an orderly transition to gradually reduce those incentives without disrupting the functioning of the housing market in Puerto Rico. The incentives provided by Act 216, as amended by Act No. 288 of December 30, 2011, are effective from November 1, 2011 to December 31, 2012, with certain reductions after June 30, 2012. See “Economic Performance by Sector—Construction” below.

Economic Development Program

The Department of Economic Development and Commerce (“DEDC”), in coordination with other government agencies, is in the process of implementing the *Strategic Model for a New Economy*, which consists of a comprehensive, long-term, economic development program aimed at improving Puerto Rico’s overall global relevance, competitiveness, and business environment, and increasing private-sector capital formation and participation in the economy. These initiatives are centered on the dual mission of fostering multi-sector growth while reducing costs and barriers to business and investment, and are a medium-to-long-term counterpart to the Economic Plan and the Supplemental Stimulus Plan described above.

The administration is emphasizing the following initiatives to enhance Puerto Rico’s competitive position: (i) overhauling the permitting process, (ii) reducing energy costs, (iii) reforming the tax system, (iv) promoting the development of various projects through public-private partnerships, (v) implementing strategic initiatives targeted at specific economic sectors, and (vi) promoting the development of certain strategic/regional projects.

Permitting Process. The first initiative, the reengineering of Puerto Rico’s permitting and licensing process, has already been achieved. On December 1, 2009, the Governor signed into law Act No. 161, known as the Law for the Restructuring & Unification of the Permit Evaluation & Authorization Process, which overhauls the existing permitting and licensing process in Puerto Rico in order to provide for a leaner and more efficient process that fosters economic development. In the short term, this restructuring is focused on eliminating the significant backlog of unprocessed permits that are currently in the pipeline of various

government agencies. In the long term, this law seeks to significantly reduce the number of inter-agency processes and transactions currently required by creating a centralized, client-focused system that simplifies and shortens the permitting process for applicants. The Integrated Permits System (SIP by its Spanish acronym), as the new Puerto Rico permits process is called, became operational on December 1, 2010. Through September 2011, 38,500 permits requests had been filed and 88% of these have already been resolved.

The Permit Management Office (OGPe, by its Spanish acronym), the government body responsible for evaluating permit applications and issuing final determinations concerning construction and land use, currently offers 80% of its services online, representing 90% of the total volume of transactions.

Energy Policy. On July 19, 2010, the Governor signed Acts No. 82 and 83, providing for, among other things, the adoption of a new energy policy, which is critical for Puerto Rico's competitiveness. Presently, fluctuations in oil prices have a significant effect on Puerto Rico's overall economic performance. Act No. 82 of 2010, known as the "Public Policy on Energy Diversification through Renewable and Alternative Sources," focuses on reducing Puerto Rico's dependence on fossil fuels, particularly oil, through the promotion of diverse, renewable-energy technologies. This new energy policy seeks to lower energy costs, reduce energy-price volatility, and establish environmentally sustainable energy production through a reduction in ecologically harmful emissions. Act 82 of 2010 creates a Renewable Portfolio Standard, recognizing many sources of renewable energy utilizing various technologies, setting a hard target of 12% renewable energy production by 2015 and 15% by 2020, and a requirement for retail energy providers to establish a plan to reach 20% renewable energy production by 2035.

Moreover, Act No. 83 of 2010, also known as the "Green Energy Incentives Act, assembles under one law the incentives for the construction and use of renewable energy sources. Act 83 offers new benefits to stimulate the development of green energy projects, creates Renewable Energy Certificates (RECs) and creates the Green Energy Fund (the "GEF"). Through the GEF the Government will co-invest \$290 million in renewable energy projects over the next 10-years. Initial funding of \$20 million began on July 1, 2011 and steps up to \$40 million per year by fiscal year 2016. Through the GEF, the Puerto Rico Energy Affairs Administration will offer cash rebates of up to 60% on the cost of installing Tier 1 projects (0 – 100 kW) for residences and small businesses and up to 50% on the cost of Tier 2 projects (100 kW – 1 MW) for commercial or industrial use. In its first round of funding, the GEF backed 25 solar energy projects with \$6.6 million, including grants to 13 businesses and a government agency. These initiatives are expected to address energy prices in Puerto Rico and provide a means of attracting investment in the energy sector.

Tax Reform. Legislation to implement the first and second phases of the tax reform was enacted as Act No. 171 of 2010 and Act 1 of 2011, respectively. See "Major Sources of General Fund Revenues—Tax Reform" under PUERTO RICO TAXES, OTHER REVENUES AND EXPENDITURES for a summary of the principal provisions of the tax reform.

Public-Private Partnerships. The Government believes that PPPs represent an important tool for economic development, particularly in times of fiscal difficulties. PPPs are long-term contracts between government and non-governmental entities—such as private companies, credit

unions, and municipal corporations—to develop, operate, manage or maximize infrastructure projects and/or government services. PPP contracts are centered on the concept of risk transfer. The non-governmental partner takes on certain responsibilities and risks related to the development and/or operation of the project in exchange for certain benefits. PPPs can play a pivotal role in restoring investment in infrastructure and bringing about economic growth.

PPPs provide the opportunity for the government to lower project development costs, accelerate project development, reduce financial risk, create additional revenue sources, establish service quality metrics, re-direct government resources to focus on the implementation of public policy, create jobs and attract new investment. Puerto Rico has opportunities for the establishment of PPPs in the areas of toll roads, airports and maritime ports, public schools, water provision, correctional facilities, and energy, among others.

On June 8, 2009, the Legislative Assembly approved Act No. 29 (“Act 29”), which established a clear public policy and legal framework for the establishment of PPPs in Puerto Rico to further the development and maintenance of infrastructure facilities, improve the services rendered by the Government and foster the creation of jobs. Act 29 created the Public-Private Partnerships Authority (the “PPP Authority”), the entity tasked with implementing the Commonwealth’s public policy regarding PPPs. On December 19, 2009, the PPP Authority approved regulations establishing the administrative framework for the procurement, evaluation, selection, negotiation and award process for PPPs in Puerto Rico.

During fiscal year 2010, the PPP Authority engaged various financial advisors to assist it in the evaluation and procurement of various projects in the energy, transportation, water and public school infrastructure sectors. During the fourth quarter of fiscal year 2010, the PPP Authority published desirability studies for four public-private partnership priority projects and commenced procurement for such projects.

As part of the Government’s PPPs initiative, the PPP Authority and the Highways and Transportation Authority (collectively, the “Sponsors”) recently completed the procurement for a concession of toll roads PR-22 and PR-5 (the “Toll Roads”). On June 10, 2011, the Sponsors selected Autopistas Metropolitanas de Puerto Rico, LLC (“Metropistas”), a consortium comprised of Goldman Sachs Infrastructure Partners and Abertis Infraestructuras, as the winning proponent based on a bid of \$1.080 billion. On June 27, 2011, Metropistas and the Highways and Transportation Authority executed the concession agreement for the Toll Roads and, on September 22, 2011, the parties successfully completed the financial closing. As a result of this transaction, the Highways and Transportation Authority received a lump-sum payment of \$1.136 billion and a commitment to invest \$56 million in immediate improvements and comply with world-class operating standards.

To modernize public school facilities throughout the island and improve academic performance, the PPP Authority launched the “Schools for the 21st Century” program, which will modernize and build a selected number of public schools throughout Puerto Rico. At least one school in each municipality will benefit from the “Schools for the 21st Century” program. The Government expects this project will impact nearly 50,000 students, 2,000 teachers and various communities and create 14,000 jobs throughout Puerto Rico’s 78 municipalities. The Government will fund this project with the proceeds of Qualified School Construction Bonds

(QSCB) issued by PBA in the aggregate principal amount of \$756 million. As of June 2011, the PPP Authority had awarded approximately \$464 million in contracts and construction had begun in approximately 57 schools.

On August 8, 2011, the PPP Authority and the Puerto Rico Ports Authority (“Ports Authority”) received statements of qualifications from twelve (12) world-class consortia in response to the Request for Qualifications (RFQ) to acquire a concession to finance, operate, maintain and improve the Luis Muñoz Marín International Airport (“Airport”), the busiest airport in the Caribbean. The PPP Authority and Ports Authority are seeking to achieve their primary objectives of: (i) maximizing the upfront value for the Airport, (ii) improving the Airport’s safety standards, service levels and quality, (iii) maintaining and improving the quality of service to travelers as well as achieving a higher level of customer satisfaction, and (iv) creating a world-class gateway to Puerto Rico while increasing the Island’s profile as a destination in the Caribbean, in order to positively impact the development of the tourism industry and overall economic prospects in Puerto Rico. On September 23, 2011, the PPP Authority and Ports Authority published a short-list of six consortia. The PPP Authority published the Request for Proposals for the Airport in October 2011 and on May 2, 2012 announced the selection of two finalists. The PPP Authority expects to select a winning bidder in the third quarter of calendar 2012.

Sector Initiatives. The administration will complement the previously mentioned initiatives with specific strategic initiatives with the objective of creating jobs and increasing economic activity across various sectors of the Puerto Rico economy. The Commonwealth has natural or structural competitive advantages in several areas, such as pharmaceutical and biotechnology manufacturing. These advantages provide opportunities for the development of regional clusters in high-tech manufacturing, research and development, tourism, renewable energy, international trade and professional services. The specific initiatives will be designed to promote sustainable economic growth while accelerating to a knowledge-based and innovation driven economy, focused mainly in the development of human capital and intellectual property, thus diversifying Puerto Rico’s economic base.

Strategic/Regional Projects. The administration has also targeted strategic/regional projects that will generate investments in various regions of the Island in order to foster balanced economic development.

One of the strategic projects for the northern region is called the Urban Bay (formerly known as the Golden Triangle), an urban redevelopment project that incorporates the areas of Old San Juan, Puerta de Tierra, Isla Grande, including the Puerto Rico Convention Center District, and Condado, as well as other communities in the vicinity of historic San Juan Bay. The aim of the Urban Bay project is to develop San Juan Bay into a major tourism, recreation, commercial and residential sector which serves the local community and becomes a major attraction for leisure and business travelers, both local and external. Construction of the immediate improvements on the project footprint is currently underway.

Also in the northern region, Science City represents a critical effort to move Puerto Rico to the forefront of science, technology and research and development. It seeks to leverage Puerto Rico’s competitive advantages in the knowledge-based sectors. Through the recently enacted

Law No. 208 of October 20, 2011, the benefits of investing in and performing science and technology research and development activities in the newly denominated “Science District” were expanded through the inclusion of such activities as eligible for tax exemption under the Economic Incentives Act. See “Tax Incentives – Industrial Incentives Program” under THE ECONOMY. The benefits of the Science District under Law 208 may also be expanded to satellite districts throughout the island. Demolition related activities and earth movement is expected to commence before the end of fiscal year 2012.

In the eastern region, the Caribbean Riviera project entails the redevelopment of the old Roosevelt Roads navy facility in Ceiba and is a key element in the administration’s strategy to create jobs and reignite the economy of Puerto Rico’s eastern region, including Ceiba, Naguabo, Vieques, and Culebra. This tourist complex will include hotels, casinos, eco-tourist attractions, international airport, retail, yacht marina, and cruise ship ports. Negotiations with the Navy regarding the transfer of the property to the Local Redevelopment Authority are in advanced stages and should be completed by the end of 2012.

In the western region, the administration is focused on the redevelopment of the Aguadilla airport to serve as the second international airport of Puerto Rico and as a regional logistics hub. The Government is in the process of submitting a formal application to obtain a Foreign Trade Zone designation for the Aguadilla airport area.

Employment and Unemployment

According to the Household Survey, the number of persons employed in Puerto Rico during fiscal year 2011 averaged 1,077,006, a decrease of 2.3% compared to previous fiscal year; and the unemployment rate averaged 15.9%. During the first ten months of fiscal year 2012, total employment averaged 1,083,289, an increase of 0.5% with respect to the same period of the prior year; and the unemployment rate decreased to 15.2%.

The following table presents annual statistics of employment and unemployment for fiscal year 2007 through fiscal year 2011, and the average figures for the first ten months of fiscal year 2012. These employment figures are based on the Household Survey, which includes self-employed individuals and agriculture employment, instead of the non-farm, payroll employment survey (the “Payroll Survey”), which does not. The number of self-employed individuals represents around 15% of civilian employment in Puerto Rico, more than double the level in the United States. On the other hand, agriculture employment in Puerto Rico represented 1.6% of total employment in fiscal year 2011.

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

Fiscal Years Ended June 30,	Labor Force	Employed	Unemployed	Unemployment Rate⁽²⁾
		(Annual Average)		
2007	1,410	1,263	147	10.4
2008	1,368	1,218	151	11.0
2009	1,349	1,168	181	13.4
2010	1,313	1,103	210	16.0
2011	1,281	1,077	204	15.9
2012 ⁽³⁾	1,278	1,083	194	15.2

⁽¹⁾ Totals may not add due to rounding.

⁽²⁾ Unemployed as percentage of labor force.

⁽³⁾ Average figures for the first ten months of fiscal year 2012 (July 2011 through April 2012).

Source: Department of Labor and Human Resources – Household Survey

Economic Performance by Sector

From fiscal year 2007 to fiscal year 2011, the manufacturing and service sectors generated the largest portion of gross domestic product. The manufacturing, service, and government sectors were the three sectors of the economy that provided the most employment in Puerto Rico.

The following table presents annual statistics of gross domestic product by sector and gross national product for fiscal years 2007 to 2011.

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

	Fiscal Years Ended June 30,				
	2007	2008	2009	2010	2011 ⁽¹⁾
Manufacturing	\$37,637	\$40,234	\$43,872	\$46,554	\$47,988
Service ⁽²⁾	40,190	41,372	39,626	40,286	40,620
Government ⁽³⁾	8,585	8,762	9,047	8,350	8,229
Agriculture	430	519	567	707	670
Construction ⁽⁴⁾	2,027	2,032	1,777	1,477	1,388
Statistical discrepancy	(464)	(312)	480	(226)	(138)
Total gross domestic product ⁽⁵⁾	\$88,405	\$92,606	\$95,370	\$97,147	\$98,757
Less: net payment abroad	(28,884)	(30,941)	(32,772)	(34,089)	(34,651)
Total gross national product ⁽⁵⁾	\$59,521	\$61,665	\$62,598	\$63,058	\$64,106

⁽¹⁾ Preliminary.

⁽²⁾ Includes wholesale and retail trade, utilities, transportation and warehousing, information, finance and insurance, real estate and rental, and certain services such as professional, scientific, technical, management, administrative, support, educational, health care, social, recreational, accommodation, food and other services.

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

⁽⁴⁾ Includes mining.

⁽⁵⁾ Totals may not add due to rounding.

Source: Planning Board

Traditionally, the Government has presented the industrial distribution of production in Puerto Rico using gross domestic product because the Planning Board had not published such a distribution using real gross national product as a base measurement. Recently, the Planning Board presented an industrial distribution of production based on real gross national product, which shows significant differences in the importance of the manufacturing sector to the Puerto Rico economy:

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

	Fiscal Years Ended June 30,				
	2007	2008	2009	2010	2011⁽¹⁾
Service ⁽²⁾	\$35,443	\$36,127	\$34,483	\$35,072	\$35,223
Manufacturing	12,570	13,556	15,135	16,536	17,596
Government ⁽³⁾	9,529	9,757	10,168	9,505	9,378
Construction ⁽⁴⁾	2,013	2,018	1,764	1,465	1,377
Agriculture	430	520	568	707	670
Statistical discrepancy	(464)	(312)	480	(226)	(138)
Total gross national product⁽⁵⁾	\$59,520	\$61,665	\$62,598	\$63,058	\$64,106

⁽¹⁾ Preliminary.

⁽²⁾ Includes wholesale and retail trade, utilities, transportation and warehousing, information, finance and insurance, real estate and rental, and certain services such as professional, scientific, technical, management, administrative, support, educational, health care, social, recreational, accommodation, food and other services.

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

⁽⁴⁾ Includes mining.

⁽⁵⁾ Totals may not add due to rounding.

Source: Planning Board

The share of industrial production of the service sector (which includes wholesale and retail trade, utilities, transportation and warehousing, information, finance and insurance, real estate and rental, and certain services such as professional, scientific, technical, management, administrative, support, educational, health care, social, recreational, accommodation, food and other services) based on gross national product appears significantly higher than the share of the manufacturing sector when compared to the shares of industrial production of these sectors based on gross domestic product. This variance occurs because manufacturing activity in Puerto Rico is principally carried out by non-resident entities whose income is not accounted for in Puerto Rico's real gross national product.

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

The following table presents annual statistics of average employment based on the North American Industry Classification System (“NAICS”) for fiscal years 2007 to 2011.

Commonwealth of Puerto Rico
Non-Farm Payroll Employment by Economic Sector⁽¹⁾
(number of employees)

	Fiscal Years Ended June 30,				
	2007	2008	2009	2010	2011⁽²⁾
Natural resources and construction	64,700	59,675	49,067	35,942	31,767
Manufacturing					
Durable goods	45,417	43,100	39,242	34,792	33,900
Non-durable goods	62,442	60,950	57,483	53,533	51,658
Sub-total	<u>107,858</u>	<u>104,050</u>	<u>96,725</u>	<u>88,325</u>	<u>85,558</u>
Trade, transportation, warehouse, and Utilities					
Wholesale trade	33,267	33,717	33,267	32,533	32,008
Retail trade	133,750	130,883	127,492	126,233	128,050
Transportation, warehouse, and utilities	16,992	16,742	15,692	14,550	14,333
Sub-total	<u>184,008</u>	<u>181,342</u>	<u>176,450</u>	<u>173,317</u>	<u>174,392</u>
Information	22,642	21,442	20,217	18,783	18,750
Finance	49,108	48,483	48,492	45,808	43,683
Professional and business	108,800	108,150	103,333	102,508	105,642
Educational and health	105,225	108,550	109,992	111,333	114,167
Leisure and hospitality	73,567	73,408	70,933	70,850	71,142
Other services	21,892	21,217	20,117	18,758	17,992
Government ⁽³⁾	298,125	297,742	300,708	276,533	260,550
Total non-farm	<u><u>1,035,925</u></u>	<u><u>1,024,058</u></u>	<u><u>996,033</u></u>	<u><u>942,158</u></u>	<u><u>923,642</u></u>

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

⁽²⁾ Preliminary.

⁽³⁾ Includes state, local, and federal government employees.

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

Manufacturing

Manufacturing is the largest sector of the Puerto Rico economy in terms of gross domestic product and the second largest in terms of gross national product. The Planning Board figures show that in fiscal year 2011 manufacturing generated \$48.0 billion, or 48.6%, of gross domestic product. Manufacturing, however, only generated \$17.6 billion, or 27.4%, of gross national product in fiscal year 2011. During fiscal year 2011, payroll employment for the manufacturing sector was 85,558, a decrease of 3.1% compared with fiscal year 2010. Most of Puerto Rico's manufacturing output is shipped to the U.S. mainland, which is also the principal source of semi-finished manufactured articles on which further manufacturing operations are performed in Puerto Rico. Federal minimum wage laws are applicable in Puerto Rico. For fiscal year 2011, however, the average hourly manufacturing wage rate in Puerto Rico was approximately 66.5% of the average mainland U.S. rate.

In the last three decades, industrial development in Puerto Rico has been relatively capital intensive and dependent on skilled labor. This gradual shift in emphasis from labor intensive to capital intensive industrial development is best exemplified by large investments over the last two decades in the pharmaceutical and medical-equipment industries in Puerto Rico. Historically, one of the factors that encouraged the development of the manufacturing sector was the tax incentives offered by the federal and Puerto Rico governments. Federal legislation enacted in 1996, however, which amended Section 936 of the U.S. Internal Revenue Code of 1986, as amended (the "U.S. Code"), phased out these federal tax incentives during a ten-year period that ended in 2006. Moreover, Act 154 expanded the income tax rules as they relate to certain nonresident alien individuals, foreign corporations and foreign partnerships and imposed a new temporary excise tax on persons that purchase products manufactured in Puerto Rico by other persons that are members of the same controlled group. The elimination of the benefits provided by Section 936 of the U.S. Code has had, and Act 154 may have a long-term impact on local manufacturing activity. See "Tax Incentives—Incentives under the U.S. Code" under THE ECONOMY and "Major Sources of General Fund Revenues—Tax Reform" and "Major Sources of General Fund Revenues—Income Taxes," respectively, under PUERTO RICO TAXES, OTHER REVENUES AND EXPENDITURES.

The following table sets forth gross domestic product by manufacturing sector for fiscal years 2007 to 2011.

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

	Fiscal Years Ended June 30,				
	2007	2008	2009	2010	2011 ⁽¹⁾
Food	\$1,083	\$ 822	\$ 977	\$ 924	\$ 931
Beverage and Tobacco Products	925	1,243	1,209	1,385	1,330
Textile Mills & Product Mills	15	15	12	12	13
Apparel	201	252	270	294	280
Leather and Allied Products	17	20	18	22	25
Wood Products	24	22	20	19	20
Paper	71	66	63	64	67
Printing and Related Support Activities	124	119	100	105	104
Petroleum and Coal Products	371	95	348	338	344
Chemical	27,017	29,339	30,380	32,137	32,553
Plastics and Rubber Products	122	118	108	108	110
Nonmetallic Mineral Products	285	219	148	90	87
Primary Metals	102	151	145	205	208
Fabricated Metal Products	239	248	207	176	170
Machinery	218	234	174	185	227
Computer and Electronic Products	4,217	4,463	7,037.3	7,491	8,334
Electrical Equipment, Appliances and Components	511	657	654	617	670
Transportation Equipment	78	78	72	67	70
Furniture and Related Products	66	56	48	45	42
Miscellaneous	1,956	2,019	1,883	2,271	2,402
Total gross domestic product of manufacturing sector⁽²⁾	\$37,637	\$40,234	\$43,872	\$46,554	\$47,988

⁽¹⁾ Preliminary.

⁽²⁾ Totals may not add due to rounding.

Source: Planning Board

The following table presents annual statistics of average manufacturing employment by industry based on the NAICS for fiscal years 2007 to 2011.

Commonwealth of Puerto Rico
Non-Farm Payroll Manufacturing Employment by Industry Group*
(number of employees)

Industry group	Fiscal Years Ended June 30,				
	2007	2008	2009	2010	2011 ⁽¹⁾
<u>Durable goods</u>					
Nonmetallic mineral products					
manufacturing	3,825	3,758	3,058	2,492	2,133
Fabricated metal products	5,675	5,375	4,908	4,042	3,625
Computer and electronic	10,092	8,600	7,042	5,733	5,983
Electrical equipment	6,617	6,658	5,867	5,058	5,042
Miscellaneous manufacturing	12,292	11,967	11,975	11,675	11,633
Other durable goods					
manufacturing	6,917	6,742	6,392	5,792	5,483
Total – durable goods	45,417	43,100	39,242	34,792	33,900
<u>Non-durable goods</u>					
Food manufacturing	12,183	11,725	11,383	11,592	11,908
Beverage and tobacco products					
manufacturing	3,258	3,267	3,133	3,275	3,000
Apparel manufacturing	7,708	9,633	9,825	8,808	8,658
Chemical manufacturing	30,467	27,900	25,042	22,392	21,033
Plastics and rubber products	2,200	1,983	1,967	1,908	1,750
Other non-durable goods					
manufacturing	6,625	6,442	6,133	5,558	5,308
Total – non-durable goods	62,442	60,950	57,483	53,533	51,658
Total manufacturing employment	107,858	104,050	96,725	88,325	85,558

* Totals may not add due to rounding.

(1) Preliminary.

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

Total employment in the manufacturing sector decreased by 31,700 from fiscal year 2005 to fiscal year 2011. Manufacturing employment had been declining during the past decade, but the decline accelerated during fiscal years 2002 and 2003, falling 10.6% and 4.8%, respectively. Thereafter, manufacturing employment stabilized around 118,000 jobs, but the acceleration in job losses reappeared in fiscal year 2006 with the sector experiencing another drop of 4.0%. For fiscal years 2007, 2008, 2009, 2010 and 2011, manufacturing employment decreased by 4.2%, 3.5%, 7.0%, 8.7% and 3.1%, respectively. For the first ten months of fiscal year 2012, average employment in the sector declined by 3,200 jobs, or 3.7%, compared to the same period of the previous year. Given that this sector pays, on average, the highest wages in Puerto Rico, its general downturn has represented a major difficulty for restoring growth for the whole economy. There are several reasons that explain this sector's job shrinkage: the end of the phase-out of the tax benefits afforded by Section 936 of the U.S. Code, the net loss of patents on certain pharmaceutical products, the escalation of manufacturing production costs (particularly electricity), the increased use of job outsourcing, and, currently, the effects of the global

economic decline. Puerto Rico's manufacturing sector continues to face increased international competition. As patents on pharmaceutical products manufactured in Puerto Rico expire and the production of such patented products is not replaced by new products, there may be additional job losses in this sector and a loss of tax revenues for the Commonwealth.

Service Sector

Puerto Rico has experienced mixed results in the service sector, which, for purposes of the data set forth below, includes wholesale and retail trade, utilities, transportation and warehousing, information, finance and insurance, real estate and rental, and certain services such as professional, scientific, technical, management, administrative, support, educational, health care, social, recreational, accommodation, food and other services. This sector has expanded in terms of income over the past decade, following the general trend of other industrialized economies, but with differences on the magnitudes of those changes. During the period between fiscal years 2007 and 2011, the gross domestic product in this sector, in nominal terms, increased at an average annual rate of 0.4%, while payroll employment in this sector decreased at an average annual rate of 0.9%. In the Puerto Rico labor market, self-employment, which is not accounted for in the Payroll Survey, represents approximately 15% of total employment according to the Household Survey. Most of the self-employment is concentrated in the service and construction sectors. The development of the service sector has been positively affected by demand generated by other sectors of the economy, such as manufacturing and construction.

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

The service sector ranks second to manufacturing in its contribution to gross domestic product, but first in its contribution to real gross national product. The service sector is also the sector with the greatest amount of employment. In fiscal year 2011, the service sector generated \$40.6 billion, or 41.1%, of gross domestic product, while it generated \$35.2 billion, or 54.9%, of gross national product. Trade, utilities, professional and business support, and education and health experienced growth at current prices in fiscal year 2011, as measured by gross domestic product, while transportation and warehousing, information, finance, and other services experienced reductions in fiscal year 2011, as measured by gross domestic product at current prices. Service-sector employment decreased from 565,242 in fiscal year 2007 to 545,767 in fiscal year 2011 (representing 59.1% of total, non-farm, payroll employment). The average service-sector employment for fiscal year 2011 represents an increase of 0.8% compared to the prior fiscal year. For the first ten months of fiscal year 2012, average service-sector employment was 539,811, a decrease of 1.1% with respect to the same period for the prior fiscal year.

Puerto Rico has a developed banking and financial system. As of December 30, 2011, there were eleven commercial banks operating in Puerto Rico. Commercial banks in Puerto Rico are generally regulated by the Federal Deposit Insurance Corporation (the "FDIC") or the Board of Governors of the Federal Reserve System and by the Office of the Commissioner of Financial Institutions of Puerto Rico (the "OCFI"). The OCFI reports that total assets of commercial banks (including assets of units operating as international banking entities) as of December 30, 2011 were \$70.8 billion, as compared to \$75.5 billion as of December 31, 2010. On April 30, 2010,

the OCFI closed three commercial banks and the FDIC was named receiver. On the same date, the FDIC entered into loss share purchase and assumption agreements with three of the other commercial banks with operations in Puerto Rico, providing for the acquisition of most of the assets and liabilities of the closed banks including the assumption of all of the deposits. Considering the magnitude of the consolidations, the amount of jobs lost to date as a result of these consolidations has not been significant. The administration expects that this consolidation will strengthen the Puerto Rico banking sector.

Broker-dealers in Puerto Rico are regulated by the Financial Industry Regulatory Authority (“FINRA”), the U.S. Securities and Exchange Commission and the OCFI, and are mainly dedicated to serve investors that are residents of Puerto Rico. According to the OCFI, assets under management by broker-dealers in Puerto Rico totaled \$5.5 billion as of December 30, 2011, as compared to \$6.0 billion on December 31, 2010. Another relevant component of the financial sector in Puerto Rico is the investment company industry. Local investment companies had recorded assets under management of \$15.3 billion as of December 30, 2011, as compared to \$14.2 billion as of December 31, 2010 according to the OCFI.

Other components of the financial sector in Puerto Rico include international banking entities (“IBEs”) and credit unions (locally known as cooperativas). IBEs are licensed financial businesses that conduct offshore banking transactions. As of December 30, 2011, there were 32 international banking entities (including units of commercial banks) operating in Puerto Rico licensed to conduct offshore banking transactions, with total assets of \$43.9 billion, an increase from \$40.6 billion in total assets as of December 31, 2010. Meanwhile, credit unions, which tend to provide basic consumer financial services, reached \$7.8 billion in assets as of December 30, 2011, a slight increase from \$7.5 billion as of December 31, 2010.

In addition, there are specialized players in the local financial industry that include mortgage-origination companies and auto and personal finance companies.

The following table sets forth gross domestic product for the service sector for fiscal years 2007 to 2011.

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

	Fiscal Years Ended June 30,				
	2007	2008	2009	2010	2011⁽¹⁾
Wholesale trade	\$ 2,752	\$ 2,951	\$ 2,846	\$ 2,856	\$ 2,847
Retail trade	4,471	4,569	4,467	4,577	4,700
Transportation and warehousing	968	979	895	910	907
Utilities	2,214	2,118	1,967	1,989	2,001
Information	2,467	2,363	2,426	2,601	2,585
Finance and insurance	6,694	7,120	5,105	5,403	5,497
Real Estate and rental	11,686	12,064	12,644	12,308	12,082
Professional and business	3,113	3,184	3,009	3,167	3,382
Education and health	3,593	3,786	4,106	4,263	4,366
Leisure and hospitality	1,862	1,875	1,773	1,821	1,865
Other services	372	363	390	391	388
Total⁽²⁾	\$40,190	\$41,372	\$39,626	\$40,286	\$40,619

⁽¹⁾ Preliminary.

⁽²⁾ Totals may not add due to rounding.

Source: Puerto Rico Planning Board

The following table sets forth employment for the service sector for fiscal years 2007 to 2011.

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

	Fiscal Years Ended June 30,				
	2007	2008	2009	2010	2011⁽¹⁾
Wholesale trade	33,267	33,717	33,267	32,533	32,008
Retail trade	133,750	130,883	127,492	126,233	128,050
Transportation, warehouse and utilities	16,992	16,742	15,692	14,550	14,333
Information	22,642	21,442	20,217	18,783	18,750
Finance	49,108	48,483	48,492	45,808	43,683
Professional and business	108,800	108,150	103,333	102,508	105,642
Educational and health	105,225	108,550	109,992	111,333	114,167
Leisure and hospitality	73,567	73,408	70,933	70,850	71,142
Other services	21,892	21,217	20,117	18,758	17,992
Total⁽²⁾	565,242	562,592	549,533	541,358	545,767

⁽¹⁾ Preliminary.

⁽²⁾ Totals may not add due to rounding.

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

Hotels and Related Services—Tourism

For fiscal year 2011, the number of persons registered in tourist hotels, including residents of Puerto Rico and tourists, was 1,910,700, an increase of 5.9% over the number of persons registered during the same period of fiscal year 2010. The average occupancy rate in tourist hotels during fiscal year 2011 was 68.9%, a decrease of 0.2% from the prior fiscal year. Also, during fiscal year 2011, the average number of rooms available in tourist hotels increased by 5.5% to 11,472 rooms compared to the same period of fiscal year 2010.

During the first eight months of fiscal year 2012, the number of persons registered in tourist hotels, including residents of Puerto Rico and tourists, was 1,313,800, an increase of 7.5% over the number of persons registered during the same period of fiscal year 2011. The average occupancy rate in tourist hotels during the first eight months of fiscal year 2012 was 67.6%, an increase of 0.7% from the prior fiscal year. Also, during the first eight months of fiscal year 2012, the average number of rooms available in tourist hotels increased by 2.7% to 11,651 rooms compared to the same period of fiscal year 2011.

In terms of employment figures, this sector has shown a behavior that seems not totally consistent with the registration figures presented in the previous paragraphs. According to the Payroll Survey, employment in the leisure and hospitality sector was 71,100 for fiscal year 2011, a slight increase of 0.4% over employment for fiscal year 2010, a growth rate significantly smaller than the growth rates of tourist hotel registrations for the same time period (5.9%). Moreover, for the first ten months of fiscal year 2012, employment in this sector increased by only 1.9% to 72,400 compared to the same period of the prior fiscal year, which is still a smaller rate than the average growth rate observed for the first eight months on the tourist hotel registrations (7.5%). These figures could imply a significant improvement on the labor productivity of this sector during fiscal years 2011 and 2012.

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

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

Fiscal Years Ended June 30,	Tourist Hotels⁽²⁾	Excursionists⁽³⁾	Other⁽⁴⁾	Total
2007	1,353,376	1,375,433	2,333,597	5,062,406
2008	1,342,810	1,496,853	2,373,436	5,213,099
2009	1,277,749	1,232,010	1,905,503	4,415,262
2010	1,349,449	1,193,549	1,836,157	4,379,155
2011 ⁽⁵⁾	1,408,536	1,165,758	1,639,379	4,213,673

Total Visitors' Expenditures
(in millions)

Fiscal Years Ended June 30,	Tourist Hotels⁽²⁾	Excursionists⁽³⁾	Other⁽⁴⁾	Total
2007	\$1,501.6	\$172.2	\$1,740.1	\$3,413.9
2008	\$1,526.3	\$194.3	\$1,814.3	\$3,535.0
2009	\$1,464.4	\$173.7	\$1,537.7	\$3,175.8
2010 ⁽⁵⁾	\$1,541.8	\$171.4	\$1,497.5	\$3,210.7
2011 ⁽⁵⁾	\$1,618.9	\$169.3	\$1,354.6	\$3,142.8

⁽¹⁾ Only includes information about non-resident tourists registering in tourist hotels. They are counted once even if registered in more than one hotel.

⁽²⁾ Includes visitors in guesthouses.

⁽³⁾ Includes cruise ship visitors and transient military personnel.

⁽⁴⁾ Includes visitors in homes of relatives, friends, and in hotel apartments.

⁽⁵⁾ Preliminary.

Sources: Puerto Rico Tourism Company and the Planning Board

The Commonwealth, through the Puerto Rico Convention Center District Authority (“PRCDA”), has developed the Dr. Pedro Rosselló González Convention Center, the largest convention center in the Caribbean, and the centerpiece of a 100-acre, private development, that includes hotels, restaurants, office space, and housing. The convention center district is being developed at a total cost of \$1.3 billion in a public/private partnership effort to improve Puerto Rico’s competitive position in the convention and group-travel segments. The convention center opened on November 17, 2005 and, since its inauguration, the facility has hosted more than 1,000 events accounting for more than 1 million attendees. A 500-room hotel located next to the convention center commenced operations in November of 2009.

The PRCDA also owns an 18,500-person capacity multipurpose arena, known as the José Miguel Agrelot Coliseum, located in San Juan, Puerto Rico. The coliseum was inaugurated in 2004 and has hosted more than 2.5 million people attending over 400 world-caliber events. The venue has received numerous awards including “Best International Large Venue of the Year” from Pollstar magazine in 2005.

Government

The government sector of Puerto Rico plays an important role in the economy. It promoted the transformation of Puerto Rico from an agricultural economy to an industrial one

during the second half of the 20th century, providing the basic infrastructure and services necessary for the modernization of Puerto Rico.

In fiscal year 2011, the government (federal, state and local) accounted for \$8.2 billion, or 8.3%, of Puerto Rico's gross domestic product. The government is also a significant employer, employing 260,550 workers (federal, state and local), or 28.2% of total, non-farm, payroll employment in fiscal year 2011. In fiscal year 2009, state and municipal government employment averaged 285,600. During fiscal year 2010, state and municipal government employment decreased by 25,700 jobs, or 9.0%. According to the payroll survey, the distribution of the job reductions during fiscal year 2010 was 20,700 jobs in the state government (including public corporations) and approximately 5,000 jobs in municipal government. During fiscal year 2011, state and municipal government employment decreased further by 14,400 jobs, or 5.5%, compared to fiscal year 2010. According to the payroll survey, the decrease was attributable to a reduction of 12,000 jobs in the state government and approximately 2,400 jobs in municipal government. Nevertheless, during the first ten months of fiscal year 2012, total government employment (federal, state and local) increased by 2.7% from the previous fiscal year, or by an average of 6,900 jobs. This increase in government employment for the first ten months of fiscal year 2012 consists of an average increase of 7,900 jobs, or 4.3%, in state government offset by an average reduction of 500 jobs, or 0.8%, and 500 jobs, or 3.6%, in federal government, respectively.

As discussed previously, Act 7 established, among other things, a temporary freeze of salary increases and other economic benefits included in laws, collective bargaining agreements, and any other agreements. In addition, Act 7 provided that, for a period of two years after its enactment (until March 9, 2011), collective bargaining agreements that had already expired or that would expire while the law is in effect and that relate to public employees could not be renegotiated or renewed. Act 73 extended the term of the non-economic clauses of such collective bargaining agreements for an additional period of two years (until March 9, 2013) and provided that the economic clauses may be negotiated considering primarily the fiscal condition of the applicable agency and the overall Government as well as the safeguarding of services to the people.

Transportation

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

Puerto Rico's airport facilities are located in Carolina, San Juan, Ponce, Mayaguez, Aguadilla, Arecibo, Ceiba, Vieques, Culebra, Patillas and Humacao.

Luis Muñoz Marín International Airport in the San Juan metropolitan area is currently served by 24 domestic and international airlines. The airport receives over 8 million passengers per year, making it the busiest airport in the Caribbean. At present, there is daily direct service between San Juan and Atlanta, Baltimore, Boston, Chicago, Dallas, Miami, New York, Orlando, Philadelphia, and numerous other destinations within the U.S. mainland. San Juan has also

become a hub for intra-Caribbean service. While the main hubs in the U.S. mainland serve as the gateway from San Juan to most international destinations, Latin American destinations are also served through Panama City, Panama, with connections to Central and South America, while European cities are also served through Madrid, Spain.

On December 22, 2009, the Federal Aviation Administration (“FAA”) approved the Ports Authority’s preliminary application to participate in the FAA’s airport public-private partnership pilot program. During fiscal year 2010, the PPP Authority engaged a team of advisors and in June 2010 published the related desirability and convenience study, which is required for the establishment of a public-private partnership. On July 5, 2011, the PPP Authority published its “Request for Qualifications to Acquire a Lease to Finance, Operate, Maintain and Improve the Luis Muñoz Marín International Airport.” On August 8, 2011, the PPP Authority and Ports Authority received statements of qualifications from twelve world-class consortia and, on September 23, 2011, published a short-list of six consortia. In October 2011, the PPP Authority issued a Request for Proposals for the Airport to the shortlisted consortia. On May 2, 2012, the PPP Authority announced the selection of two finalists to proceed to the final phase of the Request for Proposals process. The PPP Authority and the Ports Authority expect to select a winning bidder in the third quarter of calendar 2012.

Regarding other airports, Rafael Hernández Airport in Aguadilla is served by JetBlue and Spirit and has regularly scheduled service to and from Fort Lauderdale, New York, Newark and Orlando; and Ponce’s Mercedita Airport is served by JetBlue and has regularly scheduled service to and from New York and Orlando. Both of these airports also have scheduled service to other Caribbean islands. Smaller regional airports serve intra-island traffic. Cargo operations are served by both Federal Express and United Parcel Service (UPS) at the airports in San Juan and Aguadilla.

The island’s major cities are connected by a modern highway system, which, as of December 31, 2011, totaled approximately 4,640 miles and 12,045 miles of local streets and adjacent roads. The highway system comprises 389 miles of primary system highways, which are the more important interregional traffic routes and include PR-52, PR-22, PR-53, PR-66 and PR-20 toll highways, 232 miles of primary urban system highways, 959 miles of secondary system highways serving the needs of intra-regional traffic, and 3,061 miles of tertiary highways and roads serving local, intra-regional traffic. On September 22, 2011, the PPP Authority and the Highways and Transportation Authority completed the procurement for a concession of toll roads PR-22 and PR-5. See “Economic Development Program – Public-Private Partnerships” under Fiscal Stabilization and Economic Reconstruction.

The Port of the Americas is a deep draft container terminal under development on the south coast of Puerto Rico in the City of Ponce, the Commonwealth’s fourth largest municipality by population. Managed by the Authority of the Port of Ponce, the terminal can handle containerized import/export and transshipment cargo. The first phase of the port development was completed in 2004 while the second phase, which resulted in container yard with capacity of up to 250,000 Twenty-Foot Equivalent Units per year, was completed during the first quarter of calendar year 2009. A third development phase, which entails a public investment of \$84.4 million, is ongoing through September 2012. The completion of phase three will result in an annual terminal processing capacity of up to 500,000 Twenty-Foot Equivalent Units as well as

the installation of basic infrastructure required to develop an industrial value-added zone on land adjacent to the Port.

Construction

Although the construction industry represents a relatively small segment of the economy compared to other sectors, it has made significant contributions to the growth of economic activity due to its multiplier effect on the whole economy. From its peak in fiscal year 2000 to fiscal year 2011, real construction investment declined at an average annual rate of 7.4%. Construction investment started to decrease significantly in fiscal year 2005, as a consequence of the general economic conditions in Puerto Rico. During the last four fiscal years (from fiscal year 2007 to 2011) real construction investment decreased at an average annual rate of 11.5%. During the same time period, the total value of construction permits, in current dollars, decreased at an average annual rate of 16.8%. The Planning Board projects an increase in construction investment of 5.0% in real terms for fiscal year 2012, and of 9.7% for fiscal year 2013.

Public investment has been an important component of construction investment. During fiscal year 2011, approximately 53.1% of the total investment in construction was related to public projects, which represents an increase in its share of total construction investment compared to 37.9% in fiscal year 2000. Public investment in construction has been negatively affected by the Commonwealth's fiscal difficulties, while private investment in construction is still suffering from the credit conditions that prevailed during the last decade. Public investment was primarily in housing, schools, water projects, and other public infrastructure projects.

During fiscal year 2010, the number of construction permits decreased 15.2%, while the total value of construction permits dropped by 29.2% compared to fiscal year 2009. During the first ten months of fiscal year 2011 (the most recent data available), the total value of construction permits decreased further by 15.7%. These figures are consistent with cement sales, which declined by 26.3% in fiscal year 2010 and by 5.0% in 2011, respectively, reaching levels not seen in almost three decades. During the first ten months of fiscal year 2012, however, cement sales increased by 4.9% from the previous fiscal year.

Average payroll employment in the construction sector during fiscal year 2011 was 31,800, a reduction of 11.6% from fiscal year 2010. Nevertheless, during the first ten months of fiscal year 2012, payroll employment in the construction sector averaged 33,400, an increase of 4.9% for the same period in fiscal year 2011.

On September 2, 2010, the Governor signed Act 132. Act 132 was designed primarily to stimulate the Puerto Rico real estate market, which in recent years has been suffering from lower sales, rising inventories, falling median prices and increased foreclosure rates. Pursuant to the provisions of Act 132, the Government has provided tax and transaction fee incentives to both purchasers and sellers of new and existing residential properties, as well as commercial properties with sale prices that do not exceed \$3 million. The incentives provided by Act 132 were effective from September 1, 2010 through June 30, 2011, and were subsequently extended until October 31, 2011 by Act No. 115 of July 5, 2011. Certain permanent incentives are also available for rental housing. On November 1, 2011, the Government approved Act 216, which provides incentives similar to the ones available under Act 132 and establishes an orderly

transition to gradually reduce those incentives without disrupting the functioning of the housing market in Puerto Rico. The incentives provided by Act 216 are limited to residential real property and are effective from November 1, 2011 to December 31, 2012, with certain reductions after December 31, 2011 and June 30, 2012. New incentives are also available for property that constitutes the seller's principal residence, as defined in Act 216.

Agriculture

The Department of Agriculture and related agencies have directed their efforts at increasing and improving local agricultural production, increasing efficiency and the quality of produce, and stimulating the consumption of locally produced agricultural products. It should be noted, however, that agriculture production represents less than 1% of Puerto Rico's gross domestic product. During fiscal year 2011, gross income from agriculture was \$789.8 million at current prices, which remained virtually unchanged (an increase of 0.1%) as compared with fiscal year 2010. In terms of gross domestic product, agriculture generated a level of production of \$670.2 million at current prices in fiscal year 2011, a reduction of 5.2% compared to fiscal year 2010.

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

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

Higher Education

During the six decades from 1950 to 2010, Puerto Rico made significant advances in the field of education, particularly at the college and graduate-school level. The transformation of Puerto Rico during the 1950s and 1960s from an agricultural economy to an industrial economy brought about an increased demand for educational services at all levels. During the 1970s and 1980s, certain higher-wage, higher-technology industries became more prominent in Puerto Rico. More recently, employment in the service sector has increased significantly. This has resulted in an increased demand for workers having a higher level of education and greater expertise in various technical fields. During the same time period, enrollments in institutions of higher learning rose very rapidly due to growth in the college-age population, and the increasing percentage of college attendance by such population. During the 1990s and into the current decade, college attendance and college attendance as a percentage of the college-age population continued to increase, although the college-age population has declined since 2000.

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

**Commonwealth of Puerto Rico
Trend in College Enrollment**

Academic Year	Commonwealth of Puerto Rico			United States Mainland		
	Population 18-24 Years of Age	Higher Education Enrollment	Percent ⁽¹⁾	Population 18-24 Years of Age	Higher Education Enrollment	Percent ⁽¹⁾
1970	341,448 ⁽²⁾	57,340	16.8%	23,714,000 ⁽²⁾	8,580,887	36.2%
1980	397,839 ⁽²⁾	130,105	32.7%	30,022,000 ⁽²⁾	12,096,895	40.3%
1990	417,636 ⁽²⁾	156,147	37.4%	26,961,000 ⁽²⁾	13,818,637	51.3%
2000	428,894 ⁽²⁾	176,015	41.0%	27,141,150 ⁽²⁾	14,791,224	54.5%
2001	430,880 ⁽³⁾	184,126	42.7%	27,992,652 ⁽³⁾	15,312,289	54.7%
2002	428,065 ⁽³⁾	190,776	44.6%	28,480,708 ⁽³⁾	15,927,987	55.9%
2003	423,338 ⁽³⁾	199,842	47.2%	28,916,746 ⁽³⁾	16,611,711	57.4%
2004	417,141 ⁽³⁾	206,791	49.6%	29,302,179 ⁽³⁾	16,911,481	57.7%
2005	408,044 ⁽³⁾	208,032	51.0%	29,441,546 ⁽³⁾	17,272,044	58.7%
2006	398,586 ⁽³⁾	209,547	52.6%	29,602,839 ⁽³⁾	17,487,475	59.1%
2007	389,640 ⁽³⁾	225,402	57.8%	29,808,025 ⁽³⁾	17,758,870	59.6%
2008	384,751 ⁽³⁾	227,546	59.1%	30,194,274 ⁽³⁾	18,248,128	60.4%
2009	379,500 ⁽³⁾	235,618	62.1%	30,530,346 ⁽³⁾	19,102,814	62.6%
2010	375,145 ⁽²⁾	249,372	66.5%	30,672,088 ⁽²⁾	20,427,711	66.6%

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

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

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

Sources: U.S. Census Bureau (U.S. Mainland Population), U.S. National Center for Education Statistics (NCES), Planning Board (Puerto Rico Population) and Council on Higher Education of Puerto Rico

The University of Puerto Rico, the only public university in Puerto Rico, has eleven campuses located throughout the island. The University's total enrollment for academic year 2010-2011 was approximately 61,722 students. The Commonwealth appropriates annually for the University of Puerto Rico an amount equal to 9.60% of the average annual revenue from internal sources (subject to certain exceptions) for each of the two fiscal years immediately preceding the current fiscal year.

In addition to the University of Puerto Rico, there are 40 public and private institutions of higher education located in Puerto Rico. Such institutions had an enrollment during academic year 2010-2011 of approximately 188,470 students and provide programs of study in liberal arts, education, business, natural sciences, technology, secretarial and computer sciences, nursing, medicine, and law. Degrees are offered by these institutions at the associate, bachelor, master, and doctoral levels.

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

Tax Incentives

One factor that has promoted and continues to promote the development of the manufacturing and service sector in Puerto Rico is the various local and federal tax incentives available, particularly those under Puerto Rico's Industrial Incentives Program and, until 2006, Sections 30A and 936 of the U.S. Code. Tax and other incentives have also been established to promote the development of the tourism industry. These incentives are summarized below.

Industrial Incentives Program

Since 1948, Puerto Rico has had various incentives laws designed to promote investment and job creation. Under these laws, companies engaged in manufacturing and certain other designated activities were eligible to receive full or partial exemption from income, property, and other local taxes. The most recent of these incentives laws is the Economic Incentives Act, enacted in May 2008.

The benefits provided by the Economic Incentives Act are available to new companies as well as companies currently conducting tax-exempt operations in Puerto Rico that choose to renegotiate their existing tax exemption grants, expand current operations or commence operating a new eligible business. The activities eligible for tax exemption under the Economic Incentives Act include manufacturing, certain designated services performed for markets outside Puerto Rico (including the United States), the production of energy from local renewable sources for consumption in Puerto Rico and laboratories for research and development. The Economic Incentives Act expands the definition of eligible business from that included in Act No. 135 of December 2, 1997, as amended (the "1998 Tax Incentives Act"), to include clusters and supply chains.

Companies qualifying under the Economic Incentives Act can benefit from a simplified income tax system: in most cases, an income tax rate of 4% and a withholding tax rate of 12% on royalty payments. Alternatively, the income tax rate can be 8% and a withholding rate of 2% on royalty payments. Special rates apply to projects located in low and mid-development zones (an income tax reduction of 0.5%), certain local projects (an income tax rate as low as 3%), certain small- and medium-sized businesses (an income tax rate as low as 1%) and pioneering activities (an income tax rate of 1%, but for those using intangible property created or developed in Puerto Rico the income tax rate may be 0%). In addition, as with the 1998 Tax Incentives Act, the Economic Incentives Act grants 90% exemption from property taxes, 100% exemption from municipal license taxes during the first three semesters of operations and at least 60% thereafter, and 100% exemption from excise taxes, and sales and use taxes with respect to the acquisition of raw materials and certain machinery and equipment used in the exempt activities.

The Economic Incentives Act is designed to stimulate employment and productivity, research and development, capital investment, reduction in the cost of energy and increased purchase of local products.

Under the Economic Incentives Act, as with the 1998 Tax Incentives Act, companies can repatriate or distribute their profits free of Puerto Rico dividend taxes. In addition, passive income derived by exempted businesses from the investment of eligible funds in Puerto Rico

financial institutions, obligations of the Commonwealth, and other designated investments is fully exempt from income and municipal license taxes. Gain from the sale or exchange of shares or substantially all the assets of an exempted business during the exemption period that is otherwise subject to Puerto Rico income tax would be subject to a special Puerto Rico income tax rate of 4%.

The Economic Incentives Act, like the 1998 Tax Incentives Act, also provides investors that acquire an exempted business that is in the process of closing its operations in Puerto Rico a 50% credit in connection with the cash purchase of such corporation's stocks or operational assets.

Individual Investors Act and Export Services Act

On January 17, 2012, the Legislative Assembly of Puerto Rico approved new legislation to promote the economic development of Puerto Rico: (i) Act No. 22, also known as the Act to Promote the Relocation of Individual Investors to Puerto Rico (the "Individual Investors Act), and (ii) Act No. 20, also known as the Act to Promote the Exportation of Services (the "Export Services Act"), which supersedes the provisions of the Economic Incentives Act that provide benefits to designated services performed for markets outside of Puerto Rico.

The Individual Investors Act seeks to attract new residents to Puerto Rico by providing total exemption from Puerto Rico income taxes on passive income realized or accrued after such individuals become bona fide residents of Puerto Rico. The Individual Investors Act applies to any individual investor that becomes a Puerto Rico resident on or before the taxable year ending on December 31, 2035, provided that such individual was not a resident of Puerto Rico at any time during the 15-year period preceding the effective date of the Individual Investors Act. This relocation should result in new local investments in real estate, services, and other consumption products, and in capital injections to the Puerto Rico banking sector, all of which will stimulate the economy of Puerto Rico.

The Export Services Act seeks to establish and develop in Puerto Rico an international export services center. This act seeks to encourage local service providers to expand their services to persons outside of Puerto Rico, promote the development of new businesses in Puerto Rico and stimulate the inbound transfer of foreign service providers to Puerto Rico. The Export Services Act also creates a special fund for the continuous development of new tax incentives that will promote export services and the establishment of new businesses in Puerto Rico. The Export Services Act applies with respect to any entity with a bona fide office or establishment located in Puerto Rico that is or may be engaged in an eligible service. Service providers operating under a tax exemption decree issued under the Export Services Act will enjoy various Puerto Rico tax incentives during the term of such decree, such as a 4% flat income tax rate on export services income and 100% tax-exempt dividend distributions.

Green Energy Incentives Program

On July 19, 2010 the Legislative Assembly enacted Act No. 83 of July 19, 2010 ("Act 83"), also known as the "Green Energy Incentives Act", to encourage the production of renewable energy on a commercial scale. The activities eligible for tax exemption under the

Green Energy Incentives Act include businesses engaged in the production and sale of green energy on a commercial scale for consumption in Puerto Rico, a producer of green energy, the assembly and installation of machinery and equipment for the production of green energy, and the leasing of property used for the production of green energy (not including financing leases).

Companies qualifying under the Green Energy Incentives Act can avail themselves of the following tax benefits: a preferential income tax rate of 4% on Green Energy Income and a withholding tax rate of 12% on royalty payments, license fees and rental payments to non-Puerto Rico resident companies. In addition, Green Energy Incentives Act grants 90% exemption from property taxes, 100% exemption from municipal license taxes during the first three semesters of operations and at least 60% thereafter, and 100% exemption from excise taxes, and sale and use taxes with respect to the acquisition of raw materials and certain machinery and equipment used in the exempt activities.

Under the Green Energy Incentives Act, companies can repatriate or distribute their earnings and profits derived from the eligible activities free of Puerto Rico income taxes. Gain from the sale or exchange of shares or substantially all the assets of an exempted business during the exemption period that is otherwise subject to Puerto Rico income tax would be subject to a special Puerto Rico income tax rate of 4%.

In order to enjoy the tax benefits mentioned above, an eligible business must request and obtain a grant of tax exemption, which is a contract between the Government of Puerto Rico and the exempt business, and has a term of 25 years.

Moreover, the Green Energy Incentives Act creates a rebate program of a portion of the acquisition, installation, and related costs of the physical plant and the machinery and equipment of small and medium green energy projects located in Puerto Rico. In the case of large scale green energy projects (more than 1 MW) developed in Puerto Rico, the Green Energy Incentives Act creates a renewal green energy certificates program.

Tourism Incentives Program

For many years, Puerto Rico has enacted incentives laws designed to stimulate investment in hotel operations on the island. The Puerto Rico Tourism Development Act of 2010 (the “Tourism Development Act”) provides partial exemptions from income, property, and municipal license taxes for a period of ten years. The Tourism Development Act also provides certain tax credits for qualifying investments in tourism activities, including hotel and condo-hotel development projects. The Tourism Development Act provides further tourism incentives by granting tax exemption on interest income, fees and other charges received with respect to bonds, notes, or other obligations issued by tourism businesses for the development, construction, rehabilitation, or improvements of tourism projects.

As part of the incentives to promote the tourism industry, in 1993 the Commonwealth established the Tourism Development Fund as a subsidiary of GDB with the authority to (i) make investments in or provide financing to entities that contribute to the development of the tourism industry and (ii) provide financial guarantees and direct loans for financing tourism development projects. To date, the Fund has provided direct loans and financial guarantees in

the aggregate of approximately \$1.442 billion for loans made or bonds issued to finance the development of twenty-five tourism projects representing 5,109 new hotel rooms and a total investment of approximately \$2.345 billion.

Treatment of Puerto Rico Corporations under the U.S. Code - Controlled Foreign Corporations

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

CFCs operate under transfer pricing rules for intangible income that are different from those applicable to United States corporations operating under Section 936 of the U.S. Code (“Section 936 Corporations”). In many cases, they are allowed to attribute a larger share of this income to their Puerto Rico operation but must make a royalty payment “commensurate with income” to their U.S. affiliates. Section 936 Corporations were exempted from Puerto Rico withholding taxes on any cost-sharing payments they might have opted to make, but CFCs are subject to a 15% Puerto Rico withholding tax on royalty payments, unless they have a renegotiated Puerto Rico tax grant issued under the Economic Act in which case this withholding tax could be lowered to 2% or 12%.

In May 2009, the U.S. Department of the Treasury announced proposed changes to the U.S. Code that include, among others, changes to remove incentives for shifting jobs overseas. Several of these initiatives could affect CFCs operating in Puerto Rico. As of this date, no legislation has been approved by either House of Congress of the United States. It is not possible at this time to determine the legislative changes that may be made to the U.S. Code, or their effect on the long-term outlook on the economy of Puerto Rico. The administration will develop policy responses to the U.S. government to seek to safeguard Puerto Rico’s economic reconstruction and development plans.

On September 22, 2011, HR No. 3020 was presented in the U.S. Congress House of Representatives, which allows corporations organized under the laws of Puerto Rico which derive fifty percent (50%) or more of their gross income from Puerto Rico sources to elect to be treated as domestic U.S. corporations for almost all provisions of the U.S. Code, including Section 243 of the U.S. Code pertaining to the dividends received deduction. By way of exception, the electing Puerto Rico corporations would not consider as part of their gross income for federal income tax purposes income derived from sources within Puerto Rico.

DEBT

Public Sector Debt

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

Section 2 of Article VI of the Constitution of the Commonwealth provides that direct obligations of the Commonwealth evidenced by full faith and credit bonds or notes shall not be issued if the amount of the principal of and interest on such bonds and notes and on all such bonds and notes theretofore issued that is payable in any fiscal year, together with any amount paid by the Commonwealth in the fiscal year preceding the fiscal year of such proposed issuance on account of bonds or notes guaranteed by the Commonwealth, exceed 15% of the average annual revenues raised under the provisions of Commonwealth legislation and deposited into the treasury (hereinafter “internal revenues”) in the two fiscal years preceding the fiscal year of such proposed issuance. Section 2 of Article VI does not limit the amount of debt that the Commonwealth may guarantee so long as the 15% limitation is not exceeded through payments by the Commonwealth on such guaranteed debt. Internal revenues consist principally of income taxes, property taxes, sales taxes and excise taxes. Certain revenues, such as federal excise taxes on offshore shipments of alcoholic beverages and tobacco products and customs duties, which are collected by the United States Government and returned to the Treasury Department, and motor vehicle fuel taxes, crude oil and derivative products excise taxes and license fees, which are allocated to the Highway and Transportation Authority, are not included as internal revenues for the purpose of calculating the debt limit, although they may be available for the payment of debt service. In addition, the portion of the Sales Tax (as defined under “Major Sources of General Fund Revenues—Sales and Use Taxes” under “Puerto Rico Taxes, Other Revenues, and Expenditures” below) allocated to COFINA is not included as internal revenues since the legislation that created COFINA transferred ownership of such portion of the Sales Tax to COFINA and provided that such portion was not “available resources” under the Constitutional provisions relating to full faith and credit bonds.

As of May 15, 2012, future maximum annual debt service for the Commonwealth’s outstanding general obligation debt is \$989,231,968 in fiscal year ending June 30, 2016 (based on the assumption that the (i) Public Improvement Refunding Bonds, Series 2004A, which are variable rate bonds, bear interest at their actual rate per annum through July 1, 2012 and thereafter at 12% per annum, and (ii) the outstanding Public Improvement Refunding Bonds, Series 2003 C, Public Improvement Bonds of 2006, Series A, and Public Improvement Refunding Bonds, Series 2007A that are variable rate bonds, bear interest at 12% per annum). This amount (\$989,231,968) *plus* the amount paid by the Commonwealth in fiscal year 2011 on account of bonds or notes guaranteed by the Commonwealth (\$16,520,000), for a total of \$1,005,751,968, is equal to 13.24% of \$7,595,987,000, which is the average of the adjusted internal revenues for the fiscal years ended June 30, 2010 and 2011. If the interest on the outstanding bonds described in items (ii) through (iii) above was calculated using the effective fixed interest rate payable by the Commonwealth under the interest rate exchange agreements entered into in respect thereof, the future maximum annual debt service for the Commonwealth outstanding general obligations debt would be \$947,895,697 in fiscal year 2020 and the

percentage referred to in the preceding sentence would be 12.70%. The potential termination payment (which is a full faith and credit obligation of the Commonwealth) payable by the Commonwealth (based on the then applicable mark-to-market value) upon termination of the above mentioned swap agreements is not included in the calculation of the 15% constitutional debt limitation. For a discussion of the Commonwealth's obligations under its interest rate exchange agreements, see "Interest Rate Exchange Agreements" under DEBT.

Except as set forth below, annual debt service payments on bonds guaranteed by the Commonwealth are not included in the calculation of the 15% debt limitation. In the event any of the public corporations issuers of guaranteed bonds are unable to make any portion of the future debt service payments on its guaranteed bonds, the Commonwealth would be required to make such payments under its guarantee from the General Fund, and such debt service would be included in the calculation of the 15% constitutional debt limitation.

As of March 31, 2012, Port of the Americas Authority ("PAA") had outstanding bonds guaranteed by the Commonwealth (the "PAA Guaranteed Bonds"), representing a \$250 million GDB financing with an outstanding principal amount of \$214.8 million. The Commonwealth has begun to make payments of debt service on the PAA Guaranteed Bonds and expects to make all payment on the PAA Guaranteed Bonds under the full faith and credit guarantee of the Commonwealth. During fiscal year 2011, the Commonwealth made payments under its guaranty of the PAA Guaranteed Bonds of \$16.5 million. In addition, the Commonwealth had made special budgetary appropriations to PRASA to provide a subsidy for its operational expenses. See "Commonwealth Guaranteed Debt" below.

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

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

The following table presents a summary of public sector debt as of March 31, 2012. This table includes debt primarily payable from Commonwealth or municipal taxes, Commonwealth appropriations and rates charged by public corporations for services or products, as well as debt payable from other sources, some of which debt is set forth in footnote 6 below. Excluded from the table is debt the inclusion of which would reflect double counting including, but not limited to, \$988.4 million of outstanding bonds (as of March 31, 2012) issued by Municipal Finance Agency to finance its purchase of bonds of Puerto Rico municipalities. This table does not take into consideration the following debt issued after March 31, 2012: (1) \$2,318,190,000 Public

Improvement Refunding Bonds, Series 2012A (General Obligation Bonds) issued by the Commonwealth on April 3, 2012, which proceeds were used to, among other things, refund approximately \$1.2 billion of Commonwealth general obligation bonds and repay approximately \$654.7 million of GDB lines of credit, and (2) \$630,110,000 Power Revenue Bonds, Series 2012A and \$19,890,000 Power Revenue Refunding Bonds, Series 2012B, issued by PREPA on May 1, 2012, which proceeds were used to, among other things, refund approximately \$21.3 million of outstanding bonds and repay approximately \$161.9 million of GDB lines of credit.

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

March 31, 2012

GENERAL FUND RELATED DEBT	
Direct full faith and credit obligations	\$ 9,833
Puerto Rico guaranteed debt ⁽¹⁾	5,483
Debt supported by Puerto Rico appropriations or taxes ⁽²⁾	3,819
Tax and Revenue Anticipation Notes ⁽³⁾	900
Pension Obligation Bonds ⁽⁴⁾	2,948
TOTAL GENERAL FUND RELATED DEBT	\$22,983
Sales Tax debt	\$15,224
Public corporations and agencies ⁽⁵⁾	25,147
Municipal debt	3,658
Limited obligations/non-recourse debt ⁽⁶⁾	2,263
TOTAL PUBLIC SECTOR DEBT	\$69,275

* Totals may not add due to rounding.

⁽¹⁾ Consists of \$658 million of bonds issued by Aqueduct and Sewer Authority, \$440 million of State Revolving Fund Loans incurred under various federal water laws, \$214.8 million of bonds issued by Port of the Americas Authority and \$4.170 billion of PBA bonds. Excludes \$267 million of GDB bonds payable from available moneys of GDB.

⁽²⁾ Represents bonds and notes payable from the Commonwealth General Fund and Public Improvement Fund. Includes Public Finance Corporation bonds.

⁽³⁾ Includes related short-term financings.

⁽⁴⁾ Represents Senior Pension Funding Bonds, Series A, B, and C issued by the Employees Retirement System, which are payable solely from employer contributions made to the Employees Retirement System by the Commonwealth and its instrumentalities after the issuance of the bonds.

⁽⁵⁾ Excludes \$6.3 billion of notes issued by GDB, the proceeds of which have been principally used to fund loans to the Commonwealth, public corporations, agencies and municipalities. Loans made by GDB to the Commonwealth, public corporations, agencies and municipalities are included in the table.

⁽⁶⁾ Includes the following: \$1.3 billion of Children's Trust bonds, which are payable solely from the payments to be received pursuant to the tobacco litigation settlement; \$170.8 million of Housing Finance Authority bonds, which are payable from Puerto Rico Housing Administration's annual allocation of Public Housing Capital Funds from the United States Department of Housing and Urban Development ("HUD"); \$331.9 million of Capital Fund Modernization Program Subordinate Bonds, Series 2008 issued by the Housing Finance Authority and payable primarily from federal housing assistance payments made available by HUD; \$149 million of Special Facilities Revenue Bonds issued by Highways and Transportation Authority, which are payable from net toll revenues collected from the Teodoro Moscoso Bridge; \$155 million of Special Facilities Bonds issued by Ports Authority, which are solely payable from the pledge of certain payments made by a private corporation under a special facilities agreement; \$74.6 million of Educational Facilities Revenue Bonds, 2000 Series A (University Plaza Project) issued by Industrial, Tourist, Educational, Medical and Environmental Control Facilities Financing Authority ("AFICA"), which are payable from rent payments made by the University of Puerto Rico; and approximately \$73.6 million of bonds issued by AFICA to finance the construction of various government infrastructure projects, which are payable from rent payments made by various government entities.

Source: Government Development Bank for Puerto Rico

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

Debt Service Requirements for Commonwealth General Obligation Bonds

The following table presents the debt service requirements for Commonwealth general obligation bonds outstanding on May 15, 2012. This table, however, does not include payments made by the Commonwealth on the PAA Guaranteed Bonds, which are paid from General Fund budgetary appropriations determined in consultation with GDB, as holder of the PAA Guaranteed Bonds. The amounts paid by the Commonwealth under the PAA Guaranteed Bonds for the prior fiscal year, however, are taken into account in the determination of the constitutional debt limit.

In addition, in respect of certain variable rate general obligation bonds, as to which the Commonwealth has entered into interest rate exchange agreements, the interest in the table is calculated by using the respective fixed rates of interest that the Commonwealth is paying under said agreements.

Debt service requirements for each fiscal year, as shown in the following table, include principal and interest due on July 1 immediately following the close of such fiscal year.

Puerto Rico General Obligation Debt Service Requirements*
(In thousands)

Fiscal Year Ending June 30	Outstanding Bonds		
	Principal	Interest ⁽³⁾	Total ⁽³⁾
2012 ⁽¹⁾	\$ 100,221	\$ 47,402	\$ 147,623
2013	468,235 ⁽²⁾	447,186	915,421
2014	376,453	451,181	827,634
2015	407,055	457,721	864,775
2016	425,640	512,947	938,588
2017	371,192	492,990	864,181
2018	327,015	474,966	801,981
2019	475,981	443,627	919,608
2020	534,935	412,961	947,896
2021	403,150	387,294	790,444
2022	350,690	369,002	719,692
2023	273,615	352,547	626,162
2024	272,545	339,291	611,836
2025	291,470	325,956	617,426
2026	366,935	310,442	677,377
2027	308,600	290,578	599,178
2028	329,780	274,016	603,796
2029	305,180	255,981	561,161
2030	316,925	239,508	556,433
2031	319,000	223,069	542,069
2032	231,220	206,538	537,758
2033	345,450	193,865	539,315
2034	293,885	175,463	469,348
2035	375,975	160,079	536,054
2036	318,145	139,505	457,650
2037	336,405	121,248	457,653
2038	398,575	102,245	500,820
2039	421,130	79,691	500,821
2040	505,180	55,640	560,820
2041	532,625	28,194	560,819
	<u>\$10,783,206</u>	<u>\$8,371,131</u>	<u>\$19,154,337</u>

* Totals may not add due to rounding. Includes the effective fixed rate on certain variable rate general obligation bonds as to which the Commonwealth has entered into interest rate exchange agreements.

⁽¹⁾ Excludes approximately \$685 million of principal and interest due in fiscal year 2012 paid and to be paid from the proceeds of Commonwealth general obligation bonds.

⁽²⁾ Includes \$75 million in Commonwealth bond anticipation notes issued in January 2012 and payable in fiscal year 2013.

⁽³⁾ The figures for interest have been reduced by the interest that was capitalized through the issuance of Commonwealth general obligation bonds in the following amounts: \$672 thousand in fiscal year 2012, \$120.1 million in fiscal year 2013, \$97.0 million in fiscal year 2014 and \$73.9 million in fiscal year 2015.

Sources: Government Development Bank for Puerto Rico and Treasury Department

Interest Rate Exchange Agreements

General. The Commonwealth and various public corporations are party to various interest rate exchange agreements or swaps. Except for the basis swaps discussed below, the purpose of all of the interest rate exchange agreements currently in place is to hedge the Commonwealth's variable rate debt exposure and the interest rate risks associated therewith. When the Commonwealth or a public corporation has issued variable rate bonds, it has entered into an interest rate exchange agreement with a counterparty pursuant to which the Commonwealth or the public corporation agrees to pay the counterparty a fixed rate and the counterparty agrees to pay the Commonwealth or public corporation a variable rate intended to match the variable rate payable on the bonds (a "synthetic fixed rate swap"). In theory, the variable rate payments received by the Commonwealth under the swap off-set the variable rate payments on the bonds and, thus, the Commonwealth or the public corporation is left with a net fixed rate payment to a counterparty. The intention of these swaps was to lower the all-in cost of borrowing below what could have been achieved by issuing fixed rate bonds.

Basis Swap. The Commonwealth and PREPA are also party to agreements ("basis swaps"), entered into in June 2006 and March 2008, respectively, pursuant to which they are making payments on a specified notional amount based on a short-term interest rate index published by the Securities Industry and Financial Markets Association ("SIFMA") and are receiving from their counterparties payments on the same notional amount based on the published three-month London Interbank Offered Rate ("LIBOR") plus a specified fixed rate payment (the "basis annuity"). The basis swaps are the only interest rate exchange agreements that do not hedge specific variable rate debt. For fiscal year 2011 and the first nine months of fiscal year 2012, the Commonwealth received \$7.3 million and \$7.4 million, respectively, from its counterparties under the basis swap, net of the Commonwealth's payments to the counterparties, and PREPA received \$9.6 million and \$8.7 million, respectively, from its counterparty under the basis swap, net of PREPA's payments to the counterparty. In addition, in January 2012, PREPA received approximately \$265,000 in connection with the unwinding of \$225 million of notional amount of the basis swap.

Risks. By using derivative financial instruments, the Commonwealth exposes itself, among other risks, to credit risk (based on the counterparty's ability to perform under the terms of the agreement), market risk (based on the changes in the value of the instrument resulting from changes in interest rates and other market factors) and, in the case of basis swaps, basis risk (based on changes to the correlation between different indexes used in connection with a derivative and the variable rate debt they hedge). GDB, as fiscal agent, regularly monitors the exposure of the Commonwealth and the public corporations under the interest rate exchange agreements and attempts to minimize the risks. To minimize some of the credit risk, the Commonwealth and the public corporations enter into agreements with highly-rated counterparties. The outstanding interest rate exchange agreements are with eight different counterparties, all of which are rated in one of the three highest rating categories by either Moody's or S&P. In addition, most of the agreements contain requirements of posting collateral by the counterparties based on certain valuation thresholds and credit ratings.

During fiscal years 2009, 2010, 2011 and the first nine months of fiscal year 2012, in order to reduce the risks associated with the swaps portfolio, the Commonwealth and the public corporations terminated approximately \$4.4 billion of swaps. The aggregate notional amount of the swaps for the Commonwealth and the public corporations has decreased from \$9.2 billion as of June 30, 2008, to \$4.6 billion as of March 31, 2012, an aggregate decrease of 50%.

Notional Amounts. The table below shows the aggregate notional amount as of March 31, 2012 of synthetic fixed rate swaps and basis swaps of the Commonwealth and the public corporations.

Swap Portfolio Breakdown
Notional Amount
(as of March 31, 2012)

	<u>Synthetic Fixed</u>	<u>Basis Swaps</u>	<u>Total</u>
Commonwealth (General Obligation)	\$587,565,000	\$1,698,370,000	\$2,285,935,000
Electric Power Authority	411,825,000	1,150,000,000	1,561,825,000
Highways and Transportation Authority	647,025,000	—	647,025,000
Sales Tax Financing Corporation	136,000,000	—	136,000,000
Total	<u>\$1,782,415,000</u>	<u>\$2,848,370,000</u>	<u>\$4,630,785,000</u>

Market Value. Generally, the interest rate exchange agreements may be terminated by the Commonwealth or the public corporations at any time at their then current market values. The agreements may also be terminated upon the occurrence of certain credit events. If a termination occurs due to a credit event, the Commonwealth or the public corporations may be obligated to pay to the applicable swap counterparty an amount based on the terminating swap's market value, which may be substantial, or vice versa, with other termination costs being paid by the defaulting party. The mark-to-market value of the swaps fluctuates with interest rates and other market conditions. The Commonwealth's obligations under the interest rate exchange agreements are secured by the full faith, credit and taxing power of the Commonwealth.

The following table shows, as of March 31, 2012, the net mark-to-market value of all outstanding interest rate exchange agreements. Except for the basis swap of PREPA and two swaps of Highways and Transportation Authority, the mark-to-market value of all swaps of the Commonwealth and the public corporations was negative as of March 31, 2012. Thus, the Commonwealth or the public corporations, as applicable, would owe money to the counterparties if any of the agreements with a negative mark-to-market had been terminated as of that date.

Swap Portfolio Mark-to-Market Valuation
(as of March 31, 2012)

	<u>Synthetic Fixed</u>	<u>Basis Swaps</u>	<u>Total</u>
Commonwealth (General Obligation)	\$(101,975,450)	\$(19,545,950)	\$(121,521,400)
Electric Power Authority	(87,967,370)	10,732,622	(77,234,748)
Highways and Transportation Authority	(174,336,580)	—	(174,336,580)
Sales Tax Financing Corporation	(67,450,448)	—	(67,450,448)
Total	<u>\$(431,729,848)</u>	<u>\$(8,813,328)</u>	<u>\$(440,543,176)</u>

Collateral Requirements. Under the majority of the interest rate exchange agreements, the Commonwealth and the public corporations are required to deliver collateral to the counterparties to guarantee their performance under the agreements based on the credit ratings of the Commonwealth and the public corporations and certain contractual mark-to-market value thresholds. During the fourth quarter of 2008, as a result of the U.S. financial market crisis, the Commonwealth and the public corporations were required to post collateral of approximately \$251.8 million and \$82.5 million, respectively, to their counterparties on certain interest rate exchange agreements. Based on an improvement in the mark-to-market value of the swap portfolio since then, the Commonwealth, PREPA and COFINA had no collateral posted as of March 31, 2012 and Highways and Transportation Authority had posted collateral of \$28.0 million as of March 31, 2012. However, if the mark-to-market value of the swaps portfolio deteriorates or the credit ratings of the Commonwealth or the public corporations are lowered, the collateral posting obligations contained in the agreements may require further deliveries of collateral.

Variable Rate Bonds and Mandatory Tender Bonds

Variable Rate Bonds. The Commonwealth and various public corporations have outstanding variable rate bonds, consisting of (1) variable rate demand bonds which are subject to mandatory tender for purchase prior to their maturity on certain interest rate reset dates and upon expiration of an associated credit or liquidity facility (“VRDO Bonds”), (2) variable rate bonds and notes that have been purchased directly from the Commonwealth by certain financial institutions where the interest rate changes periodically based on the LIBOR or SIFMA index and that are subject to mandatory tender on certain dates prior to their maturities (“Mandatory Tender FRNs”), and (3) other bonds and notes where the interest rate changes periodically based on the LIBOR rate or a particular index but that are not subject to tender prior to their maturity. The Commonwealth and the public corporations have hedged their variable rate debt exposure by entering into interest rate exchange agreements with certain swap providers with respect to all variable rate bonds. Pursuant to these agreements, the Commonwealth and the public corporations receive a variable rate payment expected to approximate the interest cost of the variable rate bonds, and pay a fixed rate. See “Interest Rate Exchange Agreements.”

The following table shows the breakdown of variable rate debt of the Commonwealth and the public corporations as of March 31, 2012.

Variable Rate Debt Breakdown (as of March 31, 2012)

	VRDO Bonds	Mandatory Tender FRNs	Other Variable Rate Debt	Total
Commonwealth (General Obligation)	\$203,625,000	\$257,215,000	\$ 126,725,000	\$587,565,000
Electric Power Authority	—	—	411,825,000	411,825,000
Highways and Transportation Authority	200,000,000	—	447,025,000	647,025,000
Sales Tax Financing Corporation	—	—	136,000,000	136,000,000
Total	<u>\$403,625,000</u>	<u>\$257,215,000</u>	<u>\$1,121,575,000</u>	<u>\$1,782,415,000</u>

The VRDO Bonds bear a floating interest rate adjusted at specified intervals, such as daily or weekly (each, a “remarketing date”) and provide investors the option to tender or put the bonds at par on each remarketing date. The tendered bonds are then resold by a remarketing agent in the secondary market to other investors. The VRDO Bonds are secured by letters of credit or other liquidity or credit facilities (“credit/liquidity facilities”) that provide for the payment of the purchase price payable upon the tender of the bonds. The credit/liquidity facilities expire prior to the final maturity of the bonds. If, upon the expiration or termination of any credit/liquidity facility with respect to a series of VRDO Bonds, the Commonwealth or the applicable public corporation is unable to renew or replace such facility with an alternate credit/liquidity facility, the VRDO Bonds of such series are subject to mandatory tender for purchase by the credit/liquidity facility provider and generally become subject to higher interest rates and accelerated amortization schedules pursuant to the terms of each expiring credit/liquidity facility.

The recent U.S. financial market crisis has resulted in a significant reduction in the availability of credit/liquidity facilities to support VRDO Bonds, and a related increase in the price of these facilities when they can be obtained. Thus, if the Commonwealth and the public corporations are not able to renew or rollover the expiring credit/liquidity facilities with respect to VRDO Bonds, or are not able to do so at an acceptable price, the Commonwealth and the public corporations would have to refinance the VRDO Bonds or otherwise obtain financing for such bonds in order to avoid the higher interest rates and accelerated amortization schedules set forth in the expiring credit/liquidity facility.

In addition, since there are interest rate exchange agreements with respect to all VRDO Bonds, if the Commonwealth or the applicable public corporation cannot renew or replace a credit/liquidity facility upon its expiration or remarket the related series of bonds successfully upon their mandatory tender as variable rate bonds, the Commonwealth or the applicable public corporation may have to terminate the interest rate exchange agreements associated with such series of VRDO Bonds. Termination of the applicable interest rate exchange agreement may result, depending on then current interest rate levels and market conditions, in the payment of a termination amount, which may be substantial, by the Commonwealth to compensate the counterparty for its economic losses. As of March 31, 2012, the mark-to-market value of all the interest rate exchange agreements with respect to VRDO Bonds was negative \$39.9 million for the Commonwealth and negative \$46.9 million for the public corporations. See “Interest Rate Exchange Agreements – Market Value.”

The following table shows, by fiscal year, the amount of VRDO Bonds subject to mandatory tender upon expiration of the applicable credit/liquidity facilities.

VRDO Bonds Rollover
(by Fiscal Year)

	<u>2012</u>	<u>2013</u>	<u>Total</u>
Commonwealth (General Obligation)	—	\$203,625,000	\$203,625,000
Highways and Transportation Authority	—	200,000,000	200,000,000
Total	—	\$403,625,000	\$403,625,000

The Mandatory Tender FRNs are discussed in the “Mandatory Tender Bonds” section below.

Mandatory Tender Bonds. As of March 31, 2012, the Commonwealth and the public corporations also had outstanding \$257.2 million of Mandatory Tender FRNs and \$464.9 billion of fixed rate bonds also subject to mandatory tender for purchase prior to maturity (collectively, the “Mandatory Tender Bonds”). The Commonwealth and the public corporations have not provided any liquidity facility for the payment of the purchase price payable upon the mandatory tender, which purchase price is expected to be obtained from the remarketing of the bonds. If the Commonwealth or the applicable public corporation cannot remarket the Mandatory Tender Bonds, they would have to obtain other funds in order to provide for the purchase price of these bonds or, in some cases, the bonds would become subject to higher interest rates and an accelerated amortization schedule.

The following table shows, as of March 31, 2012, the breakdown of the Mandatory Tender Bonds of the Commonwealth and the public corporations and the respective dates when such bonds are subject to mandatory tender for purchase.

Mandatory Tender Bonds Breakdown
(as of March, 2012)

	<u>Mandatory Tender Bonds</u>	<u>Type</u>	<u>Mandatory Tender Date</u>
Commonwealth (General Obligation)	\$ 14,925,000	Variable	April 1, 2013
	44,905,000	Variable	May 1, 2013
	197,385,000	Variable	June 1, 2014
Public Buildings Authority	335,580,000	Fixed	July 1, 2012
	129,300,000	Fixed	July 1, 2017
Total	<u>\$722,095,000</u>		

As discussed previously, the Commonwealth has entered into interest rate exchange agreements with respect to all Mandatory Tender FRNs. In the event the Commonwealth cannot remarket these bonds on their mandatory tender dates as variable rate bonds, the Commonwealth may have to terminate the associated interest rate exchange agreements. As of March 31, 2012, the mark-to-market value of all interest rate exchange agreements with respect to the Mandatory Tender FRNs was negative \$55.3 million.

Ratings of Commonwealth General Obligation Bonds

The Commonwealth’s general obligation and appropriation debt is currently rated “Baa1” with a negative outlook by Moody’s, “BBB+” with a stable outlook by Fitch, and “BBB” with a negative outlook by S&P.

Commonwealth Guaranteed Debt

As of March 31, 2012, \$4.170 billion of Commonwealth guaranteed bonds of PBA were outstanding (not including accretion of interest from the respective issuance dates on capital appreciation bonds). Maximum annual debt service on these bonds is \$993.1 million in fiscal year 2028, assuming the receipt of the issuer subsidy from the federal government on the \$756,449,000 Government Facilities Revenue Bonds, Series R (Qualified School Construction

Bonds – Issuer Subsidy) and the \$121,528,000 Government Facilities Revenue Bonds, Series T (Qualified Zone Academy Bonds – Direct Payment), and \$1.032 billion in fiscal year 2028 without taking into consideration said subsidy, with their final maturity being July 1, 2041. No payments under the Commonwealth guaranty have been required to date for these bonds.

As of March 31, 2012, \$267 million of Commonwealth guaranteed bonds of GDB were outstanding. No payments under the Commonwealth guaranty have been required for these bonds.

As of March 31, 2012, GDB held approximately \$214.8 million of the Port of the Americas Authority’s outstanding bonds, which are guaranteed by the Commonwealth. The proceeds from these bonds have been used to continue the development of the Port of the Americas. Payments of \$43.4 million under the Commonwealth guaranty have been required to pay interest and principal on these bonds. While the responsibility for the development and operation of the Port of the Americas was transferred from the Port of the Americas Authority to the Authority of the Port of Ponce in December 2011, the Port of the Americas Authority retained the liability for the outstanding bonds, which are expected to be paid by the Commonwealth under the guarantee. See “Other Public Corporations—Port of the Americas Authority” under “Public Corporations” below.

As of March 31, 2012, the aggregate outstanding principal amount of obligations of PRASA guaranteed by the Commonwealth was \$1.098 billion. This amount consisted of \$284.8 million in revenue bonds sold to the public, \$373.0 million in bonds issued to the United States Department of Agriculture, Rural Development, and \$440.1 million of loans by the State Revolving (Clean Water and Safe Drinking Water Act) Funds for the benefit of PRASA. From January 1997 through fiscal year 2005, the Commonwealth made debt service payments under its guaranty. Beginning with the debt service payment due January 1, 2006, the Commonwealth stopped making guarantee payments on these obligations and PRASA resumed making payment on this debt. The Commonwealth, however, has been making certain subsidy payments to PRASA for its operational expenses. In the event PRASA is unable to make any portion of the future debt service payments on its guaranteed obligations, the Commonwealth would be required once more to make such payments from the General Fund under its guarantee. See “Other Public Corporations—Puerto Rico Aqueduct and Sewer Authority” under “Public Corporations” below.

Trends of Public Sector Debt

The following table shows the growth rate of short-term and long-term public sector debt and the growth rate of gross national product (in current dollars) for the five fiscal years ended June 30, 2011 and the nine months ended March 31, 2012. As of March 31, 2012, outstanding short-term debt, relative to total debt, was 7.3%. Total public sector debt for fiscal year 2011 shown in the table below represented 91.9% of gross national product for fiscal year 2011.

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

June 30,	Public Sector			Gross National Product ⁽¹⁾			
	Long Term ⁽²⁾	Short Term ⁽³⁾	Total	Short Term as % of Total	Rate of Increase	Amount	Rate of Increase
2007	39,492	3,326 ⁽⁴⁾	42,818	7.8	7.2	59,521	4.9
2008	43,663	3,269 ⁽⁴⁾	46,932	7.0	10.0	61,665	3.6
2009	48,332	4,648 ⁽⁴⁾	52,980	8.8	13.0	62,598	1.5
2010	53,351	3,472	56,823	6.1	7.3	63,058	0.7
2011	54,804	4,380	59,184	7.4	4.2	64,106	1.7
March 31, 2012	59,387	4,677	64,064	7.3	8.2	-	-

* Totals may not add due to rounding.

⁽¹⁾ In current dollars.

⁽²⁾ Does not include debt totaling \$5.3 billion consisting of (i) Senior Pension Funding Bonds, Series A, B, and C issued by the Employees Retirement System, which are payable solely from employer contributions made to the Employees Retirement System by the Commonwealth, its municipalities and participating public corporations after the issuance of the bonds, identified in footnote 4, and (ii) bonds identified in footnote 6, of the table above entitled "Commonwealth of Puerto Rico—Public Sector Debt," which would have been issued and outstanding at the time, all of which would be considered long-term debt.

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

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

Source: Government Development Bank

The following table shows the trend of public sector debt by major category for the five fiscal years ended June 30, 2011 and the nine months ended March 31, 2012.

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

June 30,	Commonwealth⁽¹⁾			Municipalities			Public Corporation⁽²⁾			Total		
	Long Term	Short Term⁽³⁾	Total	Long Term	Short Term⁽³⁾	Total	Long Term	Short Term⁽³⁾	Total	Long Term	Short Term⁽³⁾	Total
2007.....	10,335	224 ⁽⁴⁾	10,559	2,164	299	2,463	26,993	2,803	29,796	39,492	3,326	42,818
2008.....	9,273	519 ⁽⁴⁾	9,792	2,507	313	2,820	31,633	2,437	34,070	43,413	3,269	46,682
2009.....	9,382	557 ⁽⁴⁾	9,939	2,691	306	2,997	36,259	3,785	40,044	48,332	4,648	52,980
2010.....	10,033	270	10,303	2,905	326	3,231	40,413	2,876	43,289	53,351	3,472	56,823
2011.....	10,199	164	10,363	3,204	333	3,537	41,401	3,883	45,284	54,804	4,380	59,184
March 31, 2012	11,098	1,116	12,214	3,293	365	3,658	44,996	3,196	48,192	59,387	4,677	64,064

* Totals may not add due to rounding.

⁽¹⁾ Does not include the Senior Pension Funding Bonds, Series A, B, and C issued by the Employees Retirement System, which are payable solely from employer contributions made to the Employees Retirement System by the Commonwealth, its municipalities and participating public corporations after the issuance of the bonds, identified in footnote 4 of the table above entitled “Commonwealth of Puerto Rico—Public Sector Debt.”

⁽²⁾ Includes Commonwealth guaranteed debt; does not include the bonds identified in footnote 6 of the table above entitled “Commonwealth of Puerto Rico—Public Sector Debt.”

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

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

Source: Government Development Bank

PUBLIC CORPORATIONS

In Puerto Rico, many governmental and quasi-governmental functions are performed by public corporations created by the Legislative Assembly with varying degrees of independence from the central government to perform generally a single function or a limited number of related functions. Most public corporations obtain revenues from rates charged for services or products, but many are subsidized to some extent by the central government. Most public corporations are governed by boards whose members are appointed by the Governor with the advice and consent of the Senate, but some public corporations are attached to departments of the central government. Capital improvements of most of the larger public corporations are financed by revenue bonds issued under trust agreements or bond resolutions, or by notes issued under loan agreements. The following table presents the outstanding bonds and notes of certain of the public corporations as of March 31, 2012 (“notes” as used in this section refers primarily to certain types of non-bonded debt regardless of maturity). Debt of certain other public corporations is excluded from this table because such debt is payable primarily from funds or grants provided by the federal government, is payable from sources other than Commonwealth appropriations or taxes or revenues of public corporations, or is payable from revenues derived from private sector services or products, such as industrial development bonds. Also excluded from this table is debt of certain public corporations the inclusion of which would reflect double counting. No deductions have been made in the table for debt service funds and debt service reserve funds. More detailed information about the major public corporations is presented in the following sections.

Commonwealth of Puerto Rico
Outstanding Debt of Public Corporations
March 31, 2012
(in thousands)

	Bonds			Notes			Total Bonds and Notes		
	With Guaranty	Without Guaranty	Total	With Guaranty	Without Guaranty	Total	With Guaranty	Without Guaranty	Total
Aqueduct and Sewer Authority	\$ 657,722	\$ 3,434,345	\$ 4,092,067	\$ 440,137	\$ 39,504	\$ 479,641	\$ 1,097,859	\$ 3,473,849	\$ 4,571,708
Convention Center District Authority	-	438,120	438,120	-	147,600	147,600	-	585,720	585,720
Electric Power Authority	-	7,605,435	7,605,435	-	427,234	427,234	-	8,032,669	8,032,669
Highway and Transportation Authority	-	5,116,827 ⁽¹⁾	5,116,827	-	1,765,647	1,765,647	-	6,882,474	6,882,474
Housing Finance Authority	-	285,374 ⁽²⁾	285,374	-	83,303	83,303	-	368,677	368,677
Industrial Development Company	-	222,385	222,385	-	88,532	88,532	-	310,917	310,917
Infrastructure Financing Authority ⁽³⁾	-	2,477,348	2,477,348	-	35,294	35,294	-	2,512,642	2,512,642
Port of the Americas Authority	214,808	-	214,808	-	-	-	214,808	-	214,808
Ports Authority	-	46,326 ⁽⁴⁾	46,326	-	213,807	213,807	-	260,133	260,133
Public Buildings Authority	4,170,459	-	4,170,459	-	244,326	244,326	4,170,459	244,326	4,414,785
Public Finance Corporation	-	1,021,993 ⁽⁵⁾	1,021,993	-	-	-	-	1,021,993	1,021,993
P.R. Sales Taxes Financing Corp. (COFINA)	-	15,223,821	15,223,821	-	-	-	-	15,223,821	15,223,821
University of Puerto Rico	-	532,846 ⁽⁶⁾	532,846	-	73,552	73,552	-	606,398	606,398
Others ⁽⁷⁾	-	-	-	-	3,185,505	3,185,505	-	3,185,505	3,185,505
Total ⁽⁸⁾	<u>\$5,042,989</u>	<u>\$36,404,820</u>	<u>\$41,447,809</u>	<u>\$440,137</u>	<u>\$6,304,304</u>	<u>\$6,744,441</u>	<u>\$5,483,126</u>	<u>\$42,709,124</u>	<u>\$48,192,250</u>

⁽¹⁾ Excludes \$149.0 million of Special Facilities Revenue Bonds issued by the Highway and Transportation Authority, which are payable from net toll revenues collected from the Teodoro Moscoso Bridge.

⁽²⁾ Excludes the \$170.8 million of Housing Finance Authority bonds, which are payable solely from Puerto Rico Public Housing Administration's annual allocation of Public Housing Capital Funds from HUD; and \$331.9 million of Housing Finance Authority Capital Fund Modernization Program Subordinate Bonds, Series 2008 issued by the Housing Finance Authority and payable primarily from federal housing assistance payments made available by HUD.

⁽³⁾ Includes \$42.2 million of Mental Health Infrastructure Revenue Bonds, 2007 Series A (MEPSI Campus Project), which bonds are limited obligations of the Infrastructure Financing Authority payable solely from the pledge of certain payments made by a governmental entity under a lease agreement. Also includes \$669.2 million of Revenue Bonds (Ports Authority Project), Series 2011, which are limited obligations of the Infrastructure Financing Authority payable solely from loan payments made by the Ports Authority.

⁽⁴⁾ Excludes \$155 million of Special Facilities Revenues Bonds issued by the Ports Authority, which bonds are payable solely from the pledge of certain payments made by a private corporation under a special facilities agreement.

⁽⁵⁾ Payable primarily from Commonwealth appropriations.

⁽⁶⁾ Excludes \$74.6 million of Educational Facilities Revenue Bonds, 2000 Series A (University Plaza Project) issued by AFICA, which bonds are payable from rent payments made by the University of Puerto Rico.

⁽⁷⁾ Includes lines of credit with GDB.

⁽⁸⁾ Excludes accretion of interest from the respective issuance dates on capital appreciation bonds. Also excludes \$1.3 billion original principal amount of Children's Trust Tobacco Settlement Asset-Backed Bonds, Series 2002, 2005 and 2008 which bonds will be repaid from payments made by certain tobacco companies under a master settlement agreement. See "Children's Trust" under "Other Public Corporations" below.

Source: Government Development Bank

Government Development Bank for Puerto Rico

The principal functions of GDB are to act as financial advisor to and fiscal agent for the Commonwealth, its municipalities and public corporations in connection with the issuance of bonds and notes, to make loans and advances to public corporations and municipalities, and to promote the economic development of Puerto Rico. As part of its role as fiscal agent, during fiscal years 2009, 2010 and 2011, GDB entered into fiscal oversight agreements with the

Aqueduct and Sewer Authority, Electric Power Authority, Highway and Transportation Authority, Ports Authority, Health Insurance Administration and Medical Services Administration. As part of these agreements, GDB imposed certain conditions on the extension of credit to these entities and continually monitors their finances, among other things.

As of June 30, 2011, GDB (including its blended component units) had total assets of \$15.5 billion and total liabilities of \$12.9 billion. As of March 31, 2012, GDB's total assets were \$17.3 billion and its total liabilities were \$14.6 billion (preliminary, unaudited). GDB's debt is currently rated Baa1 (negative outlook) and BBB by Moody's and S&P, respectively, with a stable outlook.

As of March 31, 2012, \$6.6 billion of bonds and notes of GDB (excluding its subsidiaries) were outstanding, consisting of \$267 million in Commonwealth guaranteed bonds and \$6.3 billion of medium term senior notes. Act No. 12 of May 9, 1975, as amended, provides that the payment of principal of and interest on specified notes and other obligations of GDB, not exceeding \$550 million, may be guaranteed by the Commonwealth, of which \$267 million were outstanding as of March 31, 2012. As of said date, GDB also had approximately \$9.5 billion in loans outstanding to the central government of the Commonwealth and its public corporations and municipalities.

Act No. 82 of June 16, 2002 ("Act 82") amended GDB's Charter to authorize GDB to transfer annually to the General Fund, beginning with fiscal year 2001, up to 10% of its audited net income or \$10,000,000, whichever is greater. GDB is not required by Act 82 to transfer any funds. GDB made payments to the General Fund of \$11.6 million for fiscal year 2003 and \$18.4 million for fiscal year 2004. GDB has not made any payment to the General Fund under Act 82 since fiscal year 2004.

Under Act No. 271 of November 21, 2002, GDB made a required special capital contribution to the Special Communities Perpetual Trust (the "Perpetual Trust") of \$500 million and provided the Perpetual Trust with a \$500 million, non-revolving, line of credit. The amounts transferred to the Perpetual Trust were deposited in two investment accounts held by GDB for the benefit of the Perpetual Trust. As of March 31, 2012, the Perpetual Trust had repaid \$131.8 million of its line of credit and had an outstanding balance of \$368 million and no interest due. The line of credit is payable from legislative appropriations.

As part of its role as lender and promoter of the economic development of Puerto Rico, GDB provides financing to the Commonwealth, its public corporations and municipalities. This financing includes interim loans to finance the capital expenditures of the Commonwealth in anticipation of the issuance of bonds and notes, and loans to cover operational deficits of those government entities. GDB generally does not provide financing to any governmental entity of the Commonwealth unless GDB reasonably believes that the borrower governmental entity will have sufficient resources, including the ability to issue bonds or notes or otherwise borrow funds, to repay such loan. GDB, however, has provided financing in the past and may continue to provide financing to governmental entities that do not have sufficient independent resources to cover operating expense, to the extent permitted by law. A material increase in the amount of loans to the public sector, coupled with continued deterioration of the public sector's fiscal situation and financial condition may have an adverse effect on GDB's financial condition and

liquidity. As of March 31, 2012, GDB had outstanding loans to the Commonwealth in the aggregate principal amount of \$3.3 billion, outstanding loans to, and bonds of, the public corporations in the aggregate principal amount of \$4.3 billion, and outstanding loans to the municipalities in the aggregate principal amount of \$1.9 billion.

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

Puerto Rico Housing Finance Authority. Puerto Rico Housing Finance Authority (“Housing Finance Authority”) (formerly known as Housing Finance Corporation) was created to provide needed rental housing units and stimulate the construction industry under federally subsidized programs. Effective February 8, 2002, Housing Finance Corporation became the Housing Finance Authority and the Housing Bank and Finance Agency was dissolved and its powers transferred to the Housing Finance Authority. Housing Finance Authority provides financing for rental housing units, stimulates the construction industry under federally subsidized programs and provides interim financing for low-income housing projects and single-family homeownership programs. It is also engaged in insuring and servicing mortgages originated by the former Housing Bank and Finance Agency. As of March 31, 2012, Housing Finance Authority’s total outstanding principal balance of loans to the private sector for development of housing projects targeted to low and moderate income families were \$156.4 million. The Housing Finance Authority’s mortgage loans to low and moderate income homeowners represented an additional outstanding principal balance of \$125.5 million as of the same date.

Housing Finance Authority has outstanding tax-exempt revenue bonds the proceeds of which were loaned to the Puerto Rico Public Housing Administration to finance improvements to various housing projects in the Commonwealth. Such bonds are limited obligations of Housing Finance Authority payable solely from revenues collected from such housing units, with certain exceptions. As of March 31, 2012, \$331.9 million of these bonds were outstanding.

As of March 31, 2012, the Housing Finance Authority had total notes and bonds outstanding of \$660.9 million (including \$124.1 million of debt outstanding under GDB lines of credit and \$505.9 million in bonds issued to fund certain payments under its mortgage subsidy programs for low and moderate income families). As of March 31, 2012, Housing Finance Authority had total unrestricted net assets of \$261.7 million.

Puerto Rico Tourism Development Fund. Puerto Rico Tourism Development Fund (“TDF”) was created in September 1993 to facilitate the development of Puerto Rico’s hotel industry by working with private-sector financial institutions in structuring financings for new hotel projects. TDF can provide guarantees to interim and permanent financings. In certain transactions, TDF can act as direct lender, guarantee mezzanine financings, and provide preferred equity capital. As of June 30, 2011, TDF had \$518.5 million in guarantees and \$345.5 million in loans, net of loan loss reserves of \$86.8 million. As of June 30, 2011, TDF’s net assets were \$154.1 million.

In addition, TDF has a \$50 million preferred equity investment in a tourism-related project.

Since 1993, TDF has made payments under its guarantees and letters of credit in the aggregate amount of approximately \$221.3 million with respect to several projects. Of the total amount disbursed, TDF has been able to recover approximately \$172.3 million from the borrowers.

Government Development Bank for Puerto Rico Capital Fund. Government Development Bank for Puerto Rico Capital Fund (the “Capital Fund”) was created in November 1992 for the purpose of investing and trading in debt obligations and publicly traded shares of domestic and foreign corporations separate from GDB’s general investment operations. On June 30, 2010, the Capital Fund transferred to the Tourism Development Fund, on behalf of GDB, \$72.1 million representing all the investments in the Capital Fund portfolio. As of March 31, 2012, the Capital Fund had assets of \$222,000, consisting principally of money market investments.

Puerto Rico Development Fund. Puerto Rico Development Fund (the “Development Fund”) was established in April 1977 to provide an alternate source of financing to private enterprises. The Development Fund is also authorized to guarantee obligations of those enterprises and invest in their equity securities. On December 31, 2010, the Development Fund acquired for \$8.5 million a commercial loan from a private commercial bank, secured by a first mortgage over a 2.34 acre parcel of land in the Convention Center District. As of March 31, 2012, the Development Fund had assets of \$22 million, including \$8.0 million in loans to private entities, \$10.2 million in an interest bearing accounts, and \$3.8 million in preferred shares of various private entities.

Puerto Rico Public Finance Corporation. Puerto Rico Public Finance Corporation (“PFC”) was established in November 1984 to provide agencies and instrumentalities of the Commonwealth with alternate means of meeting their financing requirements. The trustees of certain limited obligation bonds issued by the PFC currently hold notes payable by the Commonwealth, the Maritime Shipping Authority, the Office for the Improvement of Public Schools, the Department of Health and the Aqueduct and Sewer Authority, among others. All such PFC bonds are limited, non-recourse obligations of PFC payable solely from Commonwealth appropriations made to pay debt service on the notes held by the bond trustees. As of March 31, 2012, PFC had \$1.0 billion aggregate principal amount of limited obligation bonds outstanding.

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

Other Public Corporations

Aqueduct and Sewer Authority. PRASA owns and operates Puerto Rico’s public water supply and wastewater systems. Such systems provide water and wastewater services to 97% and 58% of the Commonwealth’s population, respectively.

PRASA reported an operating loss of \$39.6 million for fiscal year 2011, compared to operating losses of \$58.3 million and \$63.7 million for fiscal years 2010 and 2009, respectively.

In order to improve its financial condition, PRASA adopted a comprehensive plan to increase its revenues and reduce its expenses.

As of March 31, 2012, PRASA's total debt was \$4.6 billion, including approximately \$39.5 million of outstanding indebtedness with GDB. PRASA's senior debt is rated Baa2, BBB- and BBB by Moody's, S&P and Fitch Ratings ("Fitch"), respectively. On November 9, 2010, Moody's affirmed PRASA's rating but revised its outlook to negative from stable. The negative outlook reflects PRASA's continued reliance on GDB and the Commonwealth for financial support, as well as the operational challenges it faces to reduce the significant amount of water lost through its Systems.

The Commonwealth guarantees the principal and interest payments on the outstanding revenue refunding bonds, 2008 Series A and 2008 Series B, any bonds issued on or before June 30, 2015 to the Rural Utilities Service of the United States Department of Agriculture, and the loans granted on or before June 30, 2015 by the Puerto Rico Water Pollution Control Revolving Fund and the Puerto Rico Safe Drinking Water Revolving Fund to PRASA. In the event that PRASA is unable to make all or any portion of the future debt service payments on these guaranteed debts, the Commonwealth will be responsible for covering such payments.

On April 28, 2006, the Authority entered into a consent decree with the U.S. Environmental Protection Agency ("EPA") that requires the Authority to implement system wide remedial measures at all of the wastewater treatment plants operated by the Authority. The EPA consent decree establishes deadlines for the compliance with the conditions set forth therein and stipulates penalties for violation of any of those deadlines.

On December 15, 2006, a settlement agreement was signed between the Authority and the Department of Health of the Commonwealth ("DOH") relating to violations of the Safe Drinking Water Act. The settlement agreement was preliminarily approved by the supervising court on March 15, 2007, and was amended and finally approved by that court on June 20, 2008. The Authority agreed to implement a work plan to remediate the violations, establish preventive and mitigation measures, and execute a preventive maintenance program for the purpose of meeting the requirements of the Safe Drinking Water Act.

PRASA needs to make a substantial investment in infrastructure and a major overhaul of its operations to maintain the viability of the Systems, to finance its expansion for new users and to implement remedial measures required by a consent decree between PRASA and the EPA and a settlement agreement with the DOH. Funds for this investment will be provided through a combination of revenues from PRASA, financing transactions, federal grants and other sources. PRASA has established a 15-year capital improvement program with a total investment of \$2.2 billion in order to comply with the consent decree and the settlement agreement. PRASA has committed an investment of \$1.2 billion to comply with the EPA consent decree and \$1.0 billion to comply with the DOH settlement agreement.

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

payments to be made by the participating cigarette manufacturers under the Master Settlement Agreement.

Children's Trust issued \$397 billion Tobacco Settlement Asset-Backed Bonds in November 2002. The proceeds were used to pay certain capital expenditures, to fund the Liquidity Reserve account and certain costs of issuance. On June 30, 2005, Children's Trust issued \$108.2 million subordinate Tobacco Settlement Asset-Backed Bonds to pay working capital expenses of the Commonwealth. On May 1, 2008, Children's Trust issued an additional \$195.9 million of subordinate Tobacco Settlement Asset-Backed Bonds to make grants to third parties, pay certain expenses of the Commonwealth and cost of issuance. As of March 31, 2012, Children's Trust had outstanding bonds in the principal amount of \$1.3 billion. These bonds and any other additional senior bonds issued by Children's Trust are payable solely from, and secured by a statutory pledge of, the payments made and to be made by the participating cigarette manufacturers under the Master Settlement Agreement. To date, all principal and interest payments required to be made by Children's Trust on its outstanding bonds have been made on a timely basis from contribution payments made by the participating cigarette manufacturers under the Master Settlement Agreement.

Convention Center District Authority. Convention Center District Authority was created to own, develop, finance, plan, design, build, operate, maintain, administrate and promote the Dr. Pedro Rosselló González Convention Center, a new convention center, and designated private parcels located within the Convention Center District in San Juan. The convention center opened in November 17, 2005. Convention Center District Authority also owns a multipurpose coliseum in San Juan, known as the José Miguel Agrelot Coliseum. As of March 31, 2012, Convention Center District Authority's debt was \$438.1 million in outstanding bonds issued in March 2006 to finance the Convention Center and payable from a portion of a hotel room tax. As of March 31, 2012, Convention Center District Authority also had outstanding indebtedness to GDB of approximately \$147.6 million related to the financing of the Coliseum.

Electric Power Authority. Puerto Rico Electric Power Authority ("PREPA") owns and operates Puerto Rico's electric power system.

PREPA reported net operating income of \$326.9 million and \$348.1 million during fiscal years 2011 and 2010, respectively. The total debt of PREPA was \$8.0 billion as of March 31, 2012. This debt includes outstanding bonds of \$7.6 billion and interim financing for operations of \$427.2 million. PREPA's debt is rated A3, BBB+ and A- by Moody's, S&P and Fitch, respectively.

On May 1, 2012, PREPA issued \$630,110,000 Power Revenue Bonds, Series 2012A and \$19,890,000 Power Revenue Refunding Bonds, Series 2012B, which proceeds were used to, among other things, refund approximately \$21.3 million of outstanding bonds and repay approximately \$161.9 million of GDB lines of credit.

As a means of reducing its dependency on oil, PREPA entered into long-term power purchase agreements with private operators of two co-generation plants that use fuels other than oil. Currently, these two co-generation plants provide approximately 31% of PREPA's energy needs. PREPA has also commenced developing plans for the conversion of its main oil-fired

units into natural gas and clean-coal fired units, as well as other strategies to further reduce its dependency on oil.

Health Insurance Administration. The Health Insurance Administration was created in 1993 to negotiate and contract for the provision of comprehensive health insurance coverage for qualifying (generally low income) Puerto Rico residents. Under this system, the government selected, through a bidding process, one private health insurance company in each of eight designated regions of the island and paid such insurance company the insurance premium for each eligible beneficiary within such region. The health insurance system covered the entire island. Approximately 1.5 million persons were covered by the system during fiscal year 2011.

The total cost of the health insurance program was \$2.017 billion for fiscal year 2011, \$1.962 billion for fiscal year 2010 and \$1.861 billion for fiscal year 2009. During fiscal year 2011, the General Fund covered \$1.132 billion of the total cost of the health insurance program and \$85 million was covered with proceeds of COFINA bonds. The remaining \$800 million was paid from federal, municipal, internal and other sources. As of March 31, 2012, the Health Insurance Administration had outstanding indebtedness to GDB and private financial institutions of \$387.7 million, consisting of loans used to pay amounts owed to suppliers, including premiums owed to certain insurance companies for services rendered under the Health Reform program.

On October 1, 2010, the administration implemented “Mi Salud,” which is the health program that replaced the government’s Health Reform program. The principal differences between “Mi Salud” and the Health Reform are the use of a preferred-provider network organization rather than independent practice associations, an increase of benefits and services and an expansion of eligible participants. During the implementation of the program’s second phase, eligibility requirements will be expanded to include small to medium businesses. The estimated cost for “Mi Salud” during fiscal year 2012 is \$2.140 billion. The General Fund is expected to cover \$867 million, while the remaining \$1.273 billion will be paid as follows: \$100.5 million from federal funds that the administration was able to identify from grant awards for previous years, \$977.2 million from federal funds for this fiscal year and \$195.3 million from municipal and other sources. This projection includes forecasted increases in the enrollment of new beneficiaries.

The Commonwealth has entered into various contracts with several Medicare Advantage organizations for the provision of health coverage to approximately 180,000 eligible beneficiaries. Pursuant to these agreements, the Commonwealth pays each Medicare Advantage organization a premium difference to cover services not included in their contracts with the Center for Medicaid and Medicare Services.

On July 7, 2011, the Secretary of Health of the Commonwealth announced the cancellation of the MCS contract effective on October 31, 2011. MCS HMO administered five regions, with approximately 850,000 insureds, of the “Mi Salud” program. On October 17, 2011, the Health Insurance Administration and Triple-S Salud, Inc. (“Triple-S”) entered into an agreement pursuant to which Triple-S will administer the provision of healthcare services to insureds in the five regions previously administered by MCS HMO. Pursuant to the agreement, Triple-S will act as a third party administrator and will be compensated based on a per member

per month administrative fee. In contrast to the agreement with MCS HMO, the Government will now be financially responsible and bear the risk for the provision of services to insureds in the five regions administered by Triple-S. Effective November 1, 2011, the Government implemented additional cost-containment measures. After six months of experience, these measures have been effective in controlling costs and, therefore, the Government expects to finish fiscal year 2012 within the estimated cost projections.

Highways and Transportation Authority. Puerto Rico Highways and Transportation Authority (“PRHTA”) is responsible for highway construction in Puerto Rico. Such construction is financed by debt (interim notes and revenue bonds), revenues of PRHTA, and federal and Commonwealth grants.

PRHTA reported a net operating loss of \$530.8 million for fiscal year 2011, compared to a net operating loss of \$445.3 million for fiscal year 2010 and \$493.9 million for fiscal year 2009. As of June 30, 2011, PRHTA’s total debt was \$7.4 billion, consisting of \$6.1 billion of bonds and \$1.3 billion of GDB financings. As of March 31, 2012, PRHTA’s total debt decreased to \$6.9 billion, consisting of \$5.1 billion of bonds and \$1.8 billion of GDB financings.

Debt service on PRHTA’s revenue bonds constitutes a first lien on its gross revenues, which consist currently of all the proceeds of the tax on gasoline, one-half of the proceeds of the tax on gas oil and diesel oil, all the proceeds of the excise taxes on crude oil, unfinished oil and derivative products, up to \$120 million per fiscal year, highway toll revenues and the gross receipts of \$15.00 per vehicle per year from certain motor vehicle license fees. Such revenues (except for toll revenues) may be applied first to the payment of debt service on general obligation bonds and notes of the Commonwealth and to payments required to be made by the Commonwealth under its guarantees of bonds and notes, to the extent that no other revenues are available for such purpose. The Commonwealth has never applied such revenues for such payment.

PRHTA’s Highway Revenue Bonds are rated A3 and BBB+ by Moody’s and S&P, respectively, and the Senior Transportation Revenues Bonds are rated Baa1 and BBB by Moody’s and S&P, respectively.

PRHTA has a mass transit system, known as Tren Urbano, serving a portion of metropolitan San Juan. It was constructed under several design/build contracts and is being privately operated under a five-year contract with an additional five-year option at PRHTA’s election. The cost of the project was \$2.4 billion, which cost was financed by federal Transit Administration grants, other federal funding sources and PRHTA’s own resources, including revenue bonds. Tren Urbano commenced operations in June 2005. The operation of the Tren Urbano generated a loss of \$54 million, \$51.7 million, \$64.5 million, and \$62.5 million in fiscal years 2011, 2010, 2009 and 2008, respectively.

PRHTA is a party to a concession agreement under which a private company designed, constructed and currently is operating a toll bridge spanning the San José Lagoon. The toll bridge was financed with special facility revenue bonds of PRHTA, payable by the private operator of the bridge principally from toll revenues. The concession is for a term of 35 years, subject to earlier termination or extension. The bridge opened for traffic in February 1994. In

certain circumstances described in the concession agreement, including where toll revenues are insufficient to generate certain rates of return to the private operator, the private operator may require PRHTA, among other things, to assume the operator's obligations with respect to the special facility revenue bonds. Some of those circumstances, including lower than projected toll revenues, exist at this time, but PRHTA does not currently anticipate that the operator will exercise its remedy against PRHTA.

On September 22, 2011, PRHTA and PPP Authority completed the procurement process whereby a concession agreement was awarded to Metropistas, for the operation of toll roads PR-22 and PR-5. In connection with the establishment of the concession, PRHTA defeased, redeemed and/or purchased approximately \$873.1 million aggregate principal amount of its bonds. See "Public-Private Partnerships – Fiscal Stabilization and Economic Reconstruction" under THE ECONOMY.

Industrial Development Company. Puerto Rico Industrial Development Company ("PRIDCO") participates in the Commonwealth-sponsored economic development program by providing physical facilities, general assistance, and special incentive grants to manufacturers. PRIDCO reported consolidated change in net assets of \$13.6 million for fiscal year 2011, compared to consolidated change in net assets of \$10.3 million for fiscal year 2010, and consolidated change in net assets of \$6.0 million for fiscal year 2009. Rentals derived from the leasing of specified facilities of PRIDCO are pledged to the payment of PRIDCO's revenue bonds. As of March 31, 2012, PRIDCO's total debt was \$405.5 million, including approximately \$88.5 million from GDB financings and the outstanding debt of Puerto Rico Industrial Investment Corporation, a subsidiary of PRIDCO. PRIDCO's debt is rated Baal and BBB- by Moody's and S&P, respectively.

Industrial, Tourist, Educational, Medical and Environmental Control Facilities Financing Authority. The Puerto Rico Industrial, Tourist, Educational, Medical and Environmental Control Facilities Financing Authority ("AFICA") was created to finance (through the issuance of its revenue bonds) industrial, tourist, educational, medical, and environmental control facilities in Puerto Rico for the use of private companies, non-profit entities, or government agencies. The bonds are payable solely from payments to be made to AFICA by such private companies, non-profit entities, or government agencies, and do not constitute a debt of the Commonwealth or any of its other public corporations or municipalities. As of March 31, 2012, approximately \$1.37 billion of AFICA bonds were outstanding. In addition, as of March 31, 2012, AFICA had a \$5.6 million outstanding under line of credit with GDB used for the acquisition of assets from PREPA. This line of credit was cancelled on May 1, 2012.

Infrastructure Financing Authority. Puerto Rico Infrastructure Financing Authority ("PRIFA") was created to provide financial, administrative, consulting, technical, advisory, and other types of assistance to other public corporations, governmental instrumentalities, political subdivisions and municipalities (collectively, "Benefited Entities") authorized to develop infrastructure facilities and to establish alternate means for financing those facilities. PRIFA is authorized to issue bonds and provide loans, grants and other financial assistance for the construction, acquisition, repair, maintenance and reconstruction of infrastructure projects by Benefited Entities.

As of March 31, 2012, PRIFA's total debt was \$2.5 billion. This debt includes bonds outstanding of \$2.4 billion and interim financing for capital improvements of \$35.3 million. PRIFA's outstanding bonds include \$669.2 million of limited obligations bonds, the proceeds of which were loaned to the Ports Authority and are payable solely from loan payments to be made by Ports Authority. PRIFA's debt is rated Baa3 and BBB+ by Moody's and S&P, respectively.

PRIFA oversees the Puerto Rico Infrastructure Fund, which is being funded annually thru fiscal year 2052 with the first \$117 million of proceeds of federal excise taxes imposed on rum and other articles produced in Puerto Rico and sold in the United States that are transferred to Puerto Rico pursuant to the United States Internal Revenue Code of 1986, as amended. See "Major Sources of General Fund Revenues – Revenues from Non-Commonwealth Sources" under PUERTO RICO TAXES, OTHER REVENUES AND EXPENDITURES. Rum is the only article currently produced in Puerto Rico subject to federal excise taxes, the proceeds of which are required to be returned to the Treasury Department. The Authority is using these funds to pay debt service of bonds issued to finance various infrastructure projects.

PRIFA also has custody and control of the Infrastructure Development Fund and its Corpus Account, a perpetual account established under Act No. 92 of June 24, 1998 that was funded with \$1.2 billion of the proceeds of the sale of Puerto Rico Telephone Company. The interest earned on the securities held in the Corpus Account were being used by PRIFA to pay debt service on its \$1.1 billion Series 2000 A and B Bonds. Act No. 3, approved by the Legislative Assembly of the Commonwealth on January 14, 2009 ("Act 3"), authorized the sale of the securities held in the Corpus Account. PRIFA sold the securities in January 2009 and used the proceeds to: (i) make a deposit into an escrow account in an amount sufficient to retire the Series 2000 A and B Bonds on October 1, 2010, (ii) make a deposit to the General Fund which was applied to cover a portion of the Commonwealth's budget deficit, (iii) make a transfer to GDB as a capital contribution, and (iv) make a deposit to the Corpus Account to be invested in a long-term investment agreement with GDB.

As part of the Government's actions to address in part the financial condition of the Employees Retirement System, the Government enacted Act 96. On June 23, 2011, in accordance with Act 96, \$162.5 million of funds on deposit in the Corpus Account were contributed to the Employees Retirement System and invested in capital appreciation bonds issued by COFINA maturing annually on August 1, 2043 through 2048 and accreting interest at a rate of 7%. PRIFA also invested \$165.0 million of funds on deposit in the Corpus Account in capital appreciation bonds of COFINA maturing annually on August 1, 2045 through 2050 and accreting interest at 7%.

Pursuant to Act No. 8 of March 9, 2009, PRIFA is responsible for implementing in the Commonwealth the applicable provisions of ARRA. One of its main responsibilities regarding ARRA is to maximize the flow of funds from the Federal Government for the appropriate investment in qualified projects and activities. PRIFA also has responsibility for the receipt, administration and disbursement of such funds and monitoring those governmental agencies and entities that receive ARRA funds.

Municipal Finance Agency. Puerto Rico Municipal Finance Agency ("MFA") is authorized to issue bonds to purchase general obligation bonds and notes of Puerto Rico

municipalities and to fund a debt service reserve. Debt service on MFA's bonds is payable from debt service payments on municipal bonds and notes held by MFA and from the debt service reserve, including investment income thereon. The Commonwealth has agreed to pay such amounts to the debt service reserve as may be necessary to maintain it at its required level, subject to appropriation by the Legislative Assembly, which appropriation is authorized but not legally required to be made. To date no such payments have been required. As of March 31, 2012, MFA had \$988.4 million of bonds outstanding.

Port of the Americas Authority. Up to the approval of Act 240 of December 12, 2011, PAA was responsible for the development and operation of the Port of the Americas, a deep draft port on the south coast of Puerto Rico. With the approval of said Act 240, the Authority of the Port of Ponce was created with the exclusive jurisdiction of the Port of the Americas.

PAA was authorized to issue bonds guaranteed by the Commonwealth, in a maximum aggregate principal amount of \$250 million, for the development of the Port. GDB was authorized by law to purchase said bonds of PAA. As of March 31, 2012, GDB held approximately \$214.8 million of PAA's outstanding guaranteed bonds. While the responsibility for the development and operation of the Port of the Americas was transferred from PAA to the Authority of the Port of Ponce, PAA retained the liability for the outstanding bonds, which are expected to be paid by the Commonwealth under the guarantee.

Ports Authority. Ports Authority owns and operates the major airport and seaport facilities in Puerto Rico. Ports Authority derives revenues from a variety of sources, including charges on airplane fuel sales, air terminal space rentals, landing fees, wharfage, dockage and harbor fees, and rentals for the lease of property and seaport equipment. Ports Authority reported operating losses of \$38.7 million and \$46.7 million during fiscal years 2010 and 2009, respectively. As of March 31, 2012, the Ports Authority had \$260.1 million in debt, including approximately \$141.0 million from GDB financings, but excluding the loan payable to PRIFA for the repayment of PRIFA's \$669.2 million limited obligation bonds. See “– Infrastructure Financing Authority” above.

As of March 31, 2012, the outstanding balance of the credit facilities for capital improvements with private financial institutions was \$67.4 million, which is guaranteed by GDB.

Public Buildings Authority. PBA is authorized to construct, purchase or lease office, school, health, correctional and other facilities for lease to departments, public corporations, and instrumentalities of the Commonwealth. Bonds that have been issued by PBA to finance such facilities (through retirement of interim notes or otherwise) are payable from lease payments, which are largely derived from legislative appropriations and are secured by the Commonwealth's guaranty. PBA is authorized by law to have outstanding at any one time up to \$4.3 billion of bonds guaranteed by the Commonwealth.

On August 24, 2011 PBA issued \$756,449,000 Government Facilities Revenue Bonds, Series R (Qualified School Construction Bonds – Issuer Subsidy) and \$303,945,000 Government Facilities Revenue Bonds, Series S. The proceeds of the Series R bonds will be used to pay part

of the cost of constructing, renovating, remodeling and/or improving approximately 100 public schools.

On December 19, 2011, PBA issued \$121,528,000 Government Facilities Revenue Bonds, Series T (Qualified Zone Academy Bonds – Direct Payment). The proceeds will be used to pay part of the cost of renovating and rehabilitating certain public schools.

As of March 31, 2012, PBA had \$4.170 billion principal amount of bonds outstanding (not including accretion of interest from the respective issuance dates on capital appreciation bonds). As of March 31, 2012, PBA's line of credit with GDB had an outstanding balance of \$244.3 million.

PBA debt is rated Baa1, BBB and BBB+ by Moody's, S&P and Fitch, respectively.

Sales Tax Financing Corporation. COFINA is an independent governmental instrumentality of the Commonwealth created by Act 91 of 2006. COFINA was originally created for the purpose of financing the payment, retirement, or defeasance of certain appropriation-backed debt outstanding as of June 30, 2006, payable to GDB and PFC.

In 2009, the Legislative Assembly of Puerto Rico expanded the purposes for which COFINA was created and, correspondingly, increased its revenues by increasing from 1% to 2.75% (one-half of the tax rate of 5.5%) the portion that is transferred to COFINA of the sales and use tax imposed by the central government. As a result, COFINA was authorized to issue bonds for the following additional purposes: (i) to pay, in whole or in part, the debt of the Secretary of the Treasury with GDB in the amount of \$1 billion, the proceeds of which were used to cover the budgetary deficit for fiscal year 2009, (ii) to pay, in whole or in part, certain financing granted to the Secretary of the Treasury by GDB payable from future Commonwealth general obligation bonds, and any debt of the Commonwealth outstanding as of December 31, 2008 that did not have a source of repayment or was payable from budgetary appropriations, (iii) to pay, in whole or in part, the accounts payable to suppliers of the Commonwealth, (iv) to pay or finance operational expenses of the Commonwealth for fiscal years 2009, 2010, and 2011, (v) to pay or finance operational expenses of the Commonwealth for fiscal year 2012, which would have to be included in the annual budget of the Government of Puerto Rico, (vi) to fund the Puerto Rico Economic Stimulus Fund, (vii) to fund the Commonwealth Emergency Fund in order to cover expenses resulting from catastrophic events such as hurricanes or floods, and (viii) to generate moneys to fund the Economic Cooperation and Public Employees Alternatives Fund. As of March 31, 2012, COFINA had approximately \$15.2 billion outstanding of its Sales Tax Revenue Bonds (excluding all accretion on capital appreciation bonds). COFINA's Sales Tax Revenue Bonds are rated Aa2, AA- and AA- by Moody's, S&P and Fitch, respectively, and the Sales Tax Revenue Bonds, First Subordinate Series are rated A1, A+ and A+ by Moody's, S&P and Fitch, respectively.

Special Communities Perpetual Trust. The Perpetual Trust is a public corporation created by law to be an irrevocable and permanent trust. Perpetual Trust's principal purpose is to fund development projects that address the infrastructure and housing needs of underprivileged communities. GDB made a special capital contribution to Perpetual Trust of \$500 million and provided the Perpetual Trust with a \$500 million, non-revolving, line of credit. As of March 31,

2012, Perpetual Trust had disbursed most of its funds and its line of credit with GDB had an outstanding balance of \$367.9 million. The line of credit is payable from legislative appropriations.

University of Puerto Rico. The University of Puerto Rico (the “University”), with approximately 62,342 students at the beginning of academic year 2010-2011, is by far the largest institution of higher education on the Island. Government appropriations are the principal source of University revenues, but additional revenues are derived from tuition, student fees, auxiliary enterprises, interest income, federal grants, and other sources. University capital improvements have been financed mainly by revenue bonds. As of March 31, 2012, the University’s total debt was \$604.0 million (excluding \$18.6 million owed by the University’s Medical Services), consisting of \$532.8 million of bonds and \$71.1 million of loans. The University’s debt is rated Baa3 and BBB- by Moody’s and S&P, respectively. Moody’s rating of the University is currently on “watchlist” for possible revision.

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

In June 2007, the Board of Trustees of the University approved Certification No. 60 establishing a new policy and methodology for tuition fees structure. This new structure covers the tuition fees to be charged to new students until academic year 2012-2013. This policy was adopted to pursue continued development and financial stability of the University.

In June 2010, the Board of Trustees of the University approved Certification No. 146 establishing a \$400 stabilization fee to be charged each semester to all students in addition to tuition charges and other fees already in place at the University. This stabilization fee was imposed to address the University’s fiscal difficulties and is expected to increase annual revenues by approximately \$40 million.

As a result of a student-led strike that lasted approximately two months, on June 26, 2010, the Middle States Commission on Higher Education (the “Commission”), the regional accreditation entity of the eleven units that comprise the University system, placed on probation ten of the University’s units for lack of evidence of compliance with two of fourteen accreditation standards. This action was prompted by a student stoppage that interrupted the operations of these units for up to 62 days, but less in most cases. The ten affected units will remain fully accredited while on probation. After a Monitoring Report submitted by the ten affected units in September 2010 and subsequent evaluation visits, in June 2011 the Commission lifted probation and reaffirmed accreditation of seven of the ten affected units and in November 2011 lifted probation and reaffirmed accreditation of the three remaining units.

Other public corporations. Public corporations not described above have outstanding debt in the aggregate amount of \$2.4 billion as of March 31, 2012. Debt service on \$1.4 billion of such outstanding debt is being paid from legislative appropriations. The Commonwealth is not, however, obligated to make any such appropriations. Additional legislative appropriations are made to enable certain of such corporations to pay their operating expenses.

INSURANCE MATTERS

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

RETIREMENT SYSTEMS

General. Substantially all of the public employees of the Commonwealth and its instrumentalities are covered by five retirement systems: the Employees Retirement System of the Government of the Commonwealth (the “Employees Retirement System”), the Puerto Rico System of Annuities and Pensions for Teachers (the “Teachers Retirement System”), the Commonwealth Judiciary Retirement System (the “Judiciary Retirement System”), the Retirement System of the University of Puerto Rico (the “University Retirement System”) and the Employees Retirement System of Puerto Rico Electric Power Authority (the “Electric Power Authority Retirement System”). The Employees Retirement System and the Teachers Retirement System are the largest plans, both in number of active members and retirees and in the amount of their actuarial accrued liabilities.

The University Retirement System and the Electric Power Authority Retirement System covers employees of the University of Puerto Rico and Electric Power Authority, respectively, and are funded by those public corporations from their revenues. Although the Commonwealth is not required to contribute directly to those two systems, a large portion of the University’s revenues is derived from legally mandated legislative appropriations. The discussion that follows only covers the Employees Retirement System, the Teachers Retirement System and the Judiciary Retirement System (each a “Retirement System” and, collectively, the “Retirement Systems”).

The Employees Retirement System is a trust created by Act No. 447 of May 15, 1951 (“Act 447”) and is a hybrid defined benefit plan consisting of different benefit structures. Members who entered the Employees Retirement System on or before December 31, 1999 generally participate in a defined benefit program. Members participating in the defined benefit program prior to April 1, 1990 (“Act 447 Participants”) are entitled to the highest benefits structure, while those who became members on or after April 1, 1990 (“Act 1 Participants”) are subject to a longer vesting period and a reduced level of benefits, as provided by Act No. 1 of February 16, 1990 (“Act 1 of 1990”).

In 1999, Act 447 was amended to close the defined benefit program and, prospectively, establish a new benefit structure similar to a cash balance plan (this new benefit structure is

referred to as “System 2000”). Members who entered the Employees Retirement System on or after January 1, 2000 (“System 2000 Participants”) participate solely in System 2000. Under the System 2000 benefits structure, a participant is entitled to receive a lump-sum payment, which may be received in full or used to purchase an annuity from a third party, based solely on the amounts contributed by such participant. System 2000 Participants receive periodic account statements similar to those of defined contribution plans showing their accrued balances. System 2000 Participants do not benefit from any employer contributions. Instead, employer contributions with respect to System 2000 Participants are used to reduce the accumulated unfunded pension benefit obligation of the Employees Retirement System.

System 2000 is not a separate plan as there are no separate accounts for System 2000 Participants. Contributions received from System 2000 Participants are pooled and invested by the Employees Retirement System together with the assets corresponding to the defined benefit structure. Thus, future benefit payments under the original defined benefit structure and System 2000 will be paid from the same pool of assets of the Employees Retirement System.

The Teachers Retirement System is a trust created by Act No. 91 of March 29, 2004 (“Act 91 of 2004”), which superseded Act No. 218 of May 6, 1951, and is a defined benefit pension plan. The Judiciary Retirement System is a trust created by Act No. 12 of October 19, 1954 and is also a defined benefit pension plan.

The Retirement Systems are funded principally by contributions made by employers (the Commonwealth, public corporations and municipalities) and employees, as well as investment income.

Governance. Governance of the Employees Retirement System and the Judiciary Retirement System is vested in a Board of Trustees, which sets policy and oversees the operations consistent with applicable laws. There are nine members of the Board, as follows: the Puerto Rico Secretary of the Treasury (or his appointee), the President of GDB (or his appointee), the Commissioner of Municipal Affairs (or his appointee) and the Director of the Office of Human Resources of the Government of Puerto Rico (or his appointee), as *ex officio* members; three members appointed to three year terms by the Governor of Puerto Rico, two of whom must be members of the Employees Retirement System or the Judiciary Retirement System, with at least ten years of credited service; and a member who is a pensioner of the Employees Retirement System or the Judiciary Retirement System. The Board is also responsible for appointing the Administrator of the Employees Retirement System and the Judiciary Retirement System.

Governance of the Teachers Retirement System is also vested in a Board of Trustees. There are nine members of the Board, as follows: the Puerto Rico Secretary of the Treasury (or his appointee), the President of GDB (or his appointee) and the Puerto Rico Secretary of Education (or his appointee), as *ex officio* members; one member who is the President of a teacher’s organization, or his representative designated by the Governor of Puerto Rico, with the advice and consent of the Senate, for a term of four years; three teachers of the System, one of which shall represent active teachers and two of which shall represent retired teachers, each appointed by the Governor of Puerto Rico, with the advice and consent of the Senate, for a term of four years; one member who is the President of the collective bargaining unit for teachers

pursuant to Puerto Rico law (or his appointee); and a member who represents the public interest, appointed by the Governor of Puerto Rico, with the advice and consent of the Senate, for a term of four years. The Board is also responsible for appointing an Executive Director of the Teachers Retirement System.

Covered Employees. The Employees Retirement System covers substantially all employees of the departments and agencies of the Commonwealth, all members and regular employees of the Legislative Branch, and all employees of the public corporations (other than the University of Puerto Rico or the Electric Power Authority) and municipalities, except for those employees that are covered by the other two Retirement Systems. The Judiciary Retirement System only covers judges.

The Teachers Retirement System covers public school teachers and certain private school teachers, as well as teachers working in administrative positions. Act 91 of 2004 establishes that: (i) the Teachers Retirement System’s active employees as of March 29, 2004 (not public school teachers or other Department of Education employees) have the option to participate in the Teachers Retirement System or in the Employees Retirement System; (ii) persons hired by the Teachers Retirement System after the approval of the new law may only become members of the Teachers Retirement System, (iii) active teacher employees of the Department of Education are members of the Teachers Retirement System, and (iv) licensed teachers working in private schools or other educational organizations may elect to become members of the Teachers Retirement System as long as the required employer and employee contributions are satisfied. Currently, there are no teachers from private schools or other educational institutions participating in the Teachers Retirement System.

The following table shows the number of active members, retired members, disabled members and beneficiaries and terminated vested members for each of the Retirement Systems as of June 30, 2011.

Participant Data (as of June 30, 2011)						
	Active Members	Retired Members	Disabled Members	Beneficiaries	Terminated Vested Members⁽¹⁾	Total
Employees Retirement System						
Act 447 Participants	30,057	79,177	16,208	13,073	-	138,515
Act 1 Participants	50,346	4,239	462	32	-	55,079
System 2000 Participants	55,569	-	-	-	-	55,569
Total	<u>135,972</u>	<u>83,416</u>	<u>16,670</u>	<u>13,105</u>	<u>-</u>	<u>249,163</u>
Teachers Retirement System	43,402	30,431	2,095	2,835	768	79,531
Judiciary Retirement System	362	335	0	56	48	801

⁽¹⁾ Represents generally members who ceased employment without the right to a retirement annuity and are due a refund of member contributions and, if applicable, employer contributions, plus interest thereon. There are terminated vested members of the Employees Retirement System, but the Employees Retirement System does not possess reliable data on the amount of such members.

The Commonwealth central government (consisting of department and agencies) is not the only employer participating in the Employees Retirement System. The municipalities and most public corporations participate as employers as well with respect to their employees. However, the assets contributed by the Commonwealth central government and all other

employers are invested together and not otherwise segregated. As of June 30, 2011, the central government was responsible for making contributions with respect to 82,554 active members of the Employees Retirement System, or 60.7% of total active members (consisting of 19,230 Act 447 Participants, 33,347 Act 1 Participants and 29,977 System 2000 Participants). Municipalities were responsible for 32,264, or 23.7%, active members, and public corporations were responsible for 21,154, or 15.6%, active members.

Funding Requirements. The Commonwealth central government is responsible for approximately 59% of total employer contributions to the Employees Retirement System, and the other 41% is the responsibility of public corporations and municipalities. The Commonwealth central government is also responsible for 100% and 99% of total employer contributions to the Judiciary and Teachers Retirement Systems, respectively. Retirement and related benefits provided by the Retirement Systems and required contributions to the Retirement Systems by employers and employees are determined by law rather than by actuarial requirements. The Commonwealth is ultimately responsible for any funding deficiency with respect to central government employees in the three Retirement Systems.

As of July 1, 2011, after the adoption of Act 116, the statutory employer contribution for the Employees Retirement System increased from a minimum of 9.275% to a minimum of 10.275% of covered payroll, and will continue to increase annually until fiscal year 2021. See “Efforts to Address Cash Flow Shortfall and Improve Funding Ratio” below. Covered payroll is the compensation regularly paid to active employees on which contributions to the retirement systems are computed and is generally equivalent to their annual salary. The employer contribution rate of 9.275% had been in effect since February 1990. Act 447 requires that employer contributions cover the difference between (i) the benefits provided by the System, plus administrative costs, and (ii) the contributions that employees are required to make to the System. This requirement, however, has not been adhered to and the level of employer contributions has been limited to the minimum statutory rate.

Required employee contributions for the Employees Retirement System vary according to how the individual employee’s retirement benefits are coordinated with social security benefits.

As of July 1, 2011, after the adoption of Act 114, the statutory employer contribution for the Teachers Retirement System increased from 8.5% to 9.5% of covered payroll, and will continue to increase annually until fiscal year 2021. See “Efforts to Address Cash Flow Shortfall and Improve Funding Ratio” below. The statutory employee contribution for the Teachers Retirement System is 9.0% of covered payroll. For the Judiciary Retirement System, the employer contribution is 30.34% of covered payroll and 8% for the employees. The employer contribution rate for the Judiciary Retirement System increased from 20.0% to 30.34% of payroll as of July 1, 2008.

The Constitution of Puerto Rico provides that in the event the Commonwealth has insufficient funds to pay all approved appropriations, the available resources of the Commonwealth shall be used to pay public debt before being used for other purposes. Public debt of the Commonwealth includes general obligation bonds and notes of the Commonwealth to which the full faith, credit and taxing power of the Commonwealth are pledged and, according to

opinions rendered by the Attorney General of the Commonwealth, also any payments required to be made by the Commonwealth under its guarantees of bonds and notes issued by its public instrumentalities. See DEBT. Furthermore, Puerto Rico law provides “priority norms” for the disbursement of public funds that apply during any fiscal year in which the resources available to the Commonwealth are insufficient to cover the appropriations approved for such year, as follows: first, the payment of the interest on, and amortization requirements for, public debt (Commonwealth general obligation and guaranteed debt); second, the fulfillment of obligations arising out of legally binding contracts, court decisions on eminent domain and certain commitments to protect the name, credit and good faith of the Commonwealth government; third, current expenditures in the areas of health, protection of persons and property, education, welfare and retirement systems; and fourth, all other purposes. Thus, according to the priority norms, contributions by the Commonwealth to the Retirement Systems expressly fall within the third priority. These restrictions do not apply to employer contributions made by public corporations and municipalities, because the funds of public corporations and municipalities are not “available resources” of the Commonwealth.

Benefits and Special Benefits. Each Retirement System provides basic benefits principally consisting of a retirement annuity and death and disability benefits (collectively referred to herein as “Basic System Pension Benefits”). Each also administers benefits granted under various special laws that have provided additional benefits for the retirees and beneficiaries (collectively referred to herein as “System Administered Pension Benefits”). The System Administered Pension Benefits include, among others, additional minimum pension, death and disability benefits, ad-hoc cost-of-living adjustments and summer and Christmas bonuses. See Note 20 to the Commonwealth’s audited financial statements for fiscal year 2011 included in the CAFR for a summary of the benefits provided by each of the Retirement Systems.

The System Administered Pension Benefits are funded on a pay-as-you-go basis by the Commonwealth from the General Fund or by the participating public corporation and municipalities. These benefits are not an obligation of the respective Retirement Systems. Except for the System Administered Pension Benefits corresponding to former employees of municipalities and public corporations, which are obligations of the municipalities and public corporations, most of the funds used to cover these benefits are required to be paid by the Commonwealth through annual appropriations from the General Fund. Historically, however, the Retirement Systems have made current payments of System Administered Pension Benefits to participants but the costs of these pension benefits have not been recuperated by the Retirement Systems in full and on a timely basis from the Commonwealth and the participating public corporations and municipalities.

Through June 30, 2004, the Teachers Retirement System had paid \$119.6 million from its resources to cover System Administered Pension Benefits that should have been received from the Commonwealth through annual appropriations. On May 31, 2004, the Teachers Retirement System made a claim to OMB to collect this amount. OMB disputed the Teachers Retirement System’s interpretation of certain System Administered Pension Benefit laws to the effect that the Commonwealth is required to reimburse the Teachers Retirement System for such benefits paid. During 2009, the Department of Education paid \$12.2 million that was part of the amounts claimed to OMB. On April 23, 2010, OMB and the Teachers Retirement System settled the

remaining claim for \$53.8 million, to be paid in five equal installments of \$10.8 million during the next five fiscal years, starting in fiscal year 2011. In July 2011, the Teachers Retirement System received the second installment.

The Employees Retirement System is also seeking reimbursement from the Commonwealth, the municipalities and public corporations in the amount of approximately \$78 million, \$24 million and \$40 million, respectively, for cumulative System Administered Pension Benefits paid to its beneficiaries through June 30, 2011.

Composition and Market Value of Investment Portfolios. As of June 30, 2011, the market value of the Employees Retirement System's investment portfolio was \$4.940 billion, compared to \$4.795 billion as of June 30, 2010. As of June 30, 2011, the investment portfolio was comprised of approximately 27.7% of equity investments, 20.8% of fixed income securities, 25.8% of internally managed mortgage and personal loans portfolio, 24.3% of short-term cash equivalents, and 1.33% of other investments. As of December 31, 2011, the market value of the Employees Retirement System's investment portfolio was \$4.226 billion. The decrease in value of the investment portfolio since June 30, 2011 principally reflects the continued use of investment portfolio assets to pay current benefits as discussed below.

As of June 30, 2011, the market value of the Teachers Retirement System's investment portfolio was \$2.407 billion, compared to \$2.205 billion as of June 30, 2010. As of June 30, 2011, the investment portfolio was comprised of approximately 50.3% of equity investments, 24.6% of fixed income securities, 16.9% of internally managed mortgage and personal loans portfolio, 7.1% of short-term cash equivalents, and 1.1% of other investments. As of December 31, 2011, the market value of the Teachers Retirement System's investment portfolio was \$2.176 billion. The decrease in value of the investment portfolio since June 30, 2011 principally reflects the continued use of investment portfolio assets to pay current benefits as discussed below.

As of June 30, 2011, the market value of the Judiciary Retirement System's investment portfolio was \$73.9 million, compared to \$83.9 million as of June 30, 2010. As of June 30, 2011, the investment portfolio was comprised of approximately 30.0% of equity investments, 54.1% of fixed income securities, 1.1% of internally managed mortgage and personal loans portfolio, and 14.8% of short-term cash equivalents. As of December 31, 2011, the market value of the Judiciary Retirement System's investment portfolio was \$68.9 million.

Actuarial Valuations of the Retirement Systems. Historically, each of the Retirement Systems has conducted an actuarial valuation as of the end of every two fiscal years. However, due to the deterioration of the funding status of the Retirement Systems, as discussed below, each of the Retirement Systems began conducting annual actuarial valuations effective June 30, 2009. The latest actuarial valuations were conducted by Milliman Inc., a firm of independent consulting actuaries, as of June 30, 2011.

Informational copies of the actuarial valuation reports of the Employees Retirement System and the Judiciary Retirement System as well as other financial information are available on the website of the Administration of the Retirement Systems at www.retiro.pr.gov. Informational copies of the actuarial valuation report of the Teachers Retirement System as well as other financial information are available at the website of the Teachers Retirement System at

www.srm.pr.gov. No information contained on these websites is deemed incorporated herein by reference.

The purpose of an actuarial valuation is to calculate the actuarial accrued liability of each of the Retirement Systems, which estimates on the basis of demographic and economic assumptions the present value of the benefits that each of the Retirement Systems will pay to its retired members and active members upon retirement. The actuarial valuations are performed in accordance with generally recognized and accepted actuarial principles and practices. The actuarial valuation compares the actuarial accrued liability with the actuarial value of assets and any excess of that liability over the assets represents an unfunded actuarial accrued liability (“UAAL”) of the applicable Retirement System. In the case of the actuarial valuations of the Retirement Systems, the actuarial value of assets is equal to the market value of assets (net of liabilities). An actuarial valuation will also express the percentage that a Retirement System is funded through a “Funded Ratio” which represents the quotient obtained by dividing the actuarial value of assets of the Retirement System by the actuarial accrued liability of the Retirement System. An actuarial valuation will also state an actuarially recommended contribution rate, which is a recommended rate of covered payroll that consists of two components: (1) normal cost, which generally represents the portion of the present value of retirement benefits that are allocable to active members’ current year service, and (2) an amortized portion of the UAAL. The amount that the Commonwealth and other participating entities actually contribute to the Retirement Systems is determined by statute and does not follow the recommendations of the actuaries, as discussed above. If additional employer contributions were to be made, they would have to be included in the Governor’s budget request and approved by the Legislature.

To calculate the actuarial accrued liability of each of the Retirement Systems, the actuarial valuations use several actuarial assumptions. Some examples of these assumptions include an expected rate of return of assets, age of retirement of active members, future pay increases for current employees, assumed rates of disability and post-employment life expectancies of retirees and beneficiaries. If the experience of the Retirement Systems is different from these assumptions, the UAAL of the Retirement Systems may increase or decrease to the extent of any variances. As discussed below, the actual return of assets of each of the Retirement Systems during fiscal year 2009 was significantly lower than the assumed investment return utilized to prepare the actuarial accrued liability. The actual return of assets of each of the Retirement Systems for fiscal year 2010 and 2011, however, was higher than the assumed investment return used in the actuarial valuations as of June 30, 2011.

The actual rate of return on assets of the Retirement Systems depends on the performance of their respective investment portfolios, which can vary materially from the expected rates of return assumed in the actuarial valuations. The investment portfolios of the respective Retirement Systems can be volatile. The value of the securities in the investment portfolios can dramatically change from one fiscal year to the next, which could, in turn, cause substantial increases or decreases in the net assets of the Retirement Systems, which directly impacts the UAAL. For fiscal year 2009, the annual rates of return of the assets of the Employees Retirement System, the Teachers Retirement System and the Judiciary Retirement System was negative 9.8%, negative 16.0% and negative 18.0%, respectively, contributing to the increase in the UAAL of the Retirement Systems between fiscal year 2007 and fiscal year 2009. For fiscal

year 2010, the year-end return of the assets of the Employees Retirement System, the Teachers Retirement System and the Judiciary Retirement System was 8.7%, 12.5% and 12.7%, respectively. For fiscal year 2011, the year-end return of the assets of the Employees Retirement System, the Teachers Retirement System and the Judiciary Retirement System was 16.0%, 22.5% and 20.5%, respectively.

The June 30, 2011 actuarial valuations of the Employees Retirement System and Judiciary Retirement System were completed in accordance with the “projected unit credit” method, with an assumed investment return of 6.4% per year, in the case of the Employees Retirement System, and 6.6% per year, in the case of the Judiciary Retirement System, and yearly salary increases of 3% per year. The actuarial valuations of the Employees Retirement System and the Judiciary Retirement System as of June 30, 2010 had assumed investment returns of 7.5% per year. Under the “projected unit credit” method, a projected benefit is determined at each active participant’s assumed retirement age assuming future compensation increases, and the projected benefit is attributed to each year of service using straight proration based on projected service to each assumed retirement age. The plan’s normal cost is the sum of the present value of the portion of each active participant’s projected benefit attributable to the current year of service.

The June 30, 2011 actuarial valuation of the Teachers Retirement System was completed in accordance with the “entry age normal” method and assumed an investment return of 6.4% per year and yearly salary increases of 3.5%. The actuarial valuation of the Teachers Retirement System as of June 30, 2010 had assumed investment returns of 8% per year. Under the “entry age normal” method, a projected benefit is determined at each active participant’s assumed retirement age assuming future compensation increases. The plan’s normal cost is the sum of each active participant’s annual cost for the current year of service determined such that, if it were calculated as a level percentage of his compensation each year, it would accumulate (at the valuation interest rate over his total prior and future years of service to the participant’s assumed retirement date) into an amount sufficient to fund the participant’s projected benefits.

Any amounts receivable from the Commonwealth with respect to benefits under System Administered Pension Benefits laws (discussed above) are considered in the actuarial valuation process to determine the unfunded pension benefit obligation of the Retirement Systems to the extent receivables are recognized as such by the Systems.

In performing the actuarial valuations, the actuaries rely on data provided by the Retirement Systems. Although the actuaries review the data for reasonableness and consistency, they do not audit or verify the data. If the data were inaccurate or incomplete, the results of the actuarial valuations may also be inaccurate or incomplete, and such defects may be material.

The following tables set forth, according to the actuarial valuations of the Retirement Systems, the actuarial value of assets, actuarial accrued liability, UAAL, funded ratio, covered payroll and UAAL as a percentage of covered payroll. The ratio of the UAAL to covered payroll is a measure of the significance of the UAAL relative to the capacity to pay it. The trend in the ratio provides information as to whether the financial strength of a pension plan is improving or deteriorating over time. As shown in the “Historical Funding Status” table, the steady increase

in the UAAL to covered payroll for each of the Retirement Systems shows a significant deterioration in their financial strength.

Funding Status
Actuarial Valuations as of June 30, 2011
(in millions)

	Actuarial Value of Assets ⁽¹⁾	Actuarial Accrued Liability ⁽²⁾	Unfunded Actuarial Accrued Liability ⁽³⁾	Funded Ratio ⁽⁴⁾	Covered Payroll ⁽⁵⁾	UAAL as a Percentage of Covered Payroll ⁽⁶⁾
Employees Retirement System.....	\$1,724	\$25,457	\$23,734	6.8%	\$3,666	647.3%
Teachers Retirement System.....	2,386	11,449	9,063	20.8	1,320	686.4
Judiciary Retirement System	64	383	319	16.7	32	1,002.2
Total.....	\$4,174	\$37,289	\$33,116	11.2%	\$5,018	659.9%

- (1) The actuarial value of assets of each of the Retirement Systems is set forth in the actuarial valuation relating to each Retirement System and is equal to the full market value of the assets held by the Retirement Systems, including expected receivable contributions from the Commonwealth, municipalities and participating public corporations, less bonds payable and other liabilities.
- (2) The actuarial accrued liability of each of the Retirement Systems is set forth in the actuarial valuation relating to each Retirement System and is an estimate based on demographic and economic assumptions of the present value of benefits that the Retirement System will pay during the assumed life expectancies of the applicable retired members and active members after they retire.
- (3) The UAAL of each of the Retirement Systems is set forth in the actuarial valuation relating to each Retirement System and reflects the amount of the excess of the actuarial accrued liability of a Retirement System over its actuarial value of assets. The indicated amounts reflect the UAAL as calculated pursuant to the requirements of the Government Accounting Standards Board (“GASB”) for purposes of presentation in the CAFR.
- (4) The Funded Ratio of each of the Retirement Systems is presented in the actuarial valuation relating to each Retirement System and reflects the quotient obtained by dividing the actuarial value of assets of the Retirement System by the actuarial accrued liability of the Retirement System. The indicated percentages reflect the Funded Ratio as calculated pursuant to the requirements of GASB for purposes of presentation in the CAFR.
- (5) The covered payroll of each of the Retirement Systems is presented in the actuarial valuation relating to each Retirement System and is equal to the annual salaries paid to active employees on which contributions to the Retirement System are made.
- (6) The UAAL as a percentage of covered payroll is presented in the actuarial valuation relating to each Retirement System and reflects the quotient obtained by dividing the UAAL of the Retirement System by the covered payroll of the Retirement System.

Source: Actuarial valuation reports as of June 30, 2011 for each of the Retirement Systems.

Historical Funding Status⁽¹⁾
Actuarial Valuations as of the Indicated Fiscal Years
(in millions)

Fiscal Year Ending June 30,	Actuarial Value of Assets	Actuarial Accrued Liability	Unfunded Actuarial Accrued Liability	Funded Ratio	Covered Payroll	UAAL as a Percentage of Covered Payroll
Employees Retirement System						
2005.....	\$2,328	\$13,969	\$11,641	16.7%	\$4,126	282.2%
2007.....	2,892	16,770	13,878	17.2	4,246	326.8
2009.....	1,851	18,944	17,092	9.8	4,293	398.2
2010.....	1,667	21,370	19,703	7.8	3,818	516.1
2011.....	\$1,724	\$25,457	\$23,734	6.8	\$3,666	647.3
Teachers Retirement System						
2004.....	\$2,403	\$ 4,702	\$ 2,299	51.1%	\$1,294	177.7%
2007.....	3,163	7,756	4,593	40.8	1,370	335.3
2009.....	2,158	8,722	6,564	24.7	1,418	462.8
2010.....	2,222	9,280	7,058	23.9	1,370	515.0
2011.....	2,386	11,449	9,063	20.8	1,320	686.4
Judiciary Retirement System						
2005.....	\$70	\$174	\$105	40.0%	\$29	356.8%
2007.....	81	259	177	31.5	31	566.6
2009.....	51	324	273	15.6	31	893.7
2010.....	55	338	283	16.4	32	882.0
2011.....	64	383	319	16.7	32	1002.2

⁽¹⁾ Please refer to the footnotes of the immediately preceding table for an explanation of the categories set forth in the columns of this table.
Source: Actuarial valuation reports as of June 30 of the fiscal years indicated above for each of the Retirement Systems.

The following table shows the actuarially recommended contributions, actual employer contributions and resulting amount unfunded and percent contributed for each of the Retirement Systems' last four fiscal years.

**Schedule of Employer Contributions
to Retirement Systems
(in millions)**

Fiscal Year Ending June 30,	Actuarially Recommended Contributions ⁽¹⁾	Actual Employer Contributions ⁽²⁾	Amount Unfunded ⁽³⁾	Percent Contributed
Employees Retirement System				
2008	\$1,191	\$663	\$528	55.7%
2009	1,259	595	664	47.3
2010	1,460	534	926	36.6
2011	1,735	702	1,033	40.5
2012	2,019	597	1,422	29.6
Teachers Retirement System				
2008	\$341	\$159	\$182	46.6%
2009	394	173	221	43.9
2010	477	166	311	34.8
2011	528	161	367	30.5
2012	659	175	484	26.6
Judiciary Retirement System				
2008	\$20	\$7	\$13	35.0%
2009	22	11	11	50.0
2010	28	11	17	39.3
2011	30	11	19	36.7
2012	34	11	23	32.4
Total				
2008	\$1,552	\$829	\$723	53.4%
2009	1,675	779	896	46.5
2010	1,965	711	1,254	36.2
2011	2,293	874	1,419	38.1
2012	2,712	783	1,929	28.9

⁽¹⁾ The actuarially recommended contributions are based on the information contained in the actuarial valuations for the Retirement Systems as of June 30, 2011.

⁽²⁾ The actual employer contributions for fiscal year 2012 are based on the statutory employer contribution plus the expected pay-as-you-go contributions for System Administered Pension Benefits, as set forth in the actuarial valuations as of June 30, 2011.

⁽³⁾ Represents the difference between the actuarially recommended pension contribution and the actual contribution from the participating employers.

Source: Information regarding the actuarially recommended contributions was derived from the June 30, 2011 actuarial valuation reports for the Retirement Systems. Information regarding the actual contributions for the Retirement Systems was provided by the Retirement Systems.

Based on the current funding requirements of the Retirement Systems, the UAAL of the Retirement Systems will continue to increase indefinitely into the future instead of being amortized and future scheduled contributions at the current funding rates will not be sufficient to make future benefit payments when due. Additional funding from the Commonwealth will ultimately be necessary to cover such unfunded obligation. It is estimated that the Commonwealth would be responsible for approximately 64% of any such funding deficiency of the Employees Retirement System and approximately 74% of the combined funding deficiency of the Retirement Systems, with the balance being the responsibility of the municipalities and participating public corporations.

Funding Shortfalls and Issuance of Pension Obligation Bonds. For several fiscal years, actual employer and employee contributions to each of the Retirement Systems have been lower than annual Basic System Pension Benefits payments and administrative expenses. These shortfalls in contributions over the amounts required to pay Basic System Pension Benefits and expenses are referred to herein as “funding shortfalls.” The funding shortfalls, however, do not reflect the actual cash flow position of the Retirement Systems, which is affected, among other things, by their investment and financing activities. One type of investment that has particularly contributed to the deterioration of the Retirement Systems’ actual cash position has been the increase in personal loans to their members, as discussed below under “*Factors That Have Contributed to Deterioration in Financial Solvency of the Employees Retirement System.*”

The Retirement Systems have been forced to cover the funding shortfalls with investment income, loans from financial institutions and various non-recurring sources of funds. In some fiscal years, the funding shortfall has also exceeded the investment income of the Retirement Systems, causing the Systems’ assets to decline and adversely affecting the funded status.

Besides using investment income to cover benefit payments, the Employees Retirement System has covered some of its historical funding shortfalls with the sale of investment portfolio assets and proceeds of loans from the Treasury Department or other financial institutions, some of which have been collateralized with the System’s assets.

During 2008, the Employees Retirement System issued approximately \$2.9 billion of Senior Pension Funding Bonds (the “Pension Bonds”), with interest rates ranging from 5.85% to 6.55%, for which repayment the Employees Retirement System pledged all employer contributions made after the issuance of the bonds. The Pension Bonds are limited, non-recourse obligations of the Employees Retirement System payable solely from and secured solely by the employer contributions. The maturity of the Pension Bonds is not subject to acceleration for any reason including non-payment of debt service on the bonds. As of June 30, 2011, approximately \$2.9 billion of the Pension Bonds remain outstanding. The Pension Bonds increased the funds of the Employees Retirement System currently available to pay pension benefits. The original expectation was that the Employees Retirement System’s investment earnings on the proceeds of the Pension Bonds would exceed the cost of the debt. The Employees Retirement System, however, has not obtained the expected arbitrage on invested proceeds and has also used some proceeds to pay current system benefits and operational expenses.

The table below shows the funding shortfalls for each of the last five fiscal years and the projected funding shortfall for the following five fiscal years for each of the Retirement Systems.

**Funding Shortfalls
(in millions)**

Fiscal Year Ending June 30,	Employer and Member Contributions ⁽¹⁾	Basic System Benefit Payments and Administrative Expenses ⁽³⁾	Net Funding Shortfall
Employees Retirement System			
2007	\$713	\$ (850)	\$(137)
2008	726	(990)	(264)
2009	762	(1,023)	(261)
2010	727	(1,102)	(375)
2011	671 ⁽²⁾	(1,183)	(512)
2012	689	(1,528)	(839)
2013	744	(1,550)	(806)
2014	801	(1,584)	(783)
2015	860	(1,629)	(769)
2016	921	(1,679)	(758)
Teachers Retirement System			
2007	\$257	\$(394)	\$(137)
2008	249	(447)	(198)
2009	263	(473)	(210)
2010	249	(503)	(254)
2011	236	(550)	(314)
2012	244	(559)	(315)
2013	267	(579)	(312)
2014	290	(600)	(310)
2015	315	(624)	(309)
2016	341	(650)	(309)
Judiciary Retirement System			
2007	\$10	\$(16)	\$(6)
2008	10	(16)	(6)
2009	13	(17)	(4)
2010	13	(19)	(6)
2011	13	(19)	(6)
2012	12	(21)	(9)
2013	13	(22)	(9)
2014	13	(23)	(10)
2015	13	(24)	(11)
2016	14	(25)	(11)

⁽¹⁾ Represents the statutory employer and member contributions and does not include amounts received from employers on account of System Administered Pension Benefits. For fiscal years 2012 through 2016, estimated payroll is assumed to grow 3% annually and employer contributions include the rate increases provided for by Act 114 and Act 116.

⁽²⁾ Excludes \$162.5 million contributed to the Employees Retirement System on June 23, 2011 and invested in COFINA bonds pursuant to Act, 96.

⁽³⁾ Includes, in the case of the Employees Retirement System, principal and interest paid on the Pension Bonds for fiscal years 2008, 2009 and 2010 and 2011 in the amounts of \$47 million, \$187 million, \$188 million and \$189 million, respectively, and for fiscal years 2012 through 2016, debt service of \$167 million per year.

Source: Information obtained from each of the Retirement Systems and the June 30, 2011 actuarial valuation reports.

The Employees Retirement System anticipates that, based on the current contributions and benefit structure, its future cash flow needs for disbursement of benefits to participants, administrative expenses and debt service are likely to continue to exceed the sum of the

employer and employee contributions received and its investment and other recurring income. For fiscal year 2012, the Employees Retirement System expects to have a funding shortfall (after payment of debt service on the Pension Bonds) of \$839 million and this negative trend is expected to continue, as shown in the table above, even after taking into account the increases in employer contributions provided for by Act 116, as described below. Based on the Employees Retirement System's current funding and disbursement projections (which reflect continued funding shortfalls) and other assumptions, the actuarial valuation as of June 30, 2011 states that the System is being rapidly defunded and projects that its net assets (total assets minus the Pension Bonds and other liabilities) will be depleted by fiscal year 2014 and its gross assets will be depleted by fiscal year 2020. This means that during the period from fiscal year 2014 through fiscal year 2020, benefits are expected to be paid from the proceeds of the Pension Bonds, and that after depletion of the gross assets, there would be no funds remaining to pay pension benefits or debt service on the pension obligation bonds.

The Teachers Retirement System has also covered funding shortfalls during the prior five fiscal years through the sale of investment portfolio assets. For fiscal year 2012, the Teachers Retirement System expects to have a funding shortfall of approximately \$315 million, and this negative trend is expected to continue as shown in the table above, even after taking into account the increases in employer contributions provided for by Act 114, as described below. Based on the Teachers Retirement System's current funding and disbursement projections (which reflect continued funding shortfalls) and other assumptions, the actuarial valuation as of June 30, 2011 states that the System is being gradually defunded and projects that its net and gross assets will be depleted by fiscal year 2022.

The Judiciary Retirement System has also experienced funding shortfalls during the last five fiscal years and has used investment income to cover some of these shortfalls. For fiscal year 2012, the Judiciary Retirement System expects to have a funding shortfall of approximately \$9 million, and this negative trend is expected to continue. Based on the Judiciary Retirement System's current funding and disbursement projections (which reflect continued funding shortfalls) and other assumptions, the actuarial valuation as of June 30, 2011 states that the System is being defunded and projects that its net and gross assets will be depleted by fiscal year 2019.

For fiscal year 2012, the combined unfunded amount of the Retirement Systems corresponding to the Commonwealth (assuming the Commonwealth is responsible for approximately 64% of the funding deficiency of the Employees Retirement System), is approximately \$861 million, which represents approximately 10% of projected General Fund revenues for the fiscal year.

If the level of contributions to the Retirement Systems and the level of benefits were to remain unchanged, the funding deficiencies are expected to continue to be covered with the investment income from, and the sale of, assets of the Retirement System, thus continuing to deplete such assets. Based on the actuarial valuation reports, for the period from fiscal year 2012 to fiscal year 2022, the average annual funding deficiency is projected to be approximately \$746 million for the Employees Retirement System, approximately \$307 million for the Teachers Retirement System and approximately \$12 million for the Judiciary Retirement System. Once the assets of the Retirement Systems are depleted, the funding deficiency would have to be

covered by the employers. As indicated above, it is estimated that the Commonwealth would have to cover approximately 64% of the funding deficiency of the Employees Retirement System and substantially all of the funding deficiency of the Teachers Retirement System and the Judiciary Retirement System.

The estimated years for depletion of the assets stated above could vary depending on how actual results differ from the assumptions used in the actuarial valuations (including the assumed investment rate of return), as well as based on any future changes to the contribution and benefits structures of the Retirement Systems.

The consulting actuaries have recommended that the funding requirements of the Retirement Systems be significantly increased in light of (i) the expected negative net cash flows and exhaustion of plan assets, (ii) the forecasted decrease in funded status, and (iii) the actuarially recommended contributions which significantly exceed actual employer contributions.

Factors That Have Contributed to Deterioration in Financial Solvency of the Employees Retirement System. On June 30, 2010, the Employees Retirement System and GDB, as fiscal agent, retained Conway MacKenzie, Inc (“CMI”), a financial advisory firm, to identify and analyze key events and decisions that have contributed to the current financial crisis of the Employees Retirement System, including the deterioration of its funded ratio. CMI issued its report in October 2010. In its report, CMI identified the following five factors as fundamental in the deterioration of the financial health of the Employees Retirement System: (i) historical inadequate funding levels, (ii) special laws, (iii) early retirement programs, (iv) personal loans, and (v) the 2008 issuances of Pension Bonds.

The report reviews the historical funding levels of the Employees Retirement System and concludes that the Employees Retirement System has been underfunded since its inception in 1951, essentially as a result of statutory funding rates that fall below actuarially determined contribution rates. In addition to inadequate annual contributions, CMI notes that investment returns and other recurring income have been insufficient to cover annual benefit payments and operating expenses, resulting in cash flow shortfalls that have forced the Employees Retirement System to liquidate plan assets.

CMI also identified the enactment of numerous special laws, which have granted incremental retirement benefits to participants beyond those provided by Act 447 and Act 1 of 1990, as having exacerbated the deteriorating financial condition of the Employees Retirement System. Many special laws were adopted without the Government securing a viable, long-term source of funding for such additional benefits, including the adoption of special laws during periods when the Government was incurring in budgetary deficits. As a result, the Employees Retirement System was forced to fund the benefits granted under these special laws, resulting in significant past-due receivables from the Commonwealth and participating public corporations and municipalities.

The adoption of several early retirement programs is also identified as having affected the financial solvency of the Employees Retirement System. These programs were adopted in order to reduce the size of the public workforce and thereby decrease payroll costs. These programs,

however, were generally not accompanied by up-front funding of the associated retirement costs and had a negative cash flow impact on the Employees Retirement System as the System funded early retirement benefits without timely reimbursement from the Commonwealth or sponsoring public corporation or municipality. In addition, the CMI report notes that it appears that many of these programs did not ultimately result in their intended goals of reducing the size of the public workforce.

Another factor identified by CMI as having contributed to the deterioration of the Employees Retirement System is the adoption in 2007 of an increase in the maximum loan balance for personal loans to members, from \$5,000 to \$15,000. This increase has resulted in a significant cash flow drain to the Employees Retirement System, amounting to approximately \$600 million during the last four fiscal years. Although the loans are secured by the employee contributions and collected through payroll withholdings, the significant cash flow to provide personal loans has required the liquidation of plan assets. As a result, a significant percentage of the Employees Retirement System's assets are now invested in personal loans that are illiquid investments.

The CMI report also addressed the 2008 issuances of approximately \$2.9 billion in Pension Bonds. The Pension Bonds were issued with the intent of increasing the funds available to the Employees Retirement System to pay benefit obligations and to reduce the UAAL. The Employees Retirement System expected to achieve these goals by investing the proceeds of the Pension Bonds at a higher return than the cost of the debt, thereby achieving a positive arbitrage. However, CMI found that potential risks were not thoroughly or properly analyzed. The Employees Retirement System has not obtained the expected arbitrage on invested proceeds and has also used some bond proceeds to pay current system benefits and operational expenses.

Finally, the CMI report addresses governance deficiencies and states that many of the measures described above, and in particular the issuances of Pension Bonds, were adopted and implemented without conducting any rigorous analysis of their impact on the financial condition of the Employees Retirement System and the risks associated with the measures. The report concludes that immediate and dramatic changes to the structure of the Employees Retirement System are necessary to avoid full depletion of the System's net assets in the near future, as discussed above.

Impact of Funding Shortfall on the Commonwealth. The Commonwealth and other participating employers are ultimately responsible for any funding deficiency in the Retirement Systems. The depletion of the assets available to cover retirement benefits will require the Commonwealth and other participating employers to cover such funding deficiency. Due to its multi-year fiscal imbalances previously mentioned, however, the Commonwealth is currently unable to make the actuarially recommended contributions to the Retirement Systems. If the Commonwealth fails to take action to address the retirement systems' funding deficiency, the continued use of investment assets to pay benefits as a result of funding shortfalls and the resulting depletion of assets could adversely affect the ability of the Retirement Systems to meet the rates of return assumed in the actuarial valuations, which could in turn result in an earlier depletion of the Retirement Systems' assets and a significant increase in the unfunded actuarial accrued liability. Ultimately, since the Commonwealth's General Fund is required to cover a significant amount of the funding deficiency, the Commonwealth would have difficulty funding

the annual required contributions unless it implements significant reforms to the retirement systems, obtains additional revenues, or takes other budgetary measures. There may be limitations on the Government's ability to change certain pension rights afforded to participants in the Retirement Systems.

Efforts to Address Cash Flow Shortfall and Improve Funding Ratio. The Retirement Systems is evaluating measures to improve the financial solvency of the Retirement Systems. In order to maintain the long-term fiscal integrity of the Retirement Systems and their ability to pay required benefits to their members, a combination of some or all of the following will be required: (i) a substantial increase in contributions by the Commonwealth and the participating employers, and (ii) actions resulting in changes to liabilities of the Retirement Systems. Because of the multi-year fiscal imbalances mentioned above, the Commonwealth is currently unable to make the actuarially recommended contributions to the retirement systems.

In March 2010, the Governor of Puerto Rico established a special commission to make recommendations for improving the financial solvency of the Retirement Systems. The Commission issued its report on October 21, 2010. The Commission's report does not make a consensus set of recommendations for addressing the financial solvency of the Retirement Systems, but rather discusses the principal recommendations made by different members of the Commission in the following areas: (i) employer and employee contributions, (ii) benefit structure, (iii) retirement age, (iv) benefits under special laws, (v) early retirement programs, (vi) mortgage loans and personal loans, and (vii) governance structure. All members of the Commission agreed that there has to be an increase in employer contributions, while some members also recommended an increase in employee contribution rates. One of the proposals was that employer contribution rates be increased by 1% of payroll per year for the next 10 to 15 years. In the benefits areas, the recommendations included various proposals to reduce or limit benefits, such as eliminating merit pensions, establishing caps on benefits, increasing the retirement age in order to receive full benefits and modifying or eliminating some benefits granted under special laws. Some members of the Commission also recommended prohibiting all future early retirement programs unless they are actuarially positive to the Retirement Systems. In order to address the liquidity position of the Retirement Systems, various members of the Commission recommended eliminating the loan programs or restricting their use. Various members also commented that improvements to the governance structure of the Retirement Systems was necessary, as it appeared that in the past governance had not been as rigorous as it should have been. Other recommendations included increasing penalties for late payments by participating employers and creating other dedicated revenue sources for the Retirement Systems, such as a special lottery drawing or a special tax on government contractors.

The administration assigned to a task force headed by the Secretary of Labor the evaluation of the Commission's recommendations. As a result of the Commission's report and the Government's analysis, the Governor submitted various bills to the Legislative Assembly to address in part the retirement systems' financial condition. One of such bills was enacted as Act Act 96. On June 23, 2011, in accordance with Act 96, \$162.5 million of funds on deposit in the Corpus Account of the Puerto Rico Infrastructure Development Fund were contributed to the Employees Retirement System and invested in capital appreciation bonds issued by COFINA maturing annually on August 1, 2043 through 2048 and accreting interest at a rate of 7%. The

principal amount of the COFINA bonds will grow to an aggregate amount of approximately \$1.65 billion at their maturity dates.

Another bill submitted by the Governor was enacted as Act 114 and Act 116. These Acts provide an increase in employer contributions to the Employee Retirement System and the Teachers Retirement System of 1% of covered payroll in each of the next five fiscal years and by 1.25% of covered payroll in each of the following five fiscal years. As a result of these increases, the Employee Retirement System and the Teachers Retirement System would receive approximately \$37 million and \$13 million, respectively, in additional employer contributions during fiscal year 2012, and the additional employer contributions are projected to increase gradually each fiscal year (by an average aggregate increase of \$71.8 million per fiscal year) to approximately \$515 million and \$203 million, respectively, by fiscal year 2021. The additional employer contributions for fiscal year 2012 have been included in the approved budget for such fiscal year. With respect to the increases in the employer contributions corresponding to the municipalities, Act 116 provides that the increases for fiscal years 2012, 2013 and 2014 will be paid for by the Commonwealth from the General Fund budget, representing approximately \$27.5 million, \$30.2 million and \$32.9 million in fiscal years 2012, 2013 and 2014, respectively. The tables below show the projected additional contributions to the Employees Retirement System and the Teachers Retirement System as a result of Act 116 based on the expected payroll assumptions used in the actuarial reports as of June 30, 2011.

**Projected Additional Employer Contributions
Employees Retirement System
(\$ in millions)**

Fiscal Year	Original Employer Contribution Rate	Additional Employer Contribution Rate	Total Employer Contribution Rate	Expected Payroll	Original Employer Contribution	Additional Employer Contribution	Total Employer Contribution
2012	9.275%	1.000%	10.275%	\$3,666	\$340	\$37	\$377
2013	9.275%	2.000%	11.275%	3,758	349	75	424
2014	9.275%	3.000%	12.275%	3,852	357	116	473
2015	9.275%	4.000%	13.275%	3,948	366	158	524
2016	9.275%	5.000%	14.275%	4,047	375	202	578
2017	9.275%	6.250%	15.525%	4,148	385	259	644
2018	9.275%	7.500%	16.775%	4,252	394	319	713
2019	9.275%	8.750%	18.025%	4,358	404	381	786
2020	9.275%	10.000%	19.275%	4,467	414	447	861
2021	9.275%	11.250%	20.525%	4,579	425	515	940

**Projected Additional Employer Contributions
Teachers Retirement System
(\$ in millions)**

Fiscal Year	Original Employer Contribution Rate	Additional Employer Contribution Rate	Total Employer Contribution Rate	Expected Payroll	Original Employer Contribution	Additional Employer Contribution	Total Employer Contribution
2012	8.50%	1.00%	9.50%	\$1,320	\$112	\$13	\$125
2013	8.50%	2.00%	10.50%	1,367	116	27	144
2014	8.50%	3.00%	11.50%	1,414	120	42	163
2015	8.50%	4.00%	12.50%	1,464	124	59	183
2016	8.50%	5.00%	13.50%	1,515	129	76	205
2017	8.50%	6.25%	14.75%	1,568	133	98	231
2018	8.50%	7.50%	16.00%	1,623	138	122	260
2019	8.50%	8.75%	17.25%	1,680	143	147	290
2020	8.50%	10.00%	18.50%	1,739	148	174	322
2021	8.50%	11.25%	19.75%	1,800	153	203	356

Because of the Commonwealth's current budgetary constraints and the significant underfunding of the Retirement Systems discussed above, however, improving the financial solvency of the Retirement Systems will require the adoption of other measures mentioned above and it will take several years before a significant improvement is achieved. The financial situation of the Retirement Systems presents a budgetary challenge to the Commonwealth. The required increase in employer contributions may have an adverse impact on the Commonwealth's budgetary situation.

A fourth bill with respect to the Employees Retirement System was enacted as Act No. 196 of September 18, 2011, which authorized the Employees Retirement System to sell or pledge personal and mortgage loans in its portfolio. This bill also set up a loan program for members of the Employees Retirement System through certain financial institutions, while also limiting the amount of employee contributions that a member can pledge as collateral for a loan.

In addition to these measures, on August 8, 2011, the Board of Trustees of the Employees Retirement System adopted a new regulation regarding the rules relating to the concession of personal loans to its members, which, among other changes, lowered the maximum amount of those loans from \$15,000 to \$5,000. This change is expected to improve gradually the Employees Retirement System's liquidity.

On July 2, 2010, the Government enacted Act 70 ("Act 70"), which is designed to reduce Government expenditures by providing a voluntary early retirement window for central government employees. At the same time, Act 70 is expected to have a positive actuarial impact on the UAAL of the Employees Retirement System and the Teachers Retirement System. Under Act 70, central government employees meeting certain years of service criteria who opted for early retirement by January 14, 2011 receive a higher pension benefit rate than they would otherwise be entitled to receive based on their current years of service, but such pension rate is lower than what they would have been entitled to if they had waited to meet the full vesting requirements. Pursuant to Act 70, the Commonwealth, as employer, will continue making the applicable employer contributions to the Employees Retirement System and the Teachers Retirement System, as well as make payments to cover the annuity payments to the employees

opting for the early retirement window, until both the years of service and age requirements for full vesting would have occurred, at which time the applicable Retirement System will continue making the annuity payments. As of September 30, 2011, approximately 3,373 employees participated of the benefits provided by Act 70.

Statements of Plan Net Assets and Changes in Plan Net Assets. The following tables present the Statement of Plan Net Assets and Statement of Changes in Plan Net Assets of each of the Retirement Systems for fiscal years 2008, 2009, 2010 and 2011.

**The Commonwealth of Puerto Rico
Employees' Retirement System
Statements of Plan Net Assets*
As of June 30, 2008, 2009, 2010 and 2011
(in thousands)**

ASSETS	2011	2010	2009
CASH AND SHORT TERM INVESTMENTS			
Deposits at Commercial Banks	\$ 220,852	\$ 54,175	\$ 21,792
Deposits with Treasury Department	134,319	110,931	103,527
Deposits with GDB:			
Unrestricted	51,396	51,446	79,500
Restricted	411,946	741,082	1,028,878
Restricted Cash Bonds	170,653	172,226	193,537
Total Cash and Short Term Investment	989,166	1,129,860	1,427,234
SECURITIES LENDING, COLLATERAL INVESTED			
Marketable Securities:			
Notes and Bonds	1,125,914	563,454	565,366
Stocks	1,270,736	1,492,386	1,477,945
Master Repo	--	--	--
Private Equity Investments	65,457	55,307	34,922
Total Investments	2,462,107	2,111,147	2,078,233
LOANS TO PLAN MEMBERS			
Mortgage	148,155	141,588	128,365
Personal	1,048,983	1,018,498	916,934
Cultural Trips	75,198	63,729	50,317
PEC	3,045	2,340	1,827
Total Loans to Plan Members	1,275,381	1,226,155	1,097,443
Investment in PRTA Holdings	0	--	--
Total cash, investments and loans to plan members	4,726,654	4,467,162	4,602,910
RECEIVABLES:			
Employers	184,152	273,139	289,427
General Fund	6,147	11,222	7,833
Judiciary Retirement System	881	19,138	17,942
Investment Sales	9,546	12,189	24,509
Accrued Interest	7,594	6,597	6,939
Other	4,595	3,893	5,081
Total Receivables	212,915	326,178	351,731
CAPITAL ASSETS	8,951	8,964	9,171
OTHER ASSETS	6,375	7,224	8,892
Prepaid Bond Cost	32,172	33,267	34,363
Total assets	4,987,067	4,842,795	5,007,067
LIABILITIES			
Book overdraft	62,843	22,933	37,961
Payables for securities lending	134,319	110,931	103,527
Funds of Mortgage Loans and Guarantee Insurance			
Reserve for Loans	9,596	8,964	6,372
Investment Purchases	1,854	5,277	13,926
Accounts Payable and Accrued Liabilities	12,923	12,250	14,228
Bonds Payable	3,003,482	2,981,775	2,961,359
Other Liabilities	24,363	21,798	13,675
Bonds Interest Payable	13,876	13,876	13,876
Total Liabilities	3,263,256	3,177,804	3,164,924
Net Assets Held in Trust for Pension Benefits	\$1,723,811	\$1,664,991	\$1,842,143

* Totals may not add due to rounding.

The Commonwealth of Puerto Rico
Employees' Retirement System
Statements of Changes in Plan Net Assets*
As of June 30, 2008, 2009, 2010 and 2011
(in thousands)

ADDITIONS:	<u>2011</u>	<u>2010</u>	<u>2009</u>
Contributions:			
Employer	\$ 349,207	\$ 381,243	\$ 400,405
Participating employees	322,008	345,265	362,040
Other Special Laws	170,369	171,843	175,254
Early Retirement	305	3,399	47,146
Special Laws 127	17,000	17,000	17,000
Cofina Investments	162,500	--	--
Total Contributions	<u>1,021,389</u>	<u>918,750</u>	<u>1,001,845</u>
Investment (loss) Income:			
Realized Gain or Loss	472,076	148,173	(152,583)
Unrealized Gain or Loss		67,838	(405,969)
Dividend Income	7,334	10,663	15,774
Interest Income	172,783	179,585	198,734
Total	<u>652,203</u>	<u>406,259</u>	<u>(344,044)</u>
Less Investment Expense	(6,483)	(7,649)	(7,589)
Other Income	49,257	31,783	35,878
Net Investment Income	<u>694,977</u>	<u>430,393</u>	<u>(315,755)</u>
Total Additions	<u>1,716,366</u>	<u>1,349,143</u>	<u>686,090</u>
DEDUCTIONS:			
Annuities	1,133,926	1,047,695	970,843
Special Laws 127	17,000	17,000	17,000
Benefits under Special Laws	170,369	171,843	175,254
Death Benefits	7,932	12,968	11,532
Refunds of Contributions:			
Employers	992	1,469	2,013
Participating Employees	90,203	43,677	32,517
Other Expenses	13,199	10,255	22,415
Administrative Expenses	34,583	33,063	32,590
Interest on Bonds	189,342	188,055	186,869
Total Deductions	<u>1,657,546</u>	<u>1,526,295</u>	<u>1,451,033</u>
Net (decrease) Increase	58,820	(177,152)	(764,943)
Net Assets Held in Trust for Pension			
Benefits:			
Beginning of the Year	<u>1,664,991</u>	<u>1,842,143</u>	<u>2,607,086</u>
End of Year	<u>\$1,723,811</u>	<u>\$1,664,991</u>	<u>\$1,842,143</u>

* Totals may not add due to rounding.

The Commonwealth of Puerto Rico
Teachers Retirement System
Statements of Plan Net Assets*
As of June 30, 2008, 2009, 2010 and 2011
(in thousands)

	<u>2011</u>	<u>2010</u>	<u>2009</u>
ASSETS			
Cash:			
Cash and cash equivalents	\$ 97,269	\$ 24,019	\$ 19,134
Cash with fiscal agent	110	-	450
Collateral for Security Lending	70,938	48,673	46,751
Cash deposited with Government Development Bank for Puerto Rico	3,291	3,288	3,276
Total Cash	<u>171,608</u>	<u>75,980</u>	<u>69,611</u>
Investments, at fair value:			
Bonds and notes	591,769	397,109	425,911
Stocks	1,211,084	1,295,232	1,259,169
Total investment at fair value	<u>1,802,853</u>	<u>1,692,341</u>	<u>1,685,080</u>
Other investments:			
Mortgage notes acquired from third parties			
Private equity investments	25,630	26,683	26,139
Total investments	<u>1,828,483</u>	<u>1,719,024</u>	<u>1,711,219</u>
Loan to plan members:			
Mortgage	128,312	119,937	109,508
Personal	276,692	288,463	288,410
Cultural trips	1,660	1,481	1,462
Total loans to plan members	<u>406,664</u>	<u>409,881</u>	<u>399,380</u>
Total investments and loans	<u>2,235,147</u>	<u>2,128,905</u>	<u>2,110,599</u>
Accounts receivable:			
Receivable for investments sold	2,320	332	23,231
Accrued interest and dividends receivable	3,982	4,584	5,445
Other	44,883	56,085	2,930
Total accounts receivable	<u>51,185</u>	<u>61,001</u>	<u>31,606</u>
Property and equipment, net	22,204	22,970	26,167
Other assets	472	832	876
Total Assets	<u>2,480,616</u>	<u>2,289,688</u>	<u>2,238,859</u>
LIABILITIES			
Investments purchased	1,701	2,722	18,981
Payable for securities lending	70,938	48,673	46,751
Cash overdraft in cash with fiscal agent	-	2,199	-
Accounts payable	1,530	1,476	4,188
Accrued expenses	13,321	6,184	5,925
Escrow fund of mortgage loans and guarantee insurance reserve for loans to plan members	6,322	5,763	4,580
Other liabilities	941	694	841
Total liabilities	<u>94,753</u>	<u>67,711</u>	<u>81,266</u>
Net Assets Held in Trust for Pension Benefits	<u>\$2,385,863</u>	<u>\$2,221,977</u>	<u>\$2,157,593</u>

* Totals may not add due to rounding.

The Commonwealth of Puerto Rico
Teachers Retirement System
Statements of Changes in Plan Net Assets*
As of June 30, 2008, 2009, 2010 and 2011
(in thousands)

	<u>2011</u>	<u>2010</u>	<u>2009</u>
ADDITIONS:			
Contributions:			
Participating Employees	\$ 123,297	\$ 129,888	\$ 136,305
Employer	112,071	118,127	125,165
Contributions transferred from other systems**	828	1,265	1,479
Special	47,753	46,572	46,214
Total contributions	<u>283,949</u>	<u>295,852</u>	<u>309,163</u>
Investment Income:			
Interest income	57,008	61,303	66,927
Dividend Income	6,915	10,111	13,194
Net appreciation (depreciation) in fair value of investments	421,923	203,265	(518,862)
Total investment income	485,846	274,679	(438,741)
Less investment expense	(4,682)	(4,735)	(4,660)
Net investment income	481,164	269,944	(443,401)
Other income	968	53,771	2,444
Total additions	<u>\$766,081</u>	<u>\$ 619,567</u>	<u>(\$ 131,794)</u>
DEDUCTIONS:			
Benefit paid to participants:			
Annuities and death benefits	513,874	470,683	418,414
Special benefits	48,286	47,870	46,747
Refunds of contributions	8,465	7,847	5,313
Administrative expenses	31,570	28,783	25,485
Total deductions	<u>602,195</u>	<u>555,183</u>	<u>495,959</u>
Net increase in net assets held in trust for pension benefits	<u>163,886</u>	<u>64,384</u>	<u>(627,753)</u>
Net assets held in trust for pension benefits			
Beginning of year	<u>2,221,977</u>	<u>2,157,593</u>	<u>2,785,346</u>
End of year	<u>\$2,385,863</u>	<u>\$2,221,977</u>	<u>\$2,157,593</u>

* Totals may not add due to rounding.

The Commonwealth of Puerto Rico
Judiciary Retirement System
Statements of Plan Net Assets*
As of June 30, 2008, 2009, 2010 and 2011
(in thousands)

ASSETS	<u>2011</u>	<u>2010</u>	<u>2009</u>
Cash and Investments:			
Cash and Cash Equivalents	\$ 6,409	\$ 4,007	\$ 3,985
Cash Deposited with GDB or Treasury Department:	1,011	30	2,353
Collateral from Securities Lending	3,218	2,474	1,482
Total Cash	<u>10,638</u>	<u>6,511</u>	<u>7,820</u>
Receivables:			
Accrued Interest	263	271	215
Investment Sales	-	41	117
Other	27	27	28
Total receivables	<u>290</u>	<u>339</u>	<u>360</u>
Marketable Securities:			
Notes and Bonds	39,954	25,973	22,805
Stocks	22,136	50,275	44,634
Total Investments	<u>62,090</u>	<u>76,248</u>	<u>67,439</u>
Loans and Interest Receivable from Members:			
Mortgage	17	20	8
Personal	750	702	462
Cultural Trips	78	46	60
Total Loans to Plan Members	<u>845</u>	<u>768</u>	<u>530</u>
Total cash, investments and loans to plan members	<u>73,863</u>	<u>81,393</u>	<u>76,149</u>
LIABILITIES			
Due to Treasury Department	5,560	5,841	4,513
Due to the Employee's Retirement System of the Government of Puerto Rico	881	19,138	17,942
Collateral from Securities ending	3,218	2,474	1,482
Escrow Funds to plan Members and Guarantee Insurance	66	62	59
Investment Purchases	2	869	867
Other Liabilities	161	72	720
Total Liabilities	<u>9,888</u>	<u>28,456</u>	<u>25,583</u>
Net Assets Held in trust for Pension Benefits	<u>\$ 63,975</u>	<u>\$ 55,410</u>	<u>\$ 50,566</u>

* Totals may not add due to rounding.

The Commonwealth of Puerto Rico
Judiciary Retirement System
Statements of Changes in Plan Net Assets*
As of June 30, 2008, 2009, and 2010 and 2011
(in thousands)

	<u>2011</u>	<u>2010</u>	<u>2009</u>
ADDITIONS:			
Contributions:			
Employer	\$ 9,966	\$ 10,021	\$ 9,970
Participating employees	2,789	3,104	3,138
Special Laws	629	629	691
Total Contributions	<u>13,384</u>	<u>13,754</u>	<u>13,799</u>
Investment Income:			
Realized Gain or Loss	12,928	5,644	(3,158)
Unrealized Gain	--	1,741	(13,582)
Dividend Income	176	211	218
Interest Income	<u>1,352</u>	<u>1,284</u>	<u>1,313</u>
Total	14,456	8,880	(15,209)
Less Investment Expense	(162)	(164)	(170)
Other Income	10	804	50
Net Investment Income	<u>14,304</u>	<u>9,520</u>	<u>(15,329)</u>
Total Additions	<u>27,688</u>	<u>23,274</u>	<u>(1,530)</u>
DEDUCTIONS:			
Annuities	18,627	17,268	15,538
Benefits Under Special Laws	--	629	691
Administrative Expenses	496	533	986
Total Deductions	<u>19,123</u>	<u>18,430</u>	<u>17,215</u>
Net Increase	8,565	4,844	(18,745)
Net Assets Held in Trust for Pension Benefits:			
Beginning of the Year	<u>55,410</u>	<u>50,566</u>	<u>69,311</u>
End of Year	<u>\$ 63,975</u>	<u>\$ 55,410</u>	<u>\$ 50,566</u>

* Totals may not add due to rounding.

POST-EMPLOYMENT BENEFITS OTHER THAN PENSIONS

In addition to the pension benefits, the Commonwealth provides non-pension post-employment benefits that consist of a medical insurance plan contribution for retired employees meeting the service credit eligibility requirements. These benefits are administered by the Retirement Systems. The medical insurance plan contribution is a payment of up to \$100 per month to the eligible medical insurance plan selected by the retiree or disabled member.

The Commonwealth funds these post-employment benefits on a “pay-as-you-go” basis from the General Fund, which means that the Commonwealth does not pre-fund, or otherwise establish a reserve or other pool of assets against the medical insurance plan contribution expenses that the Commonwealth may incur in future years. For fiscal year 2011, the Commonwealth paid \$125.4 million for these benefits for the eligible retirees of the Retirement Systems (including retirees of public corporations and municipalities, which are also paid for by the Commonwealth). For fiscal year 2012, these benefits are expected to amount to \$142.7 million.

In accordance with the provisions of GASB Statement No. 45, the Commonwealth is required to quantify and disclose its obligations to pay non-pension post-employment benefits to current and future retirees. The most recent actuarial valuation reports of these benefits are dated as of June 30, 2011. Many of the actuarial assumptions used to project the actuarial accrued liability for these benefits are the same as those used to determine the accrued actuarial liabilities of the Retirement Systems. The following table sets forth, according to the actuarial valuations, the actuarial accrued liability, UAAL, covered payroll and UAAL as a percentage of covered payroll for the non-pension post-employment benefits of the active and retired members of each of the Retirement Systems. Since these benefits are not pre-funded, as discussed above, the UAAL is equal to the actuarial accrued liability.

**Post-Employment Benefits Other Than Pensions
Actuarial Valuations as of the Indicated Fiscal Years
(in millions)**

Fiscal Year Ending June 30,	Actuarial Value of Assets	Actuarial Accrued Liability⁽¹⁾	Unfunded Actuarial Accrued Liability	Funded Ratio	Covered Payroll	UAAL as a Percentage of Covered Payroll
Employees Retirement System						
2007.....	-	\$1,557	\$1,557	0%	\$4,246	36.7%
2009.....	-	1,633	1,633	0	4,293	38.0
2010.....	-	1,699	1,699	0	3,818	44.5
2011.....		1,758	1,758	0	3,666	48.0
Teachers Retirement System						
2007.....	-	\$652	\$652	0%	\$1,370	47.6%
2009.....	-	750	750	0	1,418	52.9
2010.....	-	694	694	0	1,370	50.7
2011.....		706	706	0	1,320	53.5
Judiciary Retirement System						
2007.....	-	\$5	\$5	0%	\$31	15.0%
2009.....	-	6	6	0	31	18.5
2010.....	-	6	6	0	32	18.1
2011.....		6	6	0	32	18.3

⁽¹⁾ The actuarial accrued liability is the liability or obligation for benefits earned by active and retired employees through the valuation date based on certain actuarial methods and assumptions.

The following table shows the actuarially recommended contributions, actual employer contributions and resulting amount unfunded and percent contributed for the post-employment benefits other than pensions administered by each of the Retirement Systems' for the last three fiscal years and the current fiscal year.

**Schedule of Employer Contributions to Retirement Systems
on Account of Post-Employment Benefits Other Than Pensions
(in millions)**

Fiscal Year Ending June 30,	Actuarially Recommended Contributions ⁽¹⁾	Actual Employer Contributions ⁽²⁾	Amount Unfunded ⁽³⁾	Percent Contributed
Employees Retirement System				
2008	\$111	\$80	\$31	72.1%
2009	112	87	25	77.7
2010	128	85	43	66.6
2011	129	94	35	72.3
2012	134	109	25	81.3
Teachers Retirement System				
2008	\$37	\$26	\$11	70.6%
2009	38	28	10	73.2
2010	42	28	14	66.9
2011	40	32	8	79.1
2012	41	34	7	82.5
Judiciary Retirement System				
2008	\$0.4	\$0.2	\$0.2	55.4%
2009	0.4	0.3	0.1	62.0
2010	0.5	0.3	0.2	61.5
2011	0.5	0.3	0.2	60.4
2012	0.6	0.3	0.3	59.0
Total				
2008	\$148.4	\$106.2	\$42.2	71.6%
2009	150.4	115.3	35.1	76.7
2010	170.5	113.3	57.2	66.5
2011	169.5	126.3	43.2	74.5
2012	175.6	143.3	32.3	81.6

⁽¹⁾ The actuarially recommended contributions are based on the information contained in the actuarial valuations for the Retirement Systems as of June 30, 2011.

⁽²⁾ The actual employer contributions for fiscal year 2012 are based on the expected pay-as-you-go amounts for the post-employment benefits other than pensions, as set forth in the actuarial valuations as of June 30, 2011.

⁽³⁾ Represents the difference between the actuarially recommended pension contribution and the actual contribution from the participating employers.

COMMONWEALTH AUDITED FINANCIAL STATEMENTS

General

For fiscal year 2011, the basic financial statements of the Commonwealth were audited by Deloitte & Touche LLP. Deloitte & Touche LLP did not audit the financial statements of certain activities, funds, and component units identified separately in its report dated April 27, 2012 (which report expresses an unqualified opinion and includes emphasis of matter paragraphs regarding the Pension Trust Funds' unfunded actuarial accrued liability and funded ratio as of June 30, 2011). Those financial statements were audited by other independent auditors whose reports were furnished to Deloitte & Touche LLP, and its opinion on the basic financial statements, insofar as it relates to the amounts included in the basic financial statements pertaining to such activities, funds and component units, is based solely on the reports of the other auditors.

The CAFR for fiscal year 2011, which includes the basic financial statements of the Commonwealth for fiscal year 2011, was filed by the Commonwealth with the Municipal Securities Rulemaking Board ("MSRB") through its Electronic Municipal Markets Access System ("EMMA") on April 30, 2012, in compliance with its continuing disclosure undertakings pursuant to Rule 15c2-12 of the Securities and Exchange Commission promulgated under the Securities Exchange Act of 1934, as amended.

Prior Non-Compliance with Continuing Disclosure Obligations

The Commonwealth has made continuing disclosure undertakings in connection with its bond issuances, and has complied with all such covenants, except as hereinafter noted.

The Commonwealth's audited financial statements for the fiscal year ended June 30, 2002 were filed after the Commonwealth's filing deadline of May 1, 2003 because of delays in finalizing such financial statements resulting from the implementation of GASB Statement No. 34 ("GASB 34"). The Commonwealth's audited financial statements for the fiscal year ended June 30, 2003 were also filed after the Commonwealth's filing deadline of April 30, 2004, because of delays in finalizing the financial statements of certain of the Commonwealth's reporting units due to the implementation of GASB 34. The Commonwealth's audited financial statements for the fiscal years ended June 30, 2004, 2006, 2007 and 2008 were also filed after the Commonwealth's respective filing deadlines of May 1, 2005, 2007, 2008 and 2009, because various governmental agencies did not submit their audited financial statements to the central government's external auditors on time, thereby delaying submission of the Commonwealth's audited financial statements. The Commonwealth's audited financial statements for the fiscal year ended June 30, 2009 was also filed after the Commonwealth's filing deadline of May 1, 2010 due to delays in the engagement and transition of new external auditors, the implementation of new government accounting pronouncements, and the restatement of the financial statements of certain discretely presented component units. The Commonwealth's audited financial statements for fiscal years ended June 30, 2004, 2006, 2007 and 2008 were filed by the end of the first quarter of the following fiscal year, while the Commonwealth's audited financial statements for the fiscal year ended June 30, 2009 was filed on October 25, 2010.

The Commonwealth Report for the fiscal year ended June 30, 2008 containing the information described in paragraph 1 above, was filed after the Commonwealth's filing deadline of May 1, 2009. Such Commonwealth Report was filed on June 1, 2009. Except for such Commonwealth Report, the Commonwealth has timely filed the Commonwealth Report for all other fiscal years.

As of the date of this Report, the Commonwealth is in compliance with its continuing disclosure filing requirements related to its outstanding general obligation bonds.

The Commonwealth has established new policies and procedures that it believes will ensure full and timely compliance with all continuing disclosure obligations in the future. Such new policies and procedures include: (i) the assignment of additional resources from local and international audit firms to those component units whose financial statements have not been timely provided to the Commonwealth; (ii) the assignment of dedicated external and internal resources to (a) assist the Central Accounting Division at the Treasury Department in the preparation of complex financial information that has historically delayed the audit and (b) provide periodic and consistent follow up on component unit financial statement deliverables and deadlines; (iii) the execution of a memorandum of understanding between the Treasury Department, OMB and GDB for the coordination of all financial statement related tasks and the designation of GDB, in its role as fiscal agent, to review and monitor the progress of certain component units; and (iv) the establishment of an Audit Oversight Committee comprised of the Treasury Department and GDB personnel in order to continuously monitor the status of the audit and the Commonwealth's financial statements.

PUERTO RICO TAXES, OTHER REVENUES, AND EXPENDITURES

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

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

Summary and Management's Discussion of General Fund Results

The following table presents the actual revenues and expenditures of the General Fund on a cash basis for fiscal years 2007, 2008, 2009, 2010 and 2011.

The amounts shown in the following table as expenditures may be different than those reflected in the budget or in the Commonwealth's financial statements because the table shows only cash disbursements, while the budget includes all authorized expenditures, regardless of when the related cash is actually disbursed. In addition, transfers to the Redemption Fund (used to pay debt service on the Commonwealth's bonds), which are included in the budget under "debt service," are shown as a deduction from total revenues in calculating "adjusted revenues" in the table and are not included under "expenditures." Finally, certain expenditures incurred in excess of budgeted amounts may not be reflected in the table as expenditures to the extent they are paid from reserve funds, such as moneys in the Budgetary Fund. A discussion of the budget for fiscal year 2012 and the proposed budget for fiscal year 2013 appears below under "Budget of the Commonwealth of Puerto Rico."

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

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

	2007	2008	2009	2010	2011
Revenues:					
Income Taxes:					
Individuals	\$3,071,655	\$2,759,305	\$2,648,261	\$2,593,598	\$2,187,080
Corporations	2,002,718	1,565,534	1,375,596	1,682,321	1,677,345
Partnerships	2,960	1,942	1,839	1,688	3,249
Withheld from non-residents	933,728	1,087,782	1,081,739	830,352	1,000,428
Tollgate taxes	25,083	21,610	19,372	15,034	12,607
Interest	12,112	13,657	11,738	9,902	6,985
Dividends	138,859	59,770	48,663	29,774	26,756
Total income taxes	<u>6,187,115</u>	<u>5,509,600</u>	<u>5,187,208</u>	<u>5,162,669</u>	<u>4,914,450</u>
Sales and use tax	582,560	911,000	797,194	540,348	531,837
Commonwealth excise taxes:					
Alcoholic beverages	279,028	268,094	277,401	284,796	280,963
Foreign (Act 154)	-	-	-	-	677,565
Cigarettes	132,399	119,124	129,429	182,501	201,965
Motor vehicles	396,667	366,341	310,920	350,764	364,170
Other excise taxes	314,340	110,014	86,874	77,978	77,649
Total Commonwealth excise taxes	<u>1,122,434</u>	<u>863,573</u>	<u>804,624</u>	<u>896,039</u>	<u>1,602,312</u>
Property taxes	800	219	1,011	227,812	246,619
Inheritance and gift taxes	4,663	6,600	5,064	3,617	3,101
Licenses	97,610	87,690	96,423	95,768	81,381
Other:					
Traditional lottery	73,014	46,636	51,480	42,826	46,165
Electronic lottery	71,815	105,298	75,213	80,006	55,690
Miscellaneous non-tax revenues	330,064	466,741	284,436	314,754	346,580
Total Other	<u>474,893</u>	<u>618,675</u>	<u>411,129</u>	<u>770,843</u>	<u>448,435</u>
Total revenues from internal sources	<u>8,470,075</u>	<u>7,997,357</u>	<u>7,302,653</u>	<u>7,363,839</u>	<u>7,828,135</u>
Revenues from non-Commonwealth sources:					
Federal excise taxes ⁽¹⁾	377,872	356,827	404,265	352,301	330,181
Customs	14,504	4,846	3,269	-	-
Total revenues from non-Commonwealth sources	<u>392,376</u>	<u>361,673</u>	<u>407,534</u>	<u>352,301</u>	<u>330,181</u>
Total revenues	<u>8,862,451</u>	<u>8,359,030</u>	<u>7,710,187</u>	<u>7,716,140</u>	<u>8,158,316</u>
Other Income (refunds) ⁽²⁾	(8,335)	(10,797)	148,966	(57,241) ⁽⁸⁾	(180,362)
(Transfer) Refunding to Redemption Fund ⁽³⁾	(512,197)	(202,954)	(607,305)	(447,312)	(86,834)
Proceeds of notes and other borrowings ⁽⁴⁾	1,872,096	2,710,000	3,982,893	2,375,000	1,850,000
Repayment of notes and other borrowings ⁽⁵⁾	(1,926,273)	(2,580,764)	(3,858,393)	(2,698,818)	(1,850,000)
Receipt of COFINA Bond Proceeds	-	-	3,051,008	2,501,053 ⁽⁹⁾	1,243,898
Adjusted revenues	<u>8,287,742</u>	<u>8,274,515</u>	<u>10,427,356</u>	<u>9,388,822</u>	<u>9,135,018</u>
Expenditures:					
Grants and subsidies	3,387,199	3,471,922	3,117,817	3,581,751	3,996,469
Personal services	4,590,962	4,563,192	5,273,590	4,355,111	4,143,299
Other services	594,345	685,112	859,323	822,019	746,755
Materials and supplies	79,186	99,486	109,386	85,906	72,663
Equipment purchases	27,965	49,498	51,204	44,381	60,257
Capital outlays and other debt service	21,576	11,222	211,499	110,850	46,822
Prior year disbursements	92,770	-	-	-	-
Total expenditures	<u>8,794,003</u>	<u>8,880,432</u>	<u>9,622,818</u>	<u>9,000,018</u>	<u>9,066,265</u>
Adjusted revenues less expenditures	<u>(506,261)</u>	<u>(605,917)</u>	<u>804,538</u>	<u>388,804</u>	<u>68,753</u>
Ending cash balance	<u>\$ (506,261)</u>	<u>\$ (1,112,178)</u>	<u>\$ (307,640)</u>	<u>\$ 81,164</u>	<u>\$ 149,917</u>

- (1) Excludes transfers to the Conservation Trust Fund and amounts deposited into a separate account for the promotion of Puerto Rico rums in foreign markets.
(2) Consists of net revenues from the General Fund's non-budgetary funds plus a reserve for future tax refunds reduced by estimated tax refunds.
(3) Consists of amounts to pay principal of and interest on general obligation bonds and notes of the Commonwealth. Does not include amounts deposited directly into the Redemption Fund from non-General Fund revenues.
(4) Consists of proceeds of borrowings from GDB and a syndicate of commercial banks, and proceeds from Commonwealth's Tax and Revenue Anticipation Notes.
(5) Consists of repayments of borrowings from GDB and a syndicate of commercial banks, and repayments of Commonwealth's Tax and Revenue Anticipation Notes.
(6) Includes proceeds of \$100 million generated by the issuance of the Commonwealth's Public Improvement Refunding Bonds, Series 2006 A, which were privately placed.
(7) Includes \$50 million from the Emergency Fund used for operating expenses.
(8) Includes \$201 million transferred to the Commonwealth from the sale of securities in PRIFA's Corpus Account.
(9) Represents the COFINA bond proceeds deposited in the Stabilization Fund

Source: Treasury Department

General Fund Preliminary Revenues for Fiscal Year 2011 Compared to Fiscal Year 2010

General Fund preliminary total revenues (including lottery revenues) for fiscal year 2011 were \$8.158 billion, representing an increase of \$442.2 million, or 5.7%, from fiscal year 2010 revenues. The major changes from fiscal year 2010 were: (i) decreases in income taxes from individuals of \$406.5 million or 15.7%, resulting from the implementation of the tax reform (ii) an increase of \$170.1 million in taxes withheld from non-residents, and (iii) an additional \$677.6 million from the a new excise tax imposed on entities that purchase products manufactured in Puerto Rico by their affiliates under the provisions of Act 154, discussed below.

General Fund preliminary total expenses (on a cash basis) for fiscal year 2011 amounted to \$9.153 billion, which were composed of \$9.1 billion of operational expenses and \$86.8 million transferred to the redemption fund. The difference between preliminary revenues and expenses for fiscal year 2011 of \$995 million was covered principally with proceeds from a COFINA bond issue.

General Fund Revenues for Fiscal Year 2010 Compared to Fiscal Year 2009.

General Fund total revenues (including lottery revenues) for fiscal year 2010 were \$7.716 billion, representing an increase of \$6 million from fiscal year 2009 revenues and an increase of \$46 million from budgeted revenues for fiscal year 2010. The principal changes in sources of revenues from fiscal year 2009 include a decrease in the sales and use tax received by the General Fund of \$256.8 million due to the increased allocation of this tax to COFINA, as discussed in “Major Sources of General Fund Revenues – Sales and Use Taxes” below. This decrease in the amount of sales and use taxes allocated to the General Fund was fully offset, however, by increases in property taxes and excise taxes on cigarettes and alcoholic beverages of approximately \$226.8 million and \$60.5 million, respectively, as a result of the temporary and permanent revenue raising measures implemented as part of the Commonwealth’s fiscal stabilization plan under Act 7. See “Major Sources of General Fund Revenues – Income Taxes” below. Revenues from income taxes for fiscal year 2010 were approximately the same as in fiscal year 2009, reflecting the continuing impact of the ongoing economic recession.

General Fund total expenses (on a cash basis) for fiscal year 2010 amounted to \$9.447 billion, which were composed of \$9.0 billion of operational expenses and \$447.3 million transferred to the redemption fund. The difference between revenues and expenses for fiscal year 2010 of \$1.7 billion was covered principally with proceeds from a COFINA bond issue.

General Fund Revenues for Fiscal Year 2009 Compared to Fiscal Year 2008

General Fund total revenues (including lottery revenues) for fiscal year 2009 were \$7.710 billion, representing a decrease of \$648.8 million, or 7.8%, from fiscal year 2008 revenues. The major changes from fiscal year 2008 were: (i) decreases in income taxes from individuals of \$111 million and in corporate income taxes of \$189.9 million, (ii) a decrease of \$58.9 million in excise taxes, (iii) a decrease of \$182.3 million in miscellaneous non-tax revenues, and (iv) a decrease of \$113.8 million in the sales and use tax revenues due primarily to a one-time change in the manner sales and use tax collections are reported by the Treasury Department. Please refer to “Major Sources of General Fund Revenues – Sales and Use Taxes” below further

information regarding this reporting change. The decreases in revenues in these categories for fiscal year 2009 as compared to fiscal year 2008 reflect the acceleration of the economic recession during that fiscal year.

General Fund total expenses (on a cash basis) for fiscal year 2009 amounted to \$10.230 billion, which were composed of \$9.623 billion of operational expenses and \$607 million transferred to the redemption fund. The difference between revenues and expenses for fiscal year 2009 of \$2.5 billion was covered principally by proceeds from COFINA bond issues.

Fiscal Year 2008 Compared to Fiscal Year 2007

General Fund total revenues (including lottery revenues) for fiscal year 2008 were \$8.359 billion, representing a decrease of \$234.4 million, or 2.7%, from actual revenues for fiscal year 2007 (excluding the collection of \$269 million from special temporary tax measures in fiscal year 2007). The major changes from fiscal year 2007 were: (i) decreases in income taxes from individuals of \$312.4 million and in corporate income taxes of \$437.2 million, (ii) a decrease of \$258.9 million in excise taxes, and (iii) an increase of \$328.4 million in the sales and use tax revenues, which had only been in effect for seven and a half months during fiscal year 2007. The decrease in 2008 revenues was principally due to the ongoing economic recession and high oil prices, which directly affected income and excise tax collections.

General Fund total expenses (on a cash basis) for fiscal year 2008 amounted to \$9.083 billion, which were composed of \$8.880 billion of operational expenses and \$203 million transferred to the redemption fund. The difference between adjusted revenues and expenses for fiscal year 2008 of \$724 million was covered principally by cash-management procedures such as delaying payments to certain vendors and a GDB loan of \$190 million.

Major Sources of General Fund Revenues

Income Taxes

The historical revenue data presented in this Report is based on collections realized or accrued under the provisions of the Internal Revenue Code of 1994, as amended (the “PR Code”), which applied to taxable years beginning after June 30, 1995 and ending before January 1, 2011. The PR Code was replaced by the Internal Revenue Code for a New Puerto Rico, enacted as Act 1 of 2011, which will apply for taxable years commencing after December 31, 2010. See “Tax Reform” below. Many of the provisions of Act 1 of 2011 are identical to the equivalent provisions of the PR Code. Thus, unless otherwise noted, the discussion below refers to the provisions of both the PR Code and Act 1 of 2011.

The PR Code imposed a tax on the income of individual residents of Puerto Rico, trusts, estates, and domestic and foreign (if engaged in a trade or business in Puerto Rico) corporations and partnerships at graduated rates. A flat tax was imposed on certain payments made to non-residents of Puerto Rico, which was collected through an income tax withholding.

Individuals. Resident individuals are subject to tax on their taxable income from all sources. The PR Code had four tax brackets for individuals with tax rates of 7%, 14%, 25%, and 33%. The highest income tax bracket applicable to individuals under the PR Code was \$50,000.

Under Act 1 of 2011, the highest income tax bracket gradually increases every year for the next six years from \$60,000 to \$121,500. For taxable years starting before January 1, 2016, the income tax rates applicable to individuals remain unaltered under Act 1 of 2011. After January 1, 2016, the top individual rate is lowered to 30%. See “Tax Reform” below for certain requirements that must be satisfied in order for tax benefits under Act 1 of 2011 to enter into effect for taxable years starting after December 31, 2013. Dividend income from Puerto Rico corporations and certain qualifying foreign corporations is taxed at an income tax rate of 10%.

Gains realized from the sale or exchange of a capital asset by resident individuals, if held for more than six months, is taxed at an income tax rate of 10%.

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

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

In general, the PR Code provided for six income tax brackets for corporations and partnerships, with the highest rate (39%) applicable to net taxable income in excess of \$300,000. Gains realized from the sale or exchange of a capital asset, if held for more than six months, were taxed at a maximum regular income tax rate of 15%. Under Act 1 of 2011, for taxable years commencing after December 31, 2010, the highest corporate income tax rate is lowered to 30% for net taxable income in excess of \$1,750,000 (it will be reduced to 25% for taxable years starting after December 31, 2013 subject to the satisfaction of certain conditions) and the alternative minimum tax is also reduced from a rate of 22% to the greater of (i) the amount produced by applying a minimum rate of 20% to the alternative minimum net income or, (ii) subject to certain exceptions, the amount produced by applying a 1% excise tax on the purchase from related parties of tangible personal property to be used in a Puerto Rico trade or business applicable to persons with gross sales of \$50 million or more during any of three preceding taxable years. Dividends received by Puerto Rico corporations and partnerships from foreign corporations engaged in trade or business in Puerto Rico are subject to general income tax rates. A dividends received credit may be available when the corporation or partnership making the distribution is organized in Puerto Rico. Interest income on certain qualifying debt obligations issued by Puerto Rico corporations and certain qualifying foreign corporations and paid to corporations and partnerships qualifies for a special tax rate of 10%.

In general, corporations and the partners of partnerships operating under a new grant of tax exemption issued under the Economic Incentives Act are subject to a maximum income tax rate of 4% during their basic exemption period. Corporations and the partners of partnerships

covered by the Tourism Development Act are subject to a maximum tax rate of 39% on their taxable income after applying the 90% exemption granted under the Tourism Development Act, which results in a maximum effective tax rate of 3.9% on their net tourism development income. Under Act 1 of 2011, the net income of corporations and partnerships covered under the Tourism Development Act is subject generally to a maximum effective tax rate of 3%.

The PR Code and Act 1 of 2011 generally impose a branch profits tax on resident foreign corporations whose gross income qualifies as income effectively connected with a Puerto Rico trade or business. The branch profits tax is 10% of an annual dividend equivalent amount, and it applies without regard to the Puerto Rico source of income rules.

Interest from Puerto Rico sources paid by Puerto Rico resident borrowers to non-resident non-affiliated corporate recipients is not subject to any income or withholding tax. Interest paid by Puerto Rico resident borrowers to certain related non-resident recipients is subject to a withholding tax of 29%. Dividends paid to non-resident corporate recipients are subject to a withholding tax of 10%. Dividends distributed by corporations operating under new grants of tax exemption issued under the Economic Incentives Act and the Green Energy Incentives Act are not subject to Puerto Rico income tax. However, royalty payments made by corporations covered under the Economic Incentives Act to non-resident recipients are subject to an income tax withholding of 2% or 12%, depending on certain elections made by the grantee, and in the case of corporations covered by the Green Energy Incentives Act, royalty payments to non-residents are subject to an income tax withholding of 12%.

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

Act No. 7 – Special Tax Measures Implemented as part of the New Administration’s Fiscal Stabilization Plan. Act 7 was enacted as part of the new administration’s Fiscal Plan, and sought, among other things, to increase the tax revenues of the Puerto Rico government by imposing certain permanent and temporary tax increases.

With respect to income taxes, Act 7 included the following temporary measures that were applicable for taxable years commenced after December 31, 2008 and before January 1, 2012:

- (i) taxable corporations and individuals whose adjusted gross income equal or exceeds \$100,000 (for single individuals) or \$150,000 (in the case of married persons filing jointly) are subject to a surtax of 5% on their total tax liability (for taxable years commencing after December 31, 2010, Act 1 of 2011 eliminates this surtax);
- (ii) international banking entities that do not operate as bank units will be subject to a 5% income tax on their entire net income computed in accordance with the PR Code (international banking entities operating as bank units are subject to this 5% tax on their net income that does not constitute excess net income);

- (iii) credit unions, their subsidiaries, and affiliates are subject to a 5% tax on the amount of net taxable income in excess of \$250,000 (these entities were totally exempt before the enactment of Act 7), however, if the Government of Puerto Rico collects \$690 million prior to January 1, 2012, the 5% tax will not be applicable for the remaining period;
- (iv) the Cooperative Bank, its subsidiaries, and affiliates are subject to a 5% tax on the amount of net taxable income in excess of \$250,000 (these entities were totally exempt before the enactment of Act 7);
- (v) insurance cooperatives are subject to a 5% tax on the amount of net taxable income in excess of \$250,000 (these entities were totally exempt before the enactment of Act 7); and
- (vi) international insurers and holding companies of international insurers are subject to a 5% tax on their net income (these entities were totally exempt before the enactment of Act 7).

Notwithstanding the above, Act 1 of 2011 limited the duration of the 5% surtax on income derived by certain individuals and corporations and the special property tax to two years.

Act 7 also provided as a permanent measure a change in the method of computing the net income subject to alternative minimum tax (“AMT”) in the case of individuals by including in the computation various categories of exempt income and income subject to preferential tax rates under the PR Code, such as: (a) long-term capital gains, which enjoy a preferential tax rate of 10% under the PR Code; (b) dividends that are taxable at the rate of 10% under the PR Code; (c) interest on bank deposits and individual retirement accounts subject to the special 10% and 17% preferential income tax rates, respectively; and (d) interest from notes or bonds eligible for the special 10% tax rate provided by the PR Code.

Another change introduced by Act 7, for taxable years commenced after December 31, 2008 and before January 1, 2012 was an adjustment to the calculation of the net income subject to the AMT in the case of entities taxed as corporations that denies a deduction for expenses paid or accrued for services rendered outside of Puerto Rico by a related party. Lastly, different income tax credits awarded to investors under certain special laws for activities such as revitalization of urban centers (only in part), venture capital, solid waste, housing infrastructure, and rehabilitation of social-interest housing (only projects without qualification certifications as of March 9, 2009), among others, may not be claimed or granted for taxable years commenced after December 31, 2008 and before January 1, 2012. Tax credits associated to manufacturing, tourism, and cinematographic projects, however, were not affected by Act 7.

Tax Reform

The tax reform consists of two phases focused on providing tax relief to individual and corporations, promoting economic development and job creation, simplifying the tax system and reducing tax evasion. The tax reform is projected to provide taxpayers aggregate annual savings of \$1.2 billion for each of the next six fiscal years, commencing on taxable year 2011.

The first phase, enacted as Act No. 171 of November 15, 2010, applied to the 2010 tax return and provides a tax credit to each individual and corporate taxpayer. The tax credit applicable to individuals and determined by reference to the tax liability ranges from 7% for those taxpayers in higher brackets to 15% for taxpayers in the lowest bracket. Corporate taxpayers were also entitled to a 7% tax credit determined by reference to the tax liability; provided, that such taxpayer paid the statutorily required Christmas bonus for 2010. Also, the corporate net operating loss carry forward is extended from 7 years to 10 years. This first phase was expected to provide individual and corporate taxpayers with aggregate savings of \$309 million for taxable year 2010.

The second phase, enacted as Act 1 of 2011, (i) promotes employment by doubling the earning income credit and increasing the maximum applicable income to qualify for such credit; (ii) provides a \$400 tax credit to individuals over 65 years of age with an income below \$15,000; (iii) significantly reduces individual income tax rates and only allow the following five deductions (a) mortgage interest up to 30% of adjusted gross income, (b) charitable contributions up to 50% of adjusted gross income, (c) medical expenses in excess of 6% of adjusted gross income, (d) interest on student loans, and (e) contributions to retirement plans and accounts, including individual retirement accounts, health savings accounts and education savings accounts; and (iv) significantly reduces corporate income tax rates.

The reduction in income tax revenues resulting from the implementation of the tax reform is expected to be offset by the additional revenues produced by (i) an expanded income tax source rule and a new excise tax imposed on entities that purchase products manufactured in Puerto Rico by their affiliates under the provisions of Act 154, discussed below, (ii) enhanced enforcement efforts, including the statutorily required reporting of certain client information by financial institutions to the Treasury Department, and (iii) increased economic activity produced by the tax relief measures. The combined effect of the tax reform measures and the revenue and enforcement measures is expected to be revenue positive. Act 1 of 2011 conditions the implementation of the tax reductions applicable to individuals and corporations after fiscal year 2014 on the Commonwealth's ability to continue its path towards fiscal stability. Specifically, the tax relief provisions for individuals and corporations for taxable years 2014 through 2016 will only be implemented if (i) OMB certifies that the expense control target has been met, (ii) the Treasury Department certifies that General Fund revenue target has been met and (iii) the Planning Board certifies a year-over-year target increase in gross domestic product. There is no assurance that sufficient revenues will be collected to partially offset the reduction in income tax revenues expected from the implementation of the tax reform.

Act 154 – Expanded Income Taxation and New Excise Tax. Act 154, approved on October 25, 2010, as amended, seeks, among other things, to balance the tax burden among the taxpayers and increase the tax revenues of the Government. Act 154 modified the income taxation of certain nonresident alien individuals, foreign corporations and foreign partnerships (each a taxpayer) by expanding the circumstances in which such persons would be subject to Puerto Rico income taxation, and the act imposed an excise tax on the acquisition of certain personal property manufactured or produced in whole or in part in Puerto Rico and on the acquisition of certain manufacturing services carried out in Puerto Rico. Act 154 applies to income realized and acquisitions occurring after December 31, 2010.

The Act provides that, in certain circumstances, taxpayers will be deemed to be engaged in trade or business in Puerto Rico and taxable in Puerto Rico with respect to a portion of taxpayer's income where the taxpayers engage in significant transactions with other persons that are members of the same controlled group. Where a person engages in significant transactions with a member of the same controlled group that has gross receipts of seventy-five million dollars or more in any of the last three years and that manufactures or produces goods in Puerto Rico, or provides services in connection with the manufacture or production of goods in Puerto Rico, the person will not be subject to income tax, will instead be subject to the excise tax in lieu of any income tax. The excise tax will apply for a period of six years. The excise tax is based on the value of the personal property or services acquired and was 4% for calendar year 2011, declining to 3.75% in 2012, 2.75% in 2013, 2.5% in 2014, 2.25% in 2015 and 1% in 2016. On December 29, 2010, the Treasury Department adopted regulations that provide certain tax credits against the temporary excise tax that lessen its impact on affected taxpayers subject to the temporary excise tax. These regulations became effective on January 1, 2011. The regulations address implementation and interpretation issues and include provisions regarding certain applicable credits against the tax subject to maintaining a baseline employment and other conditions. The Government estimates that this excise tax will affect foreign corporations or partnerships that are principally engaged in the manufacturing of pharmaceuticals and electronics. At the time of adoption of Act 154, the Government expected to raise approximately \$1.4 billion from the excise tax during the first year of implementation and \$5.6 billion for the six year period that the excise tax is in place.

While the Government expects that certain taxpayers subject to the excise tax will be able to credit all or a portion of the excise tax paid against their U.S. federal income tax liabilities, it is uncertain how this new tax will affect each individual taxpayer. The long-term effects of the excise tax on the manufacturing sector of the Puerto Rico economy are also uncertain.

The first monthly excise tax payment was due in February 2011. For fiscal year 2011 (from February 2011 through June 2011), the collections from the excise tax were \$677.6 million. For the first nine months of fiscal year 2012, the collections from the excise tax were \$1.379 billion. These amounts have exceeded the Government's projection of collections from the excise tax and are consistent with the Government's expectation that the revenues therefrom would be sufficient to offset the reduction in income tax revenues expected from other aspects of the tax reform.

Based on its analysis, the Government believes that the revenue projections from the taxes imposed by Act 154 are reasonable. However, since such taxes only became effective on January 1, 2011, there can be no assurance that the revenues therefrom, together with the other revenue enhancement measures included in the tax reform, will be sufficient to fully offset the reduction in income tax revenues expected from other aspects of the tax reform.

In connection with the expansion of the taxation of foreign persons by Act 154, the Government obtained a legal opinion regarding the creditability of the excise tax for U.S. federal income tax purposes. The opinion concludes that this excise tax should be creditable against U.S. federal income tax. That conclusion was based in part upon a determination that the expansion of the taxation of foreign persons and the imposition of the excise tax more likely than

not satisfy the constitutional requirements of due process and the Commerce Clause of the United States Constitution, for reasons discussed therein.

On March 30, 2011, the IRS issued Notice 2011-29 addressing the creditability of the new excise tax imposed by Act 154. Notice 2011-29 provides that the provisions of the new Puerto Rico excise tax are novel and the determination of its creditability requires the resolution of a number of legal and factual issues. Pending the resolution of those issues, the IRS will not challenge a taxpayer's position that the excise tax is a tax in lieu of an income tax under Section 903. The IRS also provided that any change in the foregoing tax credit treatment of the excise tax after resolution of the pending issues will be prospective and will apply to excise tax paid or accrued after the date that further guidance is issued.

Act 154 has not been challenged in court; consequently, no court has passed on the constitutionality of Act 154. There can be no assurance that its constitutionality will not be challenged and that, if challenged, the courts will uphold Act 154. To the extent a court determines that the imposition of the excise tax or the expansion of the income tax or both are unconstitutional, the Government's revenues may be materially adversely affected.

Sales and Use Taxes

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

The Sales Tax is imposed on the sale, use, consumption and storage of taxable items, which include tangible personal property, taxable services, admission rights and certain other types of transactions covering separable and identifiable taxable items which are sold for a single price, subject to certain exceptions and limitations. The Sales Tax does not apply to, among other things: (i) motor vehicles, (ii) non-prepared food, (iii) healthcare services and prescription medicines, (iv) certain bakery goods, (v) crude oil and its derivatives, including gasoline, (vi) hotel room charges, (vii) financial services, (viii) services provided by the Commonwealth, including electricity and water, and (ix) local sales of goods to be used as content in a manufactured good, whether or not bound for export.

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

The Sales Tax became effective on November 15, 2006 and the effective date of the repeal of the 5% general excise tax was October 16, 2006. Municipalities were authorized to implement the Municipal Sales Tax starting on July 1, 2006. The revenues derived from the

Sales Tax are distributed as follows: 5.5% goes to the central government and 1.5% to Puerto Rico's municipalities. One half of the 5.5% Commonwealth Sales Tax is transferred to the Dedicated Sales Tax Fund, created by Act 91 of 2006, as amended, and the balance goes to the General Fund. The 1.5% Municipal Sales Tax is divided as follows: (i) 1% goes to the municipalities, and (ii) 0.5% goes to the Municipal Improvements Fund. The increase in revenues generated by the Sales Tax has been partly offset by the elimination of the 5% general excise tax and the effect of the income tax reduction measures included in Act 117.

The Treasury Department has reported and recorded Commonwealth Sales Tax revenues on a "modified cash basis." This means that the figures for each month represent the sales taxes corresponding to sales made by merchants and retailers and sales tax collected by such merchants and retailers during that month, but reported and remitted to the Treasury Department during the following month.

Effective fiscal year 2010, the Treasury Department began reporting Commonwealth Sales Tax revenues on a cash basis in order to report these revenues on the same basis and at the same time as it reports all other tax revenues. Accordingly, for fiscal year 2010, Commonwealth Sales Tax revenues were reported in the month in which such revenues were received by the Treasury Department. The new reporting method became effective as of July 1, 2009. Thus, the figures for sales tax collections previously reported in June 2009 were transferred to July 2009.

The Sales Tax generated revenues for the General Fund of approximately \$553.0 million for fiscal year 2011.

The Treasury Department has also sponsored legislation to limit or close certain gaps that existed in Act 117, as amended. In this regard, one of the amendments incorporated in Act 7, which was subsequently incorporated into Act 1 of 2011, requires a merchant or retailer to file his or her Commonwealth Sales Tax monthly return on or prior to the tenth day of the following month, rather than the twentieth day (as originally required in Act 117). Act 1 of 2011 also provides that the Commonwealth Sales Tax exemption applicable to resellers applies only to merchants and retailers (i) with gross sales greater than or equal to \$500,000 or (ii) that do not meet the \$500,000 sales threshold but meet certain other requirements imposed by the Treasury Department. A merchant or retailer that meets neither the \$500,000 threshold nor the other requirements imposed by the Treasury Department would still be entitled to a credit on sales tax paid on merchandise acquired for resale that must be claimed in each monthly filing. This measure is intended to enable responsible taxpayers to take advantage of the exemption while preventing non-compliant merchants and retailers from abusing the exemption.

Excise Taxes

The PR Code imposes an excise tax on certain articles and commodities, such as cigarettes, alcohol, sugar, cement, motor vehicles, heavy equipment, boats and certain petroleum products, which are taxed at different rates.

Under Act 7, the excise tax was increased on certain articles (cigarettes and certain alcoholic beverages) and was expanded with respect to others (motor vehicles). With respect to cigarettes, the increase was approximately 81% per taxable unit. For certain alcoholic beverages,

the increase ranged between \$0.30 and \$0.70 per standard gallon. Act 1 of 2011 incorporated most of the increases made by Act 7, but provided an increase in the tax applicable to concentrated wine must (from \$4.48 to \$7.00 per gallon), while reducing the tax payable with respect to champagne from concentrated wine must (from \$4.48 to \$2.25 per gallon). Motorcycles, all terrain vehicles and “scooters,” which used to be subject to the Sales Tax, are now subject to an excise tax of 10% under Act 1 of 2011.

Property Taxes

Personal property, which accounts for approximately 46% of total collections of taxable property, is self-assessed. Real property taxes are assessed based on 1958 property values. No real property reassessment has been made since 1958, and construction taking place after that year has been assessed on the basis of what the value of the property would have been in 1958. Accordingly, the overall assessed valuation of real property for taxation purposes is substantially lower than the actual market value. Also, an exemption on the first \$150,000 of assessed valuation in owner-occupied residences is available.

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

One of the amendments incorporated in Act 7 was that, for fiscal years 2010 through 2012, the appraisal values of real property in Puerto Rico were increased tenfold and the real personal property tax rates applicable to such values were reduced tenfold so as to offset any increased tax that would have otherwise been applicable due to the increase in appraisal values. This temporary amendment, which is expected to be revenue neutral, was intended to increase the borrowing capacity of Puerto Rico’s municipalities.

Act 7 did impose, however, an additional real property tax on residential and commercial real properties with appraised values in excess of approximately \$210,000. This tax applied during fiscal years 2010, 2011 and 2012. The additional real property tax, which was collected by the Treasury Department, amounted to 0.591% of such properties’ appraised value as determined by CRIM. Act 1 of 2011 eliminated this additional real property tax for fiscal year 2012.

The following table presents the assessed valuations and real and personal property taxes collected for fiscal years 2008 to 2012.

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

Fiscal Years Ended June 30,	Assessed Valuations ⁽¹⁾	Taxes Levied	Collections of Current Year	Collections of Previous Years	Total Collections ⁽²⁾
2008	27,941,285	1,031,277	788,364	119,062	907,426
2009	28,903,996	1,032,570	634,040	244,411	878,451
2010	175,025,782	1,093,769	666,429	269,857	936,286
2011	187,293,462	1,152,718	712,706	225,280	937,986
2012	190,635,287	1,143,427	689,555	229,851	919,406

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

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

Source: Municipal Revenues Collection Center.

Other Taxes and Revenues

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

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

Revenues from Non-Commonwealth Sources

Revenues from non-Commonwealth sources include customs duties collected in Puerto Rico and excise taxes on shipments of rum from Puerto Rico to the United States mainland. The customs duties and excise taxes on shipments are imposed and collected by the United States and returned to the Commonwealth. The excise tax on shipments of rum from Puerto Rico and other rum producing countries is currently \$13.50 per gallon. Of this amount, the lesser of \$10.50 per proof gallon and the actual excise tax imposed is currently returned (“covered over”) to the Commonwealth. Since 1999, however, the U.S. Congress has enacted special supplementary legislation increasing the maximum amount covered over to the Commonwealth to \$13.25 per proof gallon. For fiscal year 2011, the total excise taxes on rum shipments returned to the Commonwealth was \$430 million, of which \$329 million went to the General Fund.

In June 2008, the Government of the United States Virgin Islands (the “USVI”) signed an agreement with Diageo USVI, Inc (“Diageo”) for the construction and operation of a new rum distillery in St Croix, USVI, that will manufacture Captain Morgan branded products to be sold in the United States beginning in January 2012. Currently, all rum used in Captain Morgan products sold in the United States is procured through a supply contract with Serralles Destillery (“Serralles”) in Puerto Rico which expires on December 31, 2011. The Government estimates that the exports of Captain Morgan rum produced in Puerto Rico by Serralles during calendar year 2009 were 9,403,224 proof gallons. These rum exports of Captain Morgan resulted in an

estimated \$124.5 million in excise tax on rum shipments returned by the United States to Puerto Rico during fiscal year 2009. As a result of the termination of the contract between Serrallés and Diageo, it is expected that after 2011, the income received by the Commonwealth from the federal excise tax on rum shipments will decrease unless Serrallés is able to find other clients in the United States for the volume of bulk rum previously purchased by Diageo for its Captain Morgan products.

In an effort to maintain the local rum industry, as a result of the threat posed by the USVI's agreement with Diageo, and preserve or increase the amount of federal excise taxes on rum shipments returned to the Commonwealth under the cover-over program, the Governor signed Act No. 178 of December 1, 2010 ("Act 178"), which increases from 10% to 25% the portion of the monies from the federal excise tax that the Commonwealth may invest to provide incentives to and promote the Puerto Rican rum industry. The law also authorizes the Governor to increase this percentage up to 46% after December 31, 2011, through an Executive Order. In order to promote the Puerto Rican rum industry in general, the amount received from such refund will be transferred to a special account of the General Fund, which may be used for marketing, production and infrastructure investment incentives. Effective January 1, 2011, Act 1 of 2011 replaced Act No. 178 and contains identical provisions.

As permitted under Act 1 of 2011, the Government has entered into a definitive agreement with two rum producers and is currently in negotiations with other producers to provide them a series of subsidies and incentives by allowing such companies to benefit from the cover-over program rebate. These agreements are expected to promote and encourage the export of rum produced in Puerto Rico. As a result of these agreements, during fiscal year 2012 the Treasury Department expects to disburse approximately \$72 million of total revenues from the federal excise tax on rum shipments for these subsidies and incentives. This amount is expected to be partially offset by the economic activity generated by the increased investment in Puerto Rico by these rum producers.

Administrative Measures to Increase Collections of Income, Sales, and Excise Taxes and Property Taxes

The Treasury Department has elaborated a strategic plan designed to improve tax collections. The plan includes initiatives to foster tax compliance, implement effective enforcement measures, and attack tax evasion. To promote taxpayers' compliance, the Treasury Department has liberalized the procedures to enter into payment plans, offers-in-compromise agreements, and encouraged voluntary disclosures agreements.

In addition, the Treasury Department has developed initiatives focused on effective enforcement methods, such as improving the efficiency of its audit selection process, the creation of technological solutions to improve collections, and the establishment of cooperation agreements with federal and local governmental agencies. The Treasury Department is also integrating its databases and establishing a tax intelligence project to identify tax evasion and improve its audit selection process.

Specifically, the Treasury Department has developed various initiatives directed towards increasing collections of income taxes and the Commonwealth sales tax through the

implementation of various enforcement and compliance programs. Among these revenue raising initiatives is a voluntary disclosure program that provides taxpayers that meet certain criteria the opportunity to pay taxes and interests owed on unreported income and, in certain circumstances, avoid the payment of surcharges and penalties. Under this program, which began on July 1, 2009, the Treasury Department has reviewed 568 cases and collected approximately \$64.2 million. In May 2010, the Treasury Department also began to deliver letters to taxpayers identified by the tax intelligence program to encourage the use of the voluntary disclosure program. As of October 15, 2010, the Treasury Department had sent approximately 7,900 letters and had received responses from 2,000 taxpayers. Moreover, the Treasury Department sent 1,000 additional letters in March 2011 and 2,200 additional letters in April 2011 as a second notice to taxpayers that did not respond to the first letter of May 2010.

Other programs are geared towards the use of technology to detect noncompliance. For example, the Treasury Department completed in November 2010 the integration of its general computer systems with the sales tax database in order to better detect non-compliance. The Treasury Department has also implemented a program whereby its officers use hand held scanning devices to cross-check merchant licenses. Recently, the Treasury Department discontinued the use of the hand held scanning devices and will provide tablet computers to its agents, beginning in December 2011, that will allow them to review a broader range of compliance criteria, such as merchant licenses, Commonwealth Sales Tax sales and point of sale system compliance.

On September 28, 2010, the Treasury Department signed an agreement for the implementation of a new point of sale system that is intended to strengthen its sales tax enforcement efforts. The system is designed to: (i) transmit daily to the Treasury Department information on all sales tax transactions; (ii) reconcile transmitted transactional information with information reported by merchants; (iii) provide wireless transmission devices for use by street vendors; and (iv) capture a greater percentage of cash sales through the implementation of a special lottery using sales receipts as lottery tickets (the "IVU Loto"). The Treasury Department began a two phase implementation of this new point of sale system in December 1, 2010, through a pilot program in which 200 merchants in the Municipality of Ponce were selected to participate. The second phase, which includes the initial implementation of the point of sale system throughout the island, started in March 2011. Implementation of the new system is expected to be completed by the end of Fiscal Year 2011-2012 and is expected to increase sales tax collections by \$200 million during the first year. As of November 7, 2011, the point of sale devices captured approximately 187.4 million transactions which resulted in sales of \$4.4 billion and Commonwealth Sales Tax collections of \$155.6 million. The Treasury Department adopted regulations on December 14, 2010 requiring that all qualifying merchants register for participation in the point of sale system program on or prior to April 30, 2011. As of October 27, 2011, 191,037 locations had registered in the program and 59,884 of such locations will be required to acquire and use the new point of sale system.

The Treasury Department has begun to detect inconsistencies between the information captured by the point of sale system and that reported by merchants and retailers. The principal inconsistencies are: (i) merchants and retailers that report sales through the point of sale system but do not file monthly returns, (ii) sales reported through the point of sale system are higher than those reported in the monthly returns, (iii) cash credits claimed through the point of sale

system are equal to the sales reported, and (iv) merchants and retailers are not reporting cash sales. In order to address these possible instances of non-compliance, the Treasury Department has created a task force consisting of fiscal auditors and agents from the Sales and Use Tax Bureau and the Tax Evasion Bureau. The fiscal auditors are responsible for investigating inconsistencies reported by the point of sale system, determine tax deficiencies and issue preliminary deficiency notices. The agents of the Sales and Use Tax Bureau provide assistance to the fiscal auditors in connection with any additional information requirements and visit merchants and retailers to investigate the status of their permits and point of sale systems. Finally, the agents from the Tax Evasion Bureau are responsible for investigating any tax crimes discovered by the fiscal auditors and/or agents from the Sales and Use Tax Bureau. As a result of this initiative, as of October 5, 2011, the Treasury Department had identified approximately 33,481 unfiled monthly returns and sent notices to approximately 5,125 merchants and retailers. As of October 31, 2011, approximately 1,181 merchants and retailers had responded to the notices and approximately 2,577 unfiled monthly returns were filed resulting in taxable sales reported of approximately \$24.7 million and sales and use tax collections of \$1.4 million. Merchants and retailers that filed monthly returns reporting no sales will receive a deficiency notice and all other merchants and retailers that have not responded will be referred to a fiscal auditor or the Tax Evasion Bureau.

In addition, the Treasury Department established “IVU Alerta” in order to enhance Commonwealth Sales Tax compliance. The “IVU Alerta” is an internet and telephone hotline through which customers and merchants can report violations related to the Commonwealth Sales Tax. This initiative started in November 29, 2010 and, as of November 4, 2011, has received 5,610 complaints, which 4,229 have been investigated resulting in fines of approximately \$5.5 million.

Other initiatives include the establishment of tax liens pursuant to the procedures of Act No. 12 of January 20, 2010, which enables the creation of tax liens through an expedited process. As of October 2011, the Treasury Department has established 16,000 liens in favor of the Commonwealth over approximately \$742.5 million in assets. The Treasury Department is also enforcing a provision of Act 7 that allows the Treasury Department to revoke a certificate of exemption held by a merchant or retailer that fails to pay sales taxes collected in full by the 10th day of the month. Also, the Treasury Department will begin to seize the assets of businesses that are delinquent on their sales tax payments. In addition, the Treasury Department has entered into agreements with various municipalities to conduct simultaneous field visits and joint audits in order to increase the effectiveness of sales tax enforcement efforts as the ones described above.

Act No. 172 of November 15, 2010, established that taxpayers which apply for a voluntary disclosure program on or before April 15, 2011 will be eligible for a 20% flat income tax rate on the gross amounts reported and will not be subject to interest, surcharges and penalty fees. This legislation extends the benefits of the program to municipal license tax declarations for which taxpayers will pay principal on the municipal tax determined, but will not be subject to interest, surcharges and penalty fees. Declarations by taxpayers must relate to tax years commenced after July 1, 2003 and ending on or before December 31, 2009, and payment of tax determined under the program must be paid no later than June 30, 2011. Recently, the Governor signed Act No. 64 of April 19, 2011, which extended the disclosure period until June 30, 2011.

The Treasury Department has also implemented a temporary measure to collect on payroll and employer withholding debts. This measure allows employers to enter into payment plans with the Treasury Department, subject to employer making a down payment of 25%, in the case of payroll debts, and 40%, in the case of employer withholding debts, of the total outstanding debt. The payment plans do not provide for the abatement of interest, surcharges and penalties and the same must be initiated on or before June 30, 2011. As of June 31, 2011, 216 employers entered into payment plan agreements in the amount of \$5.5 million and made down payments in the amount of \$1.7 million.

Act No. 218 of November 7, 2011 (“Act 218”), also known as the Act for the Strengthening of Safety and Public Health, established a program pursuant to which taxpayers could pay the total principal amount of income, estate and gift or additional real property tax owed to the Treasury Department without being subject to the payment of interest, surcharges, penalties or other additions to the tax. Most of the amounts collected pursuant to Act 218 will be used to cover expenses related to the safety of the people of Puerto Rico. Although a taxpayer initially had until February 29, 2012 in order to avail himself of the benefits provided by Act 218, pursuant to Act No. 64 of April 19, 2012 the deadline was extended to June 15, 2012.

Transfers to General Obligation Redemption Fund

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

Components of General Fund Expenditures

Grants and Subsidies

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

Personal Services

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

Other Services

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

Materials and Supplies

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

Equipment Purchases

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

Capital Outlays and Other Debt Service

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

Transfers to Agencies

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

Other Expenditures

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

Federal Grants

Puerto Rico receives grants under numerous federal programs. Federal grants to the agencies and instrumentalities of the Commonwealth government are estimated to be \$4.619 billion for fiscal year 2012, a decrease of \$405 million, or 8%, from fiscal year 2011. This decrease in federal grants is due to the termination of the ARRA program. Federal grants for fiscal year 2013 are projected at \$4.606 billion, which is consistent with the level for fiscal year 2012. The following table presents revenues from federal grants by broad program areas, which are accounted in the central accounting system of the Treasury Department. The figures for fiscal years 2009 through 2011 are actual figures. The figures for fiscal year 2012 and 2013 are the amounts included in the adopted budget and the proposed budget, respectively.

Puerto Rico expects to receive a total of approximately \$7.090 billion in stimulus funds from ARRA, of which \$509 million, \$2.68 billion and \$2.18 billion were disbursed by the

government during fiscal years 2009, 2010 and 2011, respectively. The amount of \$916 million is expected to be disbursed by the government during fiscal year 2012 and \$680 million is expected to be disbursed in fiscal year 2013. As of May 11, 2012, approximately \$6.1 billion in ARRA funds, or 86% of awarded funds, had been disbursed. The table below only included the portion of these funds disbursed by agencies whose accounting systems are centralized in the Treasury Department.

**The Commonwealth of Puerto Rico
Federal Grants*
(in thousands)**

	2009	2010	2011	2012 ⁽¹⁾	2013 ⁽²⁾
Education	\$1,813,455	\$1,270,589	\$1,364,393	\$1,028,471	\$1,018,238
Social Services	2,453,605	2,481,447	2,431,381	2,413,800	2,409,232
Health	583,190	655,060	472,983	491,287	481,299
Labor and Human Resources ⁽³⁾	277,127	138,425	225,090	101,063	94,046
Crime	64,155	29,459	35,826	42,590	31,695
Housing ⁽⁴⁾	416,667	534,987	340,728	394,060	437,046
Drug and Justice	53,067	21,628	21,968	24,339	26,952
Agriculture and Natural Resources	114,920	25,501	14,960	14,576	14,713
Contributions to Municipalities	47,656	60,559	52,087	43,698	28,348
Other	67,017	73,813	64,219	64,687	64,539
TOTAL	<u>\$5,890,859</u>	<u>\$5,291,468</u>	<u>\$5,023,635</u>	<u>\$4,618,571</u>	<u>\$4,606,108</u>

* Does not include grants received by agencies whose accounting systems are not centralized at the Treasury Department.

(1) Preliminary, unaudited.

(2) Proposed budget.

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

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

Source: *Office of Management and Budget*

BUDGET OF THE COMMONWEALTH OF PUERTO RICO

Office of Management and Budget

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

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

Budgetary Process

The fiscal year of the Commonwealth begins each July 1. The Governor is constitutionally required to submit to the Legislative Assembly an annual balanced budget of

revenues, capital improvements, and operating expenses of the central government for the ensuing fiscal year. The annual budget is prepared by OMB, in coordination with the Planning Board, the Treasury Department, and other government offices and agencies. Section 7 of Article VI of the Constitution provides that “The appropriations made for any fiscal year shall not exceed the total revenues, including available surplus, estimated for said fiscal year unless the imposition of taxes sufficient to cover said appropriations is provided by law.”

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

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

Financial Control and Adjustment Procedures

Revenue estimates for budgetary purposes are prepared by the Treasury Department, except for estimates of federal grants, which are prepared by OMB based on information received from the various departments and other recipients of such grants. Revenue and federal grant estimates are under continuous review and, if necessary, are revised at least quarterly during the fiscal year. Fiscal control over expenditures is exercised by the Governor, through the Director of OMB, and the Secretary of the Treasury.

During any fiscal year in which the resources available to the Commonwealth are insufficient to cover the appropriations approved for such year, the Governor may take administrative measures to reduce expenses and submit to both houses of the Legislative Assembly a detailed report of any adjustment necessary to balance the budget, or make recommendations to the Legislative Assembly for new taxes or authorize borrowings under provisions of existing legislation or take any other necessary action to meet the estimated deficiency. Any such proposed adjustments shall give effect to the “priority norms” established by law for the disbursement of public funds in the following order of priority; first, the payment of the interest on and amortization requirements for public debt (Commonwealth general obligations and guaranteed debt for which the Commonwealth’s guarantee has been exercised); second, the fulfillment of obligations arising out of legally binding contracts, court decisions on eminent domain, and other unavoidable obligations to protect the name, credit and good faith of

the Commonwealth; third, current expenditures in the areas of health, protection of persons and property, education, welfare, and retirement systems; and fourth, all other purposes.

A Budgetary Fund was created by Act No. 147 of June 18, 1980, as amended (the “Budgetary Fund”), to cover the appropriations approved in any fiscal year in which the revenues available for such fiscal year are insufficient, to secure the payment of public debt, and to provide for unforeseen circumstances in the provision of public service. An amount equal to one percent of the General Fund net revenues of the preceding fiscal year is required to be deposited annually into the Fund. In addition, other income (not classified as revenues) that is not assigned by law to a specific purpose is also required to be deposited in the Budgetary Fund. The maximum balance of the Budgetary Fund may not exceed 6% of the total appropriations included in the budget for the preceding fiscal year. During the last fiscal years, the Legislative Assembly approved joint resolutions to halt temporarily the deposit of funds into the Budgetary Fund, and such funds were used instead to cover the budgetary deficits. As of May 1, 2012, the balance in the Budgetary Fund was \$3.1 million.

An Emergency Fund was created by Act No. 91 of June 21, 1966 (“Act 91 of 1966”), as amended (the “Emergency Fund”), to cover unexpected public needs caused by calamities, such as wars, hurricanes, earthquakes, droughts, floods and plagues, and to protect people’s lives and property and the public sector credit. The Emergency Fund is capitalized annually with an amount totaling no less than one percent of the General Fund net revenues of the preceding fiscal year. Act No. 91 was amended in 2003 to set an upper limit to the Emergency Fund of \$150 million at the beginning of the fiscal year. Act No. 91 was further amended in 2005 to authorize the disbursement of funds from the Emergency Fund to cover certain General Fund expenditures and operational costs of the State Emergency Management Agency and authorized GDB to lend to the Commonwealth up to \$150 million to replenish the Emergency Fund to provide funding for emergency and disaster needs. As of May 1, 2012, the balance in the Emergency Fund was \$0.7 million and \$8.5 million was available to be borrowed from GDB. Joint Resolution No. 60 of July 1, 2011 authorized the conversion of this loan into a revolving line of credit with the same authorized limit of \$150 million.

Appropriations

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

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

(ii) *General Fund appropriations for special operating expenses, for contributions to municipalities, the University of Puerto Rico and the Judicial Branch, and for capital expenditures.* These are authorized by separate law.

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

(iv) *Bond Fund appropriations for capital expenditures financed by bonds.* Expenditures of these funds occur in one or more years.

In Puerto Rico, the central government performs many functions, which in the fifty states are the responsibility of local governments, such as providing public education, police and fire protection. The central government also provides significant annual grants to the University of Puerto Rico and to the municipalities. In addition, the Commonwealth appropriates annually to the Judicial Branch an amount equal to 4% of the average annual revenue from internal sources for each of the two preceding fiscal years. This percentage may be increased upon review, with scheduled reviews every five years.

For fiscal year 2011, approximately 25% of the General Fund was committed to the payment of fixed charges such as municipal subsidies, grants to the University of Puerto Rico, mandated funding for the Judicial Branch, rent payments to PBA, and debt service on the direct debt of the Commonwealth (excluding debt service that was refinanced, as discussed below). This proportion is expected to remain stable in fiscal years 2012 and 2013.

For fiscal year 2009, over 64% of the controllable funds portion of the General Fund was committed for the payment of the central government payroll (not including the University of Puerto Rico and the Judicial Branch). In fiscal year 2011 and 2012, the Commonwealth decreased this proportion to an average of 54% due mainly to the savings in operational expenses from the implementation of the Fiscal Plan.

The following table shows a breakdown between controllable and non-controllable General Fund expenses for fiscal years 2011 through 2013. The expenses shown in the table for rent payments to PBA and debt service on the general obligation bonds exclude the amounts of debt service on the PBA bonds and general obligation bonds refinanced, or expected to be refinanced, in those fiscal years. See “Fiscal Stabilization Plan – Financial Measures” under Fiscal Stabilization and Economic Reconstruction. If these amounts were included, the percent of non-controllable expenses to total General Fund expenses would be higher.

**Expenses Breakdown for the General and Stabilization Funds
(in millions)**

	<u>2011</u>	<u>2012*</u>	<u>2013+</u>
Non-Controllable Expenses			
Mandated Expenses (Formula)			
Contributions to Municipalities	\$ 355	\$ 380	\$ 388
University of Puerto Rico	691	704	757
Judicial Branch	348	328	343
Rent Payments to Public Buildings Authority ⁽¹⁾	216	218	208
General Obligation Debt Service	201	179	148
Other Debt Service	517	491	417
Total of Non-Controllable Expenses	<u>\$2,328</u>	<u>\$2,300</u>	<u>\$2,261</u>
Percent of Total General Fund Expenses	25%	25%	25%
Controllable Expenses	\$6,930	\$6,960	\$6,822
Payroll and Related Costs ^{(1) (2)}	\$3,693	\$3,799	\$3,692
Payroll as a Percentage of Controllable Expenses	<u>53%</u>	<u>55%</u>	<u>54%</u>
Total General & Stabilization Funds Expenses	<u><u>\$9,258</u></u>	<u><u>\$9,260</u></u>	<u><u>\$9,083</u></u>

* Estimated, Adopted FY 2012 Budget

+ Proposed Budget

(1) Excludes University of Puerto Rico and the Judicial Branch.

(2) Includes the Schoolwide Program teachers payroll appropriated in the Non-Distributed Allocations expense category.

Source: *Office of Management and Budget*

Budget for Fiscal Year 2012

The following table presents a summary of the Commonwealth's central government budget for the fiscal year ending June 30, 2012.

Commonwealth of Puerto Rico Summary of Central Government Annual Budget Fiscal Year Ending June 30, 2012 (in thousands)*

	General and Stabilization Fund	Bond Fund	Special Funds	Total
Revenues from internal sources:				
Property taxes	\$ 40,000	-	\$ 116,321	\$ 156,321
Personal income taxes	2,134,000	-	-	2,134,000
Retained non-resident income tax	917,000	-	-	917,000
Corporate income taxes	1,531,000	-	-	1,531,000
Partnership income taxes	2,000	-	-	2,000
Tollgate taxes	7,000	-	-	7,000
17% withholding tax on interest	7,000	-	-	7,000
10% withholding tax on dividends	26,000	-	-	26,000
Inheritance and gift taxes	5,000	-	-	5,000
Sales and use taxes	560,000	-	-	560,000
Excise taxes:				
Alcoholic beverages	284,000	-	-	284,000
Foreign (Act 154)	1,799,000	-	-	1,799,000
Motor vehicles and accessories	387,000	-	-	387,000
Cigarettes	185,000	-	-	185,000
Other (excise taxes)	76,000	-	729,306	805,306
Licenses	76,000	-	-	76,000
Miscellaneous non-tax revenues:				
Contributions from lottery fund	45,000	-	-	45,000
Electronic lottery	53,000	-	-	53,000
Registration and document certification fees	159,000	-	-	159,000
Other	58,000	-	365,135	423,135
Total revenues from internal sources	8,351,000	-	1,210,762	9,561,762
Revenues from non-Commonwealth sources:				
Federal excise taxes on off-shore shipments	291,000	-	-	291,000
Federal grants ⁽¹⁾	0	-	4,618,571	4,618,571
Customs	8,000	-	-	8,000
Total revenues from non-Commonwealth sources	299,000	-	4,618,571	4,917,571
Total revenues	8,650,000	-	5,829,333	14,479,333
Other:				
Balance from previous year	0	-	1,379,091	1,379,091
COFINA Stabilization Fund	610,000	-	0	610,000
Bonds authorized	-	\$290,000	-	290,000
Total other sources	610,000	290,000	1,379,091	2,279,091
Total resources	9,260,000	290,000	7,208,424	16,758,424
Appropriations:				
Current expenses:				
General government	830,984	-	61,079	892,063
Education	3,077,142	-	1,422,047	4,499,189
Health	1,367,265	-	540,927	1,908,192
Welfare	445,562	-	2,646,848	3,092,410
Economic development	359,517	-	203,518	563,035
Public safety and protection	1,523,677	-	135,819	1,659,496
Transportation and communication	150,561	-	51,843	202,404
Housing	18,814	-	397,454	416,268
Contributions to municipalities	395,644	-	4,809	400,453
Special pension contributions	420,312	-	0	420,312
Debt service	179,359	-	116,321	295,680
Other debt service (appropriations)	491,163	-	734,552	1,225,715
Total appropriations – current expenses	9,260,000	-	6,315,217	15,575,217
Capital improvements	0	290,000	158,201	448,201
Total appropriations	9,260,000	290,000	6,473,418	16,023,418
Year-end balance	0	-	735,006	735,006
Total appropriations and year-end balance	\$9,260,000	\$290,000	\$7,208,424	\$16,758,424

* Totals may not add due to rounding.

(1) Does not include grants received by agencies whose accounting systems are not centralized in the Treasury Department.

Sources: Treasury Department and Office of Management and Budget

The budget for fiscal year 2012 provided for total resources of \$16.8 billion and total General Fund revenues of \$9.260 billion, compared to General Fund revenues of \$9.165 billion for fiscal year 2011. The budgeted General Fund revenues of \$9.260 billion included \$610 million in additional resources from the COFINA Stabilization Fund.

The principal changes in budgeted General Fund revenues compared to the fiscal year 2011 budget were accounted mainly by projected increases in new temporary excise tax under Act 154 (up \$1,121.2 million), sales and use taxes (up \$28.3 million), excise taxes on motor vehicles and accessories (up \$22.8 million) and projected decreases in cigarettes taxes (down \$17.0 million), federal excise taxes on offshore shipments (down \$37.5 million), personal income taxes (down \$52.2 million), retained non-resident income taxes (down \$83.4 million), corporate income tax (down \$143.1 million), and property taxes (down \$206.6 million).

The fiscal year 2012 budget provided for total expenditures of \$9.260 billion, consisting of General Fund expenditures of \$8.650 billion and additional expenditures of \$610 million that were covered with proceeds of COFINA deposited in the Stabilization Fund. The budgeted total expenditures for fiscal year 2012 were \$9.260 billion, or 2%, higher than budgeted total expenditures of \$9.062 billion for fiscal year 2011, and \$1.087 billion, or 11%, lower than total expenditures of \$10.170 billion for fiscal year 2010.

Budgeted expenses and capital improvements for the central government of all budgetary funds totaled \$16.0 billion, an increase of \$180.3 million from fiscal year 2011 budgeted appropriations. The principal changes in General Fund expenditures by program areas in fiscal year 2012 compared to the fiscal year 2011 budget were mainly due to increases in education (up \$214.0 million), general obligation bonds debt service (up \$118.1 million), economic development (up \$103.9 million), special pension contributions (up \$85.8 million), and public safety and protection (up \$36.9 million), and decreases in welfare (down \$8.7 million), other debt service appropriations (down \$26.0 million), general government (down \$40.7 million), and health (down \$320.2 million).

Proposed Budget for Fiscal Year 2013

The following table presents a summary of the Commonwealth's central government proposed budget for the fiscal year ending June 30, 2013.

Commonwealth of Puerto Rico
Summary of Proposed Central Government Annual Budget
Fiscal Year Ending June 30, 2013
(in thousands)*

	General and Stabilization Fund	Bond Fund	Special Funds	Total
Revenues from internal sources:				
Property taxes	\$ 0	-	\$ 116,843	\$ 116,843
Personal income taxes	2,107,000	-	-	2,107,000
Retained non-resident income tax	942,000	-	-	942,000
Corporate income taxes	1,623,000	-	-	1,623,000
Partnership income taxes	2,000	-	-	2,000
Tollgate taxes	7,000	-	-	7,000
17% withholding tax on interest	7,000	-	-	7,000
10% withholding tax on dividends	27,000	-	-	27,000
Inheritance and gift taxes	5,000	-	-	5,000
Sales and use taxes	691,000	-	-	691,000
Excise taxes:				
Alcoholic beverages	290,000	-	-	290,000
Foreign (Act 154)	1,750,000	-	-	1,750,000
Motor vehicles and accessories	400,000	-	-	400,000
Cigarettes	173,000	-	-	173,000
Other (excise taxes)	78,000	-	740,426	818,426
Licenses	79,000	-	-	79,000
Miscellaneous non-tax revenues:				
Contributions from lottery fund	43,000	-	-	43,000
Electronic lottery	65,000	-	-	65,000
Registration and document certification fees	168,000	-	-	168,000
Other	70,000	-	335,788	405,788
Total revenues from internal sources	<u>8,527,000</u>	<u>-</u>	<u>1,193,057</u>	<u>9,720,057</u>
Revenues from non-Commonwealth sources:				
Federal excise taxes on off-shore shipments	219,000	-	-	219,000
Federal grants ⁽¹⁾	0	-	4,606,108	4,606,108
Customs	4,000	-	-	4,000
Total revenues from non-Commonwealth sources	<u>223,000</u>	<u>-</u>	<u>4,606,108</u>	<u>4,829,108</u>
Total revenues	<u>8,750,000</u>	<u>-</u>	<u>5,799,165</u>	<u>14,549,165</u>
Other:				
Balance from previous year	0	-	735,006	735,006
COFINA Stabilization Fund	332,700	-	-	332,700
Bonds authorized	0	-	-	0
Total other sources	<u>332,700</u>	<u>-</u>	<u>735,006</u>	<u>1,067,706</u>
Total resources	<u>9,082,700</u>	<u>-</u>	<u>6,534,171</u>	<u>15,616,871</u>
Appropriations:				
Current expenses:				
General government	901,948	-	49,473	951,421
Education	3,076,357	-	1,356,121	4,432,478
Health	1,373,089	-	499,454	1,872,543
Welfare	437,747	-	2,623,224	3,060,971
Economic development	157,413	-	102,654	260,067
Public safety and protection	1,526,716	-	115,847	1,642,563
Transportation and communication	144,912	-	52,212	197,124
Housing	18,975	-	383,318	402,293
Contributions to municipalities	400,664	-	567	401,231
Special pension contributions	489,558	-	0	489,558
Debt service	148,437	-	116,843	265,280
Other debt service (appropriations)	406,884	-	745,595	1,152,479
Total appropriations – current expenses	<u>9,082,700</u>	<u>-</u>	<u>6,045,308</u>	<u>15,128,008</u>
Capital improvements	0	-	115,274	115,274
Total appropriations	<u>9,082,700</u>	<u>-</u>	<u>6,160,582</u>	<u>15,243,282</u>
Year-end balance	0	-	373,589	373,589
Total appropriations and year-end balance	<u>\$9,082,700</u>	<u>-</u>	<u>\$6,534,171</u>	<u>\$15,616,871</u>

* Totals may not add due to rounding.

(1) Does not include grants received by agencies whose accounting systems are not centralized in the Treasury Department.

Sources: Treasury Department and Office of Management and Budget

The budget provides for total resources of \$15.6 billion and General Fund total revenues of \$9.083 billion. The budgeted General Fund total revenue of \$9.083 billion includes \$333 million in additional resources from the COFINA Stabilization Fund and other sources.

The principal changes in budgeted General Fund revenues compared to the fiscal year 2012 budget are accounted mainly by the projected collections from sales and use taxes (up \$131.0 million), corporate income tax (up \$92.0 million), withholding taxes on non-residents (up \$25.0 million), alcoholic beverage (up \$6.0 million), excise taxes on motor vehicles and accessories (up \$13.0 million), and projected decreases in the new temporary excise tax under Act 154 (down \$49.0 billion), federal excise taxes on offshore shipments (down \$72.0 million), property taxes (down \$40.0 million) and personal income taxes (down \$27.0 million).

The fiscal year 2013 budget provides for total expenditures of \$9.083 billion, consisting of General Fund expenditures of \$8.750 billion and additional expenditures of \$333 million that are expected to be covered with proceeds of COFINA bonds deposited in the Stabilization Fund. The budgeted total expenditures for fiscal year 2013 are \$9.083 billion, or 1.9%, lower than budgeted total expenditures of \$9.260 billion for fiscal year 2012, and \$21 million, or 0.2%, higher than total expenditures of \$9.062 billion for fiscal year 2011.

Budgeted expenses and capital improvements for the central government of all budgetary funds total \$15.2 billion, a decrease of \$780.1 million from fiscal year 2012 budgeted appropriations. The principal changes in General Fund expenditures by program in fiscal year 2013 compared to the fiscal year 2012 budget are mainly due to increases in, special pension contributions (up \$69.2 million), health (up \$5.8 million), contributions to municipalities (up \$5.0 million) public safety and protection (up \$3.0 million), and decreases in welfare (down \$7.8 million), general obligation bonds debt service (down \$30.9 million), other debt service appropriations (down \$84.3 million) and economic development (down \$202.1 million).

Differences between Budget and Basic Financial Statements

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

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

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

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

LITIGATION

General. The Commonwealth is a defendant in numerous legal proceedings pertaining to matters incidental to the performance of routine governmental operations. Under Act No. 104 of June 25, 1955, as amended (“Act 104”), persons are authorized to sue the Commonwealth only for causes of actions specified in said Act. The Commonwealth may be liable under Act 104 for damages up to a maximum amount of \$75,000, or \$150,000 if the suit involves actions for damages to more than one person or where a single injured party is entitled to several causes of action.

Under certain circumstances, as provided in Act No. 9 of November 26, 1975, as amended, the Commonwealth may provide its officers and employees, including directors of public corporations and government instrumentalities and mayors of the municipalities of the Commonwealth, with legal representation, as well as assume the payment of any judgment that may be entered against them. There is no limitation on the amount of the judgment that may be paid under the Act in cases before federal court, but in all other cases the Puerto Rico Secretary of Justice may determine whether, and to what extent, the Commonwealth will assume payment of such judgment.

With respect to pending and threatened litigation, excluding the litigation mentioned in the following paragraphs, as of June 30, 2011, the Commonwealth has included in its financial statements reported liabilities of approximately \$281 million for awarded and anticipated unfavorable judgments. Such amount represents the amount estimated at the time as a probable liability or a liability with a fixed or expected due date, which would require future available financial resources for its payment. The amounts claimed exceed \$17 billion; however, the ultimate liability cannot be presently determined. The Commonwealth believes that the claims are excessive and that the ultimate liability in excess of amounts provided in the financial statements, if any, would not be significant.

Recovery of Medicaid Funds. The Commonwealth is a defendant in two lawsuits filed, one in Commonwealth court and one in the U.S. District Court for the District of Puerto Rico, by certain Federally Qualified Health Centers (“FQHC”) seeking to recover from the Commonwealth approximately \$800 million in Medicaid wraparound payments which the Department of Health failed to make since 1997. In June 2004, the Superior Court of the Commonwealth in San Juan determined that the Commonwealth must make Medicaid “wraparound” payments to the health centers to cover the difference between the reimbursement they are owed and what they are paid by managed care organizations. The Court of Appeals of Puerto Rico, however, upheld a partial ruling allowing the Commonwealth to deduct from the payments due to the FQHCs certain grants received by these centers from the federal government. Currently, attorneys in the case filed in Commonwealth court are trying to determine the amounts due to FQHCs thereunder.

With respect to the federal case, in February 2005, the U.S. Court of Appeals (First Circuit) upheld a preliminary injunction issued by the U.S. District Court for the District of Puerto Rico requiring the Commonwealth to make Medicaid “wraparound” payments to the health centers. In December 2008, the U.S. Court of Appeals determined that the U.S. District Court erred when it vacated the preliminary injunction entered against two of the FQHCs and

determined that the Department of Health had met its obligations to establish and implement a payment system for FQHCs in compliance with the federal Medicaid statute. The U.S. Court of Appeals reversed the District Court's order vacating the preliminary injunction and remanded the case for further proceedings.

Recently, the Court entered a preliminary injunction as to the remaining 15 health centers, and granted a request by the Department of Health for Eleventh Amendment sovereign immunity. The plaintiff FQHCs immediately filed an appeal regarding the issue of Eleventh Amendment.

Meanwhile, the Department of Health filed a counter appeal regarding the Court's interpretation of certain components of the wraparound formula that must be used under the preliminary injunction to calculate wraparound payments owed to the plaintiffs. The Department has already made approximately \$40 million in uncontested wraparound payments owed under the injunction. However, the Court granted the Department's request for a stay pending appeal regarding payment of an additional \$29 million that are owed under the Court's wraparound formula. This sum has already been consigned with the Court pending appeal or otherwise deposited in specially earmarked accounts, but may have to continually be increased to reflect the difference between the amounts owed under the Court's formula and the Department's formula since the consignment.

As of June 30, 2011, the Commonwealth accrued \$500 million in its financial statements for this legal contingency.

Special Education Students. The Commonwealth is also a defendant in a class action presented in 1980 by parents of special-education students before Commonwealth courts alleging that the Puerto Rico Department of Education had failed to provide legally required special education and related services. In February 2002, the court issued a judgment approving the stipulations reached by the parties regarding the manner special education services should be provided. Since December 2002, the Department of Education has paid fines for not complying with the stipulations reached. The fines were originally set in the amount of \$1,000 daily, and were raised to \$2,000 daily in January 2006. In February 8, 2010, the court issued a resolution advancing its intention to establish a new scheme of fines ranging from \$0.25 to \$0.75 daily per registered student. As of February 2010, there were 121,339 students registered in the Special Education Program. Said resolution also creates a new scheme of monitoring compliance with the stipulations, including the added participation of 12 experts (each party has the right to designate 2 experts) in 6 areas of expertise. Said monitoring scheme began on July 1, 2010.

The February 2002 judgment only disposed of the injunctive relief sought by plaintiffs. Still pending before the court are the claims for damages regarding the failure to provide adequate services. In 2005, the Court of First Instance denied damages for the class as a whole. The plaintiffs appealed the decision and, in October 2005, the Court of Appeals decided that there could be no general damages award, but that every member of the class must come forward and prove their individual damages within this case. Assuming the Court grants damages to the plaintiffs, the Commonwealth estimates that each plaintiff could receive at least \$5,000. Based on a current enrollment of 120,000 students, the total award could amount to at least \$600 million. The Commonwealth plans to defend vigorously each case.

The plaintiffs approached the Commonwealth to inquire about its disposition to reach a settlement agreement regarding the damages phase. At the Commonwealth's request, the plaintiffs submitted a settlement offer. Settlement conversations stopped after the parties reached an impasse during negotiations.

As of June 30, 2011, the Commonwealth had accrued \$600 million in its financial statements for this legal contingency.

Other. The Commonwealth and various component units are defendants in other lawsuits alleging violations of civil rights, breach of contract, and other damage claims. Preliminary hearings and discovery proceedings are in progress. No provision for any liability that may result upon adjudication of these lawsuits has been recognized by the Commonwealth. The Commonwealth believes that the ultimate liability, if any, would not be significant.

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PROPOSED FORM OF BOND OPINION

Upon delivery of the 2012 Series A Bonds, Squire Sanders (US) LLP is prepared to render its final opinion with respect to the 2012 Series A Bonds in substantially the following form:

June __, 2012

To: Puerto Rico Public Finance Corporation
San Juan, Puerto Rico

We have served as bond counsel to our client the Puerto Rico Public Finance Corporation (the “Corporation”) and not as counsel to any other person in connection with the issuance by the Corporation of its \$410,665,000 aggregate principal amount of 2012 Series A Bonds (Commonwealth Appropriation Bonds) (the “2012 Series A Bonds”), dated the date of this letter. The Corporation is an independent governmental instrumentality of the Commonwealth of Puerto Rico (the “Commonwealth” or “Puerto Rico”) created by Government Development Bank for Puerto Rico (“Government Development Bank”) as a wholly-owned subsidiary pursuant to Resolution No. 5044, adopted by the Board of Directors of Government Development Bank on December 12, 1984, as amended (“Resolution No. 5044”). Government Development Bank is a corporation and governmental instrumentality of the Commonwealth created pursuant to Act No. 17 of the Legislature of Puerto Rico approved September 23, 1948, as amended (“Act No. 17”), which, among other things, acts as the financial advisor and fiscal agent for the Commonwealth, its instrumentalities, commissions, authorities, municipalities and political subdivisions, and makes loans and advances funds to the Commonwealth and such entities.

The 2012 Series A Bonds are issued pursuant to a Trust Agreement dated as of June 1, 2004 (the “Trust Agreement”), by and between the Corporation and U.S. Bank National Association, as trustee, and a resolution of the Board of Directors of the Corporation, adopted on June 13, 2012, authorizing the issuance and sale of the 2012 Series A Bonds (the “Bond Resolution”). Capitalized terms not otherwise defined in this letter are used as defined in the Trust Agreement.

In our capacity as bond counsel, we have examined the transcript of proceedings relating to the issuance of the 2012 Series A Bonds, a copy of the signed and authenticated 2012 Series A Bond of the first maturity, Act No. 17, Resolution No. 5044, the Bond Resolution, the Trust Agreement and such other documents, matters and law as we deem necessary to render the opinions set forth in this letter.

Based on that examination and subject to the limitations stated below, we are of the opinion that under existing law:

1. Act No. 17 has been validly enacted and is in full force and effect, and Resolution No. 5044 has been validly and legally adopted and is in full force and effect, and the Corporation is a duly constituted and existing subsidiary corporation of Government Development Bank and an independent governmental instrumentality of the Commonwealth.
2. The Bond Resolution has been validly and legally adopted.
3. The 2012 Series A Bonds and the Trust Agreement are valid and binding obligations of the Corporation, enforceable in accordance with their respective terms.
4. The 2012 Series A Bonds have been duly authorized and issued and constitute special limited obligations of the Corporation, and the principal of and interest on (collectively, "debt service") the 2012 Series A Bonds, together with debt service on any other obligations issued and outstanding on a parity with the 2012 Series A Bonds as provided in the Trust Agreement, are payable from and secured solely by the Pledged Revenues. The 2012 Series A Bonds shall not be deemed to constitute a debt or obligation of the Commonwealth or any of its instrumentalities, municipalities or other political subdivisions, other than the Corporation, and neither the Commonwealth nor any such instrumentalities, municipalities or other political subdivisions, other than the Corporation, are liable for the payment of debt service on the 2012 Series A Bonds.

We express no opinion as to any federal, state, Commonwealth of Puerto Rico or local tax consequences regarding the 2012 Series A Bonds.

The opinions stated above are based on an analysis of existing laws, regulations, rulings and court decisions and cover certain matters not directly addressed by such authorities. In rendering all such opinions, we assume, without independent verification, and rely upon (i) the accuracy of the factual matters represented, warranted or certified in the proceedings and documents we have examined and (ii) the due and legal authorization, execution and delivery of those documents by, and the valid, binding and enforceable nature of those documents upon, any parties other than the Corporation.

The rights of the owners of the 2012 Series A Bonds and the enforceability of the 2012 Series A Bonds and the Trust Agreement are subject to bankruptcy, insolvency, arrangement, fraudulent conveyance or transfer, reorganization, moratorium and other laws relating to or affecting creditors' rights, to the application of equitable principles, to the exercise of judicial discretion, and to limitations on legal remedies against public entities.

The opinions rendered in this letter are stated only as of this date, and no other opinion shall be implied or inferred as a result of anything contained in or omitted from this letter. Our engagement as bond counsel with respect to the 2012 Series A Bonds has concluded on this date.

Respectfully submitted,

[To be signed "Squire Sanders (US) LLP"]

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FORM OF OPINION OF SPECIAL PUERTO RICO TAX COUNSEL

June , 2012

Juan Carlos Batlle
President
Government Development Bank
San Juan, Puerto Rico

RE: \$410,665,000 Puerto Rico Public Finance Corporation, 2012 Series A Bonds

Dear Mr. Batlle:

We have acted as Special Puerto Rico Tax Counsel in connection with the issuance by the Commonwealth of Puerto Rico (the “Commonwealth”) of \$410,665,000 Puerto Rico Public Finance Corporation, 2012 Series A (the “Bonds”). As such counsel, we have examined, among other things, the provisions of the Internal Revenue Code for a New Puerto Rico, Act No. 1 of 2011 of the Legislative Assembly of Puerto Rico, approved January 31, 2011, as amended (the “PR Code”), and of the United States Internal Revenue Code of 1986, as amended (the “US Code”).

From such examination and based on the provisions of the laws of the Commonwealth and the United States of America as now in force, and having regard to legal questions we deem relevant, we are of the opinion that:

1. Interest on the Bonds is:
 - (a) exempt from Puerto Rico income taxes under Section 1031.02(a)(3)(B) of the PR Code;
 - (b) excluded under Section 1022.04(b)(2) of the PR Code from the “adjusted net book income” of a corporation for purposes of computing the alternative minimum tax imposed by Section 1022.03(a) of the PR Code;
 - (c) exempt from the Puerto Rico alternative basic tax under Section 1021.02(a)(2) of the PR Code; and
 - (d) exempt from Puerto Rico municipal license taxes under Section 9(25) of the Puerto Rico Municipal License Tax Act of 1974, as amended.
2. The Bonds are exempt from Puerto Rico personal property tax pursuant to Section 3.11 of the Puerto Rico Municipal Property Tax Act of 1991, as amended, and Section 3 of the Puerto Rican Federal Relations Act.
3. The Bonds are exempt from Puerto Rico (i) gift tax with respect to donors who are residents of Puerto Rico at the time the gift is made and (ii) estate tax with respect to estates of decedents who are residents of Puerto Rico at the time of death and who acquired their United States citizenship solely by reason of birth or residence in Puerto Rico.

4. The Bonds will be considered an obligation of an instrumentality of Puerto Rico for purposes of: (i) the non-recognition of gain rules under Section 1034.04(f)(2)(A) of the PR Code applicable to certain involuntary conversions; and (ii) the exemption from the surtax imposed by Section 1022.05 of the PR Code available to corporations that have a certain percentage of their net income invested in obligations of instrumentalities of Puerto Rico and certain other investments pursuant to Section 1022.05(g) of the PR Code.

5. Interest on the Bonds constitutes industrial development income under Section 2(j) of the Economic Incentives for the Development of Puerto Rico Act, or under analogous provisions of similar prior acts (collectively referred to as the “Acts”), when received by a holder of a grant of tax exemption issued under any of the Acts that acquired the Bonds with eligible funds, as such term is defined in the Acts.

6. Gain recognized from the sale or exchange of the Bonds will be subject to income tax under the PR Code to taxpayers subject to Puerto Rico income tax on such gains, including individuals residing in Puerto Rico and corporations organized under the laws of Puerto Rico.

The PR Code does not contain any provisions regarding the treatment of the excess of a Bond's redemption price at maturity over its initial issue price (original issue discount). However, under the administrative practice followed by the Treasury Department with respect to the repealed Puerto Rico Internal Revenue Code of 1994, original issue discount was treated as interest.

Prospective owners of the Bonds, including but not limited to financial institutions, should be aware that, pursuant to Sections 1033.17(a)(5), 1033.17(a)(10) and 1033.17(f) of the PR Code, ownership of the Bonds may, under certain circumstances, result in a disallowance, for regular and alternative minimum Puerto Rico income tax purposes, of interest expense and other expenses related to an investment in the Bonds.

IRS Circular 230 Disclosure: The following U.S. tax discussion is general in nature and is not intended to be a tax opinion or tax advice. The U.S. tax discussion was prepared to support the promotion and marketing of the Bonds. No taxpayer can rely on the U.S. tax discussion to avoid penalties that may be imposed on the taxpayer by the IRS. Each prospective purchaser should seek advice from an independent tax advisor about the tax consequences under its own particular circumstances of investing in the Bonds.

The following discussion is limited to Bonds held as capital assets and does not purport to address interest or gain on the Bonds that is effectively connected with a Puerto Rico trade or business. Based upon the provisions of the United States Internal Revenue Code of 1986, as amended (the “US Code”), now in force and the rules and regulations thereunder, it is our opinion that:

1. Interest or original issue discount on the Bonds owned by an individual is excludable from the gross income of the individual for United States federal income tax purposes under Section 933 of the US Code if (a) the individual is a bona fide resident of Puerto Rico during the entire taxable year in which such interest or original issue discount is to be recognized for purposes of the US Code and (b) such interest or original issue discount is not, and is not treated as, income effectively connected with, or attributable to, the conduct of a trade or business within the United States by such individual under the US Code. In addition, for U.S. federal income tax purposes, no deduction or credit will be allowed that is allocable to or chargeable against amounts so excluded from the Puerto Rico individual's gross income.

2. Interest or original issue discount on the Bonds derived by a corporation organized under the laws of Puerto Rico or by any foreign corporation for purposes of the US Code is not subject to United States federal income tax under the US Code if: (a) such interest or original issue discount is not, and is not treated as, income effectively connected with, or attributable to, the conduct of a trade or

business in the United States by such corporation under the US Code; (b) such corporation is not a controlled foreign corporation or a passive foreign investment company under the US Code; and (c) such corporation is not treated as a domestic corporation for purposes of the US Code.

3. United States taxpayers, other than individuals who comply with the requirements set forth below, may be subject to federal income tax on any gain realized upon sale of the Bonds. Pursuant to Notice 89-40, issued by the United States Internal Revenue Service on March 27, 1989, and the regulations issued under Section 937 of the US Code, the gain from the sale of the Bonds by an individual who is a bona fide resident of Puerto Rico will constitute Puerto Rico source income, and therefore will qualify for exclusion from gross income under Section 933 of the US Code, provided (i) said Bonds do not constitute inventory in the hands of such individual, (ii) such gain is not attributable to an office or fixed place of business of the individual located outside of Puerto Rico and (iii) the individual has been a bona fide resident of Puerto Rico for the shorter of (1) the full period during which the individual has owned the Bonds or (2) each of the ten years preceding the year of the sale. In the case the individual is a bona fide resident of Puerto Rico for the tax year for which the source of income must be determined and the individual was a United States citizen or resident (other than a bona fide resident of Puerto Rico) for any of the ten years preceding said year, the individual may elect to treat as gain from sources within Puerto Rico the portion of the gain attributable to the individual's holding period in Puerto Rico.

4. Puerto Rico corporations generally will not be subject to income or withholding tax under the US Code on gain recognized on the sale or exchange of the Bonds, unless the gain is effectively connected, or treated as effectively connected, with the conduct by the Puerto Rico corporation of a trade or business in the United States.

Prospective owners of the Bonds should consult their tax advisors with respect to the precise determination of the Puerto Rico and United States federal tax consequences arising from ownership or disposition of the Bonds.

The preceding opinions are based upon laws, regulations, rulings and decisions now in effect, all of which are subject to change (including with retroactive effect) or possible differing interpretations. The opinions only deal with Bonds held as capital assets and do not address the tax consequences relevant to investors that are treated as pass-through entities or are subject to special tax regimes under the PR Code or the US Code.

Our opinion is limited to the above, and we do not express any other opinion regarding the Puerto Rico or United States federal income tax consequences arising from the ownership or disposition of the Bonds. Moreover, we do not express any opinion as to the tax consequences under the laws of any state or of any other taxing jurisdiction.

This letter is furnished by us solely for the benefit of the Commonwealth of Puerto Rico and the holders from time to time of the Bonds and may not be relied upon by any other person.

Respectfully submitted,

[To be signed by O'Neill & Borges LLC]

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COPY OF TRUST AGREEMENT

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PUERTO RICO PUBLIC FINANCE CORPORATION

TO

**U.S. BANK TRUST NATIONAL ASSOCIATION,
TRUSTEE**

TRUST AGREEMENT

Dated June 1, 2004

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TRUST AGREEMENT

THIS TRUST AGREEMENT, dated as of June 1, 2004, is by and between the **PUERTO RICO PUBLIC FINANCE CORPORATION** (the "Corporation"), a governmental instrumentality of the Commonwealth of Puerto Rico (the "Commonwealth" or "Puerto Rico") and a wholly-owned subsidiary of Government Development Bank for Puerto Rico ("Government Development Bank") and **U.S. BANK TRUST NATIONAL ASSOCIATION**, as trustee, a national banking association organized and existing under the laws of the United States of America (said bank and any bank, trust company or national banking association becoming successor trustee under this Agreement being hereinafter called the "Trustee").

PREAMBLE

FIRST: By Act Number Seventeen (17) of the Legislature of Puerto Rico, approved September twenty-third (23rd), nineteen hundred forty-eight (1948), as amended, Government Development Bank was created as a corporation and a governmental instrumentality of the Commonwealth, with powers, among others, to create subsidiary or affiliate corporations by resolution of its Board of Directors, whenever in the opinion of said Board such creation is advisable or desirable or necessary to carry out the functions or the purposes of Government Development Bank or the exercise of its powers.

SECOND: By Resolution Number Five Thousand Forty-Four (5044), adopted December twelfth (12th), nineteen hundred eighty-four (1984), as amended, of the Board of Directors of Government Development Bank, the Corporation was created as a subsidiary corporation of Government Development Bank, constituting an independent governmental instrumentality of Puerto Rico separate and apart from Government Development Bank.

THIRD: By virtue of said Resolution Number Five Thousand Forty-Four (5044), as amended, the Corporation is authorized and empowered, among other things, to

(a) purchase, hold, sell, exchange or otherwise dispose of bonds and other obligations of governmental instrumentalities for such price and on such terms as it shall determine;

(b) borrow money and contract debts for its corporate purposes upon such terms and conditions as it may from time to time determine, with or without security, dispose of its obligations evidencing such borrowing, make, execute and deliver trust indentures and other agreements with respect to any such borrowing, contracting of debt, issuance of bonds, notes, debentures or other obligations, and by the authority of the Government of Puerto Rico, issue its bonds, notes, debentures or other obligations in such form, secured in such manner, and subject to such terms of redemption with or without premium, and sell the same at public or private sale for such price or prices, all as may be determined by its Board of Directors; and

(c) make and execute agreements, contracts and other instruments necessary or desirable in the exercise of its powers and functions under said Resolution Number Five Thousand Forty-Four (5044), as amended, with any person, firm, corporation, Federal agency and with the Commonwealth and any of its political subdivisions, public agencies and other public instrumentalities.

FOURTH: By the Acts (as hereinafter defined) the Authorized Debtors (as hereinafter defined) were required to execute with Government Development Bank the agreements, promissory notes or financial contracts necessary to recognize, formalize, restructure and/or refinance (more than once if necessary) the advances, repayment commitments, obligations and/or loans of such Authorized Debtors with Government Development Bank.

FIFTH: Each of the Acts provides that the Commonwealth's Office of Management and Budget shall include in the annual budget of the Commonwealth, the amount necessary to pay principal, interest and any Additional Payments of the debt obligations of the Authorized Debtors arising from the restructuring and/or refinancing of the loans, subject to limitations contained in the respective Acts.

SIXTH: Government Development Bank has previously entered into Debt Restructuring and Assignment Agreements (the "Assignment Agreements") with the Authorized Debtors and the Corporation providing for, among other things, the restructuring and refunding of the loans by the execution of certain promissory notes (the "Existing Notes") and providing in the aggregate for the payment of, among other things, the principal of and interest on the bonds (the "Prior Bonds") issued by the Corporation to finance the purchase of the Existing Notes.

SEVENTH: The Corporation has determined initially to issue Bonds hereunder in the aggregate initial principal amount of ONE BILLION THREE HUNDRED FIFTY-THREE MILLION TWENTY-FIVE THOUSAND DOLLARS for the purposes of (a) restructuring and refunding a portion of the Prior Bonds, (b) refunding interest (but not principal) accrued during the Fiscal Year ending June 30, 2005, on certain of the Parity Bonds (as hereinafter defined) and (c) paying certain costs incurred by the Corporation in connection with the issuance of such Bonds.

EIGHTH: Upon execution and delivery of the Bonds hereunder, the Corporation, the Government Development Bank and the Authorized Debtors shall enter into Supplemental Debt Restructuring and Assignment Agreements (the "Supplemental Assignment Agreements"), providing for (A) the restructuring and refunding of a portion of the Existing Notes by the execution of certain amendments to the Existing Notes (each such note as amended shall represent the unrefunded portion of the Prior Bonds and, together with all other notes securing bonds of the Corporation payable under the Acts, shall be referred to herein as a "Parity Note" and collectively, as the "Parity Notes") and, in each case, the execution and delivery of a new note representing the portion of the Prior Bonds refunded with a portion of the proceeds of the Bonds (such new note shall be referred to herein as a "Note" and collectively as the "Notes") and (B) in the aggregate the payment of annual installments of principal, interest and Additional Payments sufficient to pay in each Fiscal Year (without duplication): (i) the interest, principal, redemption premium, if any, and Accreted Value or Appreciated Value of the Bonds which is due and payable in the Bond Year commencing within such Fiscal Year (whether at maturity, in connection with an Amortization Requirement, upon redemption or otherwise) (with interest payable on Variable Rate Bonds calculated at the maximum rate specified in such Bonds) less any amounts available in the Sinking Fund for the payment of such amounts in such Bond Year; (ii) any fees, expenses or other amounts becoming due and payable in such Bond Year to the provider, if applicable, of a Credit Facility or a Liquidity Facility (each a "Facility") under the agreement relating to such Facility or any amounts required to reimburse a Facility provider for

payments made under any such Facility in respect of the Bonds and not theretofore reimbursed; (iii) all Corporation Swap Payments (if applicable) expected to be due and payable for such Bond Year (to the extent not already included in the portion corresponding to interest on the Bonds); (iv) the amounts required to be deposited to the credit of the Reserve Account (if applicable) established under the Trust Agreement in such Bond Year, including any amounts required to cure any deficiency therein; (v) any fees or reimbursement for expenses payable to the Trustee under this Trust Agreement; (vi) any amount then due by Corporation to the Hedge Counterparty (if applicable) for breakage cost or other termination payment under the terms of any Swap Agreement (if applicable); and (vii) any other amount becoming due and payable in such Bond Year in respect of the Bonds or becoming due and payable under the provisions of this Trust Agreement.

NINTH: The Corporation has determined to provide for the issuance of additional refunding Bonds on a parity with the Bonds initially issued under the provisions hereof for the purpose of (A) providing funds, together with any other available funds, for refunding any Bonds outstanding hereunder, any Prior Bonds and any other bonds payable from Budgetary Appropriations, either in whole or in part, including the payment of any redemption premium thereon and the interest to accrue to the date fixed for redemption, (B) paying the cost of issuance of such additional refunding Bonds, (C) making a deposit to the Reserve Account (if applicable), and (D) paying capitalized interest on such additional refunding Bonds.

TENTH: The Notes securing the Bonds to be issued hereunder are payable, on a parity with the Parity Notes, from annual appropriations to be made by the Legislature of Puerto Rico pursuant to the Acts.

ELEVENTH: The Corporation has determined that the Bonds to be issued hereunder, the certificate of authentication by the Trustee to be endorsed on all such Bonds and the form of assignment shall be, respectively, in substantially the forms set forth in the resolution of the Board authorizing the issuance of such Bonds.

WHEREAS, the execution and delivery of this Agreement have been duly authorized by resolution of the Corporation; and

WHEREAS, all acts, conditions and things required by the Puerto Rican Federal Relations Act, the Constitution and laws of the Commonwealth, and the rules and regulations of the Corporation to happen, exist and be performed precedent to and in the execution and delivery of this Agreement have happened, exist and have been performed as so required in order to make this Agreement a legal, valid and binding trust agreement for the security of the Bonds to be issued hereunder enforceable in accordance with its terms; and

WHEREAS, the Trustee has accepted the trusts created by this Agreement and in evidence thereof has joined in the execution hereof;

NOW, THEREFORE, THIS AGREEMENT WITNESSETH, that in consideration of the premises, of the acceptance by the Trustee of the trusts hereby created, and of the purchase and acceptance of the Bonds issued hereunder by the holders thereof, and for the purpose of fixing and declaring the terms and conditions upon which the Bonds are to be issued, executed,

authenticated, delivered, secured and accepted by all persons who shall from time to time be or become Holders thereof, and in order to secure: (i) the payment of the Bonds issued and at any time Outstanding hereunder and the interest and premium, if any, thereon according to their tenor, purport and effect; (ii) all Reimbursement Obligations of the Corporation to a provider of a Credit Facility or Liquidity Facility pursuant to its Reimbursement Agreement (if applicable); (iii) all obligations of the Corporation to any Hedge Counterparty under any Swap Agreement (if applicable) (the Holders of the Bonds, any provider of a Credit Facility or Liquidity Facility and the Hedge Counterparty are referred to collectively as the "Secured Parties"); and (iv) the performance and observance of all the covenants, agreements and conditions therein and herein contained, the Corporation has executed and delivered this Agreement and does hereby assign and pledge to the Trustee all of its right, title and interest in and to the Pledged Revenues (as hereinafter defined) for the benefit of the Secured Parties, and does hereby constitute: (1) a first lien on all of the Corporation's right, title and interest in and to (A) such portion of the amounts paid and to be paid in respect of the Notes that are required under the terms of this Agreement to be deposited to the credit of the Bond Service Account and the Redemption Account, (B) the Hedge Counterparty Swap Payments, if any, (C) all moneys and investments on deposit to the credit of the Bond Service Account and the Redemption Account, and (D) all investment earnings on the foregoing, for the equal and ratable benefit of (I) the Holders from time to time of the Bonds, as security for the payment of the Bonds and the interest and premium, if any, thereon and any other amount payable hereunder and in respect of the Bonds and as security for the satisfaction of any other obligation assumed by it in connection with such Bonds (for the equal and proportionate benefit and security of all and singular the present and future Holders of the Bonds, without preference, priority or distinction as to lien or otherwise, except as otherwise hereinafter provided, of any one Bond over any other Bond by reason of priority in the issue, sale or negotiation thereof or otherwise), (II) the provider of a Credit Facility or Liquidity Facility as security for all obligations of the Corporation under any Reimbursement Agreement (if applicable), including without limitation, for the payment of any Reimbursement Obligations thereunder, and (III) any Hedge Counterparty (if applicable), as security for the obligations of the Corporation under any Swap Agreement; (2) a first lien on all of the Corporation's right, title and interest in and to (A) such portion of the amounts paid and to be paid in respect of the Notes that are required under the terms of this Agreement to be deposited to the credit of the Surplus Account and any sub-account in the Reserve Account (if applicable), (B) all moneys and investments on deposit to the credit of the Surplus Account, and any sub-account in the Reserve Account (if applicable), and (C) all investment earnings on the foregoing, for the equal and ratable benefit of (I) the Holders from time to time of Bonds (or the particular Series of Bonds for which each such sub-account in the Reserve Account is applicable), as security for the payment of such Bonds and the interest and premium, if any, thereon and any other amount payable hereunder and in respect of such Bonds and as security for the satisfaction of any other obligation assumed by it in connection with such Bonds (for the equal and proportionate benefit and security of all and singular the present and future Holders of such Bonds, without preference, priority or distinction as to lien or otherwise, except as otherwise hereinafter provided, of any one such Bond over any other such Bond by reason of priority in the issue, sale or negotiation thereof or otherwise) and (II) the provider of a Credit Facility or Liquidity Facility, as security for all obligations of the Corporation under any Reimbursement Agreement (if applicable), including without limitation for the payment of any Reimbursement Obligations thereunder (but, with respect to (x) amounts paid and to be paid in respect of the Notes, which amounts are

required to be deposited in any sub-account in the Reserve Account, and (y) all moneys, investments and investment earnings to the credit of such sub-account, such lien shall be only for the benefit of the provider of a Credit Facility or Liquidity Facility which is issued for the benefit of the Holders of Bonds for which such sub-account in the Reserve Account is established); and (3) a second lien (subject and subordinated to the first lien established under clause (2) above) on all of the Corporation's right, title and interest in and to (A) such portion of the amounts paid and to be paid in respect of the Notes that are required under the terms of this Agreement to be deposited to the credit of the Surplus Account and any sub-account in the Reserve Account (if applicable), (B) all moneys and investments on deposit to the credit of the Surplus Account and any sub-account in the Reserve Account (if applicable), and (C) all investment earnings on the foregoing, for the benefit of any Hedge Counterparty as security for the obligations of the Corporation under any Swap Agreement (if applicable) (but, with respect to (x) amounts paid and to be paid in respect of the Notes, which amounts are required to be deposited in any sub-account in the Reserve Account, and (y) all moneys, investments and investment earnings to the credit of such sub-account, such lien shall apply only to the extent that such Swap Agreement is for the benefit of the Holders of Bonds for which such sub-account in the Reserve Account is applicable); all as provided herein, and it is mutually agreed and covenanted by and between the parties hereto, as follows:

ARTICLE I.

DEFINITIONS

SECTION 101. Definitions As used in this Agreement, except as otherwise defined below, words and terms shall have the meanings ascribed to them in the recitals to this Agreement. In addition, the following words and terms shall have the following meanings, unless some other meaning is plainly intended:

"Accreted Value" shall mean with respect to any Capital Appreciation Bond or Capital Appreciation and Income Bond (i) as of any Valuation Date, the amount set forth for such date in the resolution authorizing such Capital Appreciation Bond or Capital Appreciation and Income Bond and (ii) as of any date other than a Valuation Date, the sum of (a) the Accreted Value on the preceding Valuation Date (or, if there is no preceding Valuation Date, the initial principal amount) and (b) the product of (1) a fraction, the numerator of which is the number of days having elapsed from the preceding Valuation Date (or from the original issue date if there is no preceding Valuation Date) and the denominator of which is the number of days from such preceding Valuation Date (or from the original issue date if there is no preceding Valuation Date) to the next succeeding Valuation Date and (2) the difference between the Accreted Values for such Valuation Dates (or between the initial principal amount and the Accreted Value on the first Valuation Date).

"Acts" shall mean (i) Act Number One Hundred Sixty-Four (164) of the Legislature of Puerto Rico, approved December seventeenth (17th), two thousand one (2001) ("Act 164"); (ii) Act Number Eighty-Five (85) of the Legislature of Puerto Rico, approved June thirteenth (13th), nineteen hundred ninety-eight (1998) ("Act 85"); (iii) Joint Resolution Five Hundred Twenty-Three (523) of the Legislature of Puerto Rico, approved August twenty-fourth (24th), two thousand (2000) ("Joint Resolution 523"); (iv) Act Number One Hundred Thirteen (113) of the

Legislature of Puerto Rico, approved September twenty-seventh (27th), nineteen hundred ninety-four (1994) ("Act 113"); and (v) any other Act or Joint Resolution of the Legislature of Puerto Rico which authorizes the issuance of bonds which are refunded in whole or in part with the proceeds of Bonds issued hereunder.

"Additional Payments" shall mean (A) any payments required to be made under any interest rate swap agreement; (B) termination payments under interest rate swap agreements or investment agreements; (C) required deposits to a debt service reserve fund; (D) redemption premiums; (E) trustee fees; (F) letter of credit fees; and (G) any other payment required to be made under a bond of the Corporation or this Agreement.

"Agreement" shall mean this Trust Agreement, together with all agreements supplemental hereto as herein permitted.

"Allocable Share" shall mean that percentage (determined from time to time by the Corporation in its absolute discretion and certified to the Trustee by the President or any Vice President of the Corporation at the time Bonds are issued hereunder) which represents the proportion that the principal amount of Bonds issued hereunder to refund a particular series of Prior Bonds bears to the aggregate principal amount of Bonds Outstanding hereunder.

"Amortization Requirement" shall mean, for the Term Bonds of any Series for any Bond Year, the principal amount fixed or computed for the retirement by purchase or redemption of Term Bonds in such Bond Year.

The Amortization Requirement for the Term Bonds of each Series shall be initially in the respective principal amounts for each Bond Year as fixed in a resolution of the Corporation adopted prior to the issuance of the Bonds of such Series, and the aggregate amount of such Amortization Requirements for the Term Bonds of such Series shall be equal to the aggregate principal amount of the Term Bonds of such Series.

If at the close of any Bond 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 403 of this Agreement during such Bond Year, shall be in excess of the amount of the Amortization Requirement for the Term Bonds of such Series for such Bond Year, then the amount of the Amortization Requirement for the Term Bonds of such Series shall be reduced for such subsequent Bond Years in such amounts aggregating the amount of such excess as shall be determined by the President in an order filed with the Trustee on or before the fifteenth (15th) day of the August following the close of such Bond Year.

It shall be the duty of the Trustee, on or before the 15th day of each Bond Year, to compute the Amortization Requirement for the then current Bond Year for the Term Bonds of each Series then Outstanding. The Amortization Requirement for the then current Bond Year shall continue to be applicable during the balance of such current Bond Year and no adjustment shall be made therein by reason of Term Bonds purchased or redeemed or called for redemption during such current Bond Year.

"Appreciated Value" shall mean, with respect to any Capital Appreciation and Income Bond (i) up to the Interest Commencement Date set forth in the resolution of the Board providing

for the issuance of such Bond, an amount equal to the Accreted Value of such Bond and (ii) as of any date of computation on and after the Interest Commencement Date, an amount equal to the Accreted Value of such Bond on the Interest Commencement Date.

"Assignment Agreements" shall have the meaning provided in the recitals hereof.

"Authorized Debtors" shall mean (i) the Department of Health of the Commonwealth of Puerto Rico, (ii) the Department of the Treasury of the Commonwealth of Puerto Rico, (iii) the Puerto Rico Infrastructure Finance Authority, (iv) the Puerto Rico Solid Waste Authority, (v) the Puerto Rico Aqueduct and Sewer Authority, (vi) the Puerto Rico Land Authority, (vii) the Puerto Rico Sugar Corporation, (viii) the Office for the Improvement of Public Schools, (ix) the Puerto Rico Maritime Shipping Authority, (x) the Housing Bank and Finance Agency of Puerto Rico and its successor in interest, the Puerto Rico Housing Finance Authority, (xi) the Hotel Development Corporation and (xii) any other debtor of the Corporation or the Government Development Bank for which the Corporation has issued Prior Bonds.

"Beneficial Owner" shall mean, whenever used with respect to a Bond, the person in whose name such Bond is recorded as the beneficial owner of such Bond by a Participant on the records of such Participant or such person's subrogee.

"Board" shall mean the Board of Directors of the Corporation as constituted from time to time and which shall be the Board of Directors of Government Development Bank as provided by Resolution Number Five Thousand Forty-Four (5044), adopted December twelfth (12th), nineteen hundred eighty-four (1984) by the Board of Directors of Government Development Bank, as amended, or, if said Board shall be abolished, the board or body succeeding to the principal functions thereof or to whom the powers of the Corporation shall be given by law.

"Bond Service Account" shall mean the account of that name established in the Sinking Fund under Section 401 hereof.

"Bond Year" shall mean the period commencing on the first day of August of any year and ending on the last day of July of the following year.

"Bondholder," "Holder," "holder," "Holder of Bonds," or "Owner" or any similar term, shall mean any person who shall be the registered owner of any Outstanding Bond or Bonds.

"Bonds" or "bonds" shall mean the bonds of the Corporation issued under the provisions of Sections 207 and 208 hereof.

"Budgetary Appropriation" shall mean the funds appropriated by the Legislature of Puerto Rico in the annual budget of capital improvements and operating expenses of the Commonwealth for any Fiscal Year for the payment of the Notes and the Parity Notes pursuant to the provisions of the Acts or, in the case such budget of the Commonwealth for any Fiscal Year has not been approved by the commencement of such Fiscal Year, until such budget is approved, the funds representing the amounts which had been appropriated in the budget of the Commonwealth for the previous Fiscal Year for the payment of the Notes and the Parity Notes

pursuant to the provisions of the Acts in accordance with Article VI, Section 6 of the Constitution of the Commonwealth.

“Business Day” shall mean a day other than a Saturday, Sunday or a day on which commercial banks in the City of New York, New York, or San Juan, Puerto Rico, are closed to the public.

“Capital Appreciation Bonds” shall mean any Bonds the accruing interest on which is compounded periodically on each of the dates designated for compounding in the resolution authorizing said Bonds and payable in an amount equal to the then current Accreted Value only at the maturity, earlier redemption or other payment date therefor, all as so provided by such resolution, and which may be either Serial Bonds or Term Bonds.

“Capital Appreciation and Income Bonds” shall mean any Bonds the accruing interest on which is not paid prior to the Interest Commencement Date specified in the resolution authorizing such Bonds and the Appreciated Value for such Bonds is compounded periodically on the dates designated in such resolution prior to the Interest Commencement Date for such Capital Appreciation and Income Bonds, and which may be either Serial Bonds or Term Bonds.

“Capitalized Interest Sub-account” shall mean the sub-account of that name established in the Bond Service Account under Section 401 hereof.

“Corporation Swap Payments” shall mean the net payments required to be made by the Corporation to the Hedge Counterparty under a Rate Swap (if applicable).

“Credit Facility” shall mean an irrevocable letter of credit, policy of municipal bond insurance, guaranty, purchase agreement, credit agreement or similar facility in which the person providing such facility irrevocably agrees to provide funds to make payment of the principal of, premium, if any, and interest on Bonds to which such Credit Facility relates.

“DTC” shall mean The Depository Trust Company, a limited purpose trust company organized under the laws of the State of New York, and its successors and assigns.

“Existing Notes” shall have the meaning provided in the recitals hereof.

“Facility” shall have the meaning provided in the recitals hereof.

“Fiscal Year” shall mean the period commencing on the first day of July of any year and ending on the last day of June of the following year.

“GDB Letter of Credit” shall mean each of the irrevocable, transferable standby letters of credit issued by Government Development Bank in favor of the Trustee solely for the benefit of the holders of the Bonds of one or more Series.

“GDB Reimbursement Agreement” shall mean each of the Letter of Credit and Reimbursement Agreements between the Corporation and Government Development Bank dated June Twenty-Eighth (28th), two thousand four (2004) relating to a GDB Letter of Credit and any

additional Letter of Credit Agreement between the Corporation and Government Development Bank relating to a GDB Letter of Credit.

“Government Obligations” shall mean (i) direct obligations of, or obligations the timely payment of principal of and the interest on which are unconditionally guaranteed by, the United States Government, (ii) direct obligations of, or obligations the principal of and interest on which are unconditionally guaranteed by, any of the following: Banks for Cooperatives, Federal Farm Credit Banks, Federal Home Loan Banks, Export-Import Bank of the United States, Federal Financing Bank, Government National Mortgage Association, Farmer’s Home Administration, Federal Home Loan Mortgage Corporation, Federal National Mortgage Association or Federal Housing Administration, and which obligations are rated at the time of purchase in the highest rating category by both Moody’s and S&P, (iii) all other obligations issued or unconditionally guaranteed as to principal and interest by an agency or instrumentality controlled or supervised by and acting as an instrumentality of the United States Government pursuant to authority granted by the Congress, which obligations are rated at the time of purchase in the highest rating category by both Moody’s and S&P and (iv) receipts evidencing the ownership of payments of principal of or interest on any of such obligations, which receipts are rated in the highest rating category by both Moody’s and S&P.

“Hedge Counterparty” shall mean the provider of any Rate Swap with respect to the Bonds as counterparty under a Swap Agreement which provider must have a rating with respect to its long-term unsecured debt which is rated in one of the three highest rating categories (without regard to any gradation within such category) by S&P or Moody’s.

“Hedge Counterparty Swap Payments” shall mean the net payments required to be made by a Hedge Counterparty to the Corporation under a Rate Swap.

“Interest Commencement Date” shall mean, with respect to any Capital Appreciation and Income Bond, the date specified in the resolution providing for the issuance of such Bond after which interest accruing on such Bond shall be payable on a periodic basis, with the first such payment date being the applicable Interest Payment Date immediately succeeding such Interest Commencement Date.

“Interest Payment Dates” shall mean the dates on which interest on a Series of Bonds or portion thereof is scheduled to be due and payable, as is provided by a resolution of the Board adopted prior to the issuance of such Series of Bonds.

“Interim Bonds” shall mean any Bonds issued on an interim basis that are expected to be repaid from the proceeds of Bonds or other indebtedness.

“Investment Agreement” shall mean any agreement for the investment of moneys entered into by the Trustee with a Qualified Financial Institution or collateralized at all times by Government Obligations having a market value at least equal to the principal amount of such agreement, as to which collateral the Trustee has a perfected first priority security interest, which collateral is held by the Trustee or its agent free and clear of claims by third parties and which collateral will result in the agreement being rated in the highest rating category by both Moody’s and S&P.

“Investment Obligations” shall mean (i) Government Obligations, (ii) time deposits, certificates of deposit or similar arrangements with, or banker’s acceptances issued by, any bank, banking association or trust company, including the Trustee, the deposits of which are insured by the Federal Deposit Insurance Corporation having a combined capital and surplus aggregating not less than ONE HUNDRED FIFTY MILLION DOLLARS (\$150,000,000) and reported deposits of not less than TWO HUNDRED FIFTY MILLION DOLLARS (\$250,000,000), (iii) repurchase agreements with banks mentioned in (ii) above, including the Trustee, or with primary government dealers having a capital and surplus in excess of ONE HUNDRED FIFTY MILLION DOLLARS (\$150,000,000), with respect to any of the securities mentioned in (i) above, provided such securities are on deposit with the Trustee (or any duly appointed agent of the Trustee) and such agreements are structured as sale purchase agreements rather than secured loans, (iv) obligations issued by the Commonwealth or any state or territory of the United States, which are rated in one of the three highest rating categories (without regard to any gradations within such category) by both Moody’s and S&P, (v) municipal obligations, the payment of the principal of and the interest on which is insured, which are rated in one of the three highest rating categories (without regard to any gradations within such category) by both Moody’s and S&P, (vi) commercial paper rated, or backed by a letter of credit or line of credit the provider of which is rated, in the highest rating category (without regard to any gradations within such category) by both Moody’s and S&P, (vii) an Investment Agreement, (viii) money market accounts of any state, Commonwealth or federally chartered bank, banking association, trust company or subsidiary trust company, including the Trustee, that is rated or whose parent bank is rated in the highest short-term rating category or in the highest long-term rating category by Moody’s or S&P (without regard to any gradations within such category) or money market funds registered under the Investment Company Act of 1940, as amended, whose shares are registered under the Securities Act of 1933, as amended, and having a rating by S&P of “AAAmG” or “AAAm”, (ix) units of beneficial interest in any non-arbitrage investment program pools created by Government Development Bank or any of its subsidiaries or affiliates, (x) any obligation permitted under the laws of the Commonwealth which are rated in one of the three highest rating categories (without regard to any gradations within such category) by both Moody’s and S&P, and (xi) any securities otherwise permitted as eligible collateral under Act Number Sixty-Nine (69) of the Legislature of Puerto Rico, approved August fourteen (14), nineteen hundred ninety-one (1991), as amended.

“Legislative Appropriation” shall mean the Budgetary Appropriations appropriated by the Legislature of Puerto Rico for the payment of the Notes pursuant to the provisions of the Acts or, in the case such budget of the Commonwealth for any Fiscal Year has not been approved by the commencement of such Fiscal Year, until such budget is approved, the funds representing the Budgetary Appropriations appropriated in the budget of the Commonwealth for the previous Fiscal Year for the payment of the Notes pursuant to the provisions of the Acts in accordance with Article VI, Section 6 of the Constitution of the Commonwealth.

“Liquidity Facility” shall mean a letter of credit, policy of municipal bond insurance, guaranty, purchase agreement or similar facility in which the person providing such facility agrees to provide funds to pay the purchase price of Put Bonds upon their tender by the Holders of Put Bonds.

“Maximum Difference” shall mean, with respect to any Series of Bonds, the maximum increase from one Fiscal Year to the next (through the date specified in the resolution authorizing such Series of Bonds) in the aggregate debt service on such Bonds.

“Moody’s” shall mean Moody’s Investors Service, Inc., a corporation organized and existing under the laws of the State of Delaware, its successors and their assigns, and, if such corporation shall be dissolved or liquidated or shall no longer perform the functions of a securities rating agency, “Moody’s” shall be deemed to refer to any other nationally recognized securities rating agency designated by the Corporation.

“Notes” shall mean the promissory notes of the Authorized Debtors executed in connection with the refunding of all or a portion of the outstanding Prior Bonds pursuant to the Supplemental Assignment Agreements, and pledged to the Trustee pursuant to this Agreement.

“Outstanding”, when used with reference to the Bonds shall mean, as of any date of determination, all Bonds theretofore authenticated and delivered except:

(i) Bonds theretofore cancelled by the Trustee or delivered to the Trustee for cancellation;

(ii) Bonds paid or Bonds that are deemed paid and no longer outstanding, as provided herein;

(iii) Bonds in lieu of which other Bonds have been issued pursuant to the provisions hereof relating to Bonds destroyed, mutilated, stolen or lost, unless evidence satisfactory to the Trustee has been received that any such Bond is held by a bona fide purchaser;

(iv) Bonds tendered or deemed tendered, as provided in the resolution of the Board for any Series of Bonds; and

(v) for purposes of any consent or other action to be taken hereunder by the Holders of a specified percentage principal amount of Bonds, Bonds actually known by the Trustee to be held by or for the account of the Corporation.

“Parity Bonds” shall mean bonds of the Corporation issued pursuant to the Acts and secured by one or more Parity Notes.

“Parity Notes” shall have the meaning provided in the recitals hereof.

“Participant” shall mean each broker-dealer, bank or other financial institution for which DTC or any other Securities Depository holds securities as a Securities Depository.

“Pledged Revenues” shall mean all of the Corporation’s right, title and interest in and to (i) all amounts paid and to be paid in respect of the Notes, (ii) all moneys and Investment Obligations on deposit to the credit of the Sinking Fund, (iii) the Hedge Counterparty Swap Payments, if any, and (iv) all investment earnings on the foregoing.

“Prior Bonds” shall have the meaning provided in the recitals hereof.

“Predecessor Bonds” of any particular bond means every previous bond evidencing all or a portion of the same debt as that evidenced by such particular bond; and, for purposes of this definition, any bond authenticated and delivered under Section 211 of this Agreement in lieu of a mutilated, destroyed or lost bond shall be deemed to evidence the same debt as the mutilated, destroyed or lost bond.

“President” shall mean the President of the Corporation, or if there is no President, then the person designated by the Board or by the bylaws of the Corporation to perform the functions of the President.

“Principal Corporate Trust Office” or “principal corporate trust office” of the Trustee shall mean the principal corporate trust office of the Trustee, at which, at any particular time, its corporate trust business shall be administered, except that with respect to presentation of Bonds for payment or for registration of transfer or exchange and the location of the bond registration books, such term shall mean the office or agency of the Trustee, if different, at which, at any particular time, its corporate agency business shall be conducted.

“Put Bonds” shall mean Bonds that by their terms may be tendered by and at the option of the Holder thereof for payment prior to the stated maturity thereof.

“Qualified Financial Institution” shall mean the Federal National Mortgage Association, or any bank, trust company or national banking association, or a corporation subject to registration with the Board of Governors of the Federal Reserve System under the Bank Holding Company Act of 1956, as amended, or any government securities dealer, insurance company or other financial institution, in each case whose unsecured obligations or uncollateralized long term debt obligations (or obligations guaranteed by its parent entity) shall at all times during the term of the Investment Agreement issued by such Qualified Financial Institution have been assigned a rating by S&P and Moody’s in one of the three highest rating categories (without regard to any gradations within any such category), or which has issued a letter of credit, contract or agreement in support of debt obligations which at all times shall have been so rated.

“Rate Swap” shall mean any interest rate swap arrangement between the Corporation and a Hedge Counterparty pursuant to any Swap Agreement and related documentation.

“Rating Agencies” shall mean S&P and Moody’s.

“Redemption Account” shall mean the account of that name established in the Sinking Fund under Section 401 hereof.

“Reimbursement Agreement” shall mean any letter of credit and reimbursement agreement or other similar agreement to pay the amounts due to the provider of a Credit Facility or a Liquidity Facility between the Corporation and any provider of a Credit Facility or a Liquidity Facility.

“Reimbursement Obligation” shall mean all amounts payable by the Corporation to a provider of a Credit Facility or Liquidity Facility pursuant to its agreement with such provider, including any fees payable and expenses reimbursable to such provider.

“Reserve Account” shall mean the account of that name which may be established in the Sinking Fund under Section 405 hereof.

“Reserve Account Insurance Policy” shall mean the insurance policy, surety bond or other evidence of insurance deposited to the credit of the Reserve Account in lieu of or in partial substitution for cash or securities on deposit therein, which policy, bond or other evidence of insurance constitutes an unconditional senior obligation of the issuer thereof. The issuer thereof shall be a municipal bond insurer whose senior debt obligations, ranking pari passu with its obligations under such policy, bond or other evidence of insurance, are rated, at the time of deposit for the credit of the Reserve Account, in any of the three highest rating categories (without regard to any gradations within any such category) by Moody’s and S&P.

“Reserve Account Letter of Credit” shall mean the irrevocable, transferable letter of credit deposited to the credit of the Reserve Account in lieu of or in partial substitution for cash or securities on deposit therein, which letter of credit constitutes an unconditional senior obligation of the issuer thereof. The issuer of such letter of credit shall be Government Development Bank or a banking association, bank or trust company or branch thereof whose senior debt obligations, ranking pari passu with its obligations under such letters of credit are rated at the time of deposit to the credit of the Reserve Account, in any of the three highest rating categories (without regard to any gradations within any such category) by Moody’s and S&P.

“S&P” means Standard & Poor’s Ratings Services, a division of The McGraw-Hill Companies, Inc., a corporation organized and existing under the laws of the State of New York, its successors, its assigns, and, if such corporation shall be dissolved or liquidated or shall no longer perform the functions of a securities rating agency, “S&P” shall be deemed to refer to any other nationally recognized securities rating agency designated by the Corporation.

“Secretary” shall mean the Secretary or Assistant Secretary of the Corporation from time to time, or if there is no secretary or assistant secretary, then any person designated by the Board or by the bylaws of the Corporation to perform the functions of the Secretary.

“Securities Depository” means DTC, or any other depository trust company (or any of its designees) appointed for the Bonds.

“Serial Bonds” shall mean the Bonds designated as serial bonds in the resolutions authorizing such Bonds.

“Series” shall mean all of the Bonds authenticated and delivered at one time on original issuance and pursuant to any resolution authorizing such Bonds as a separate Series of Bonds, or any Bonds thereafter authenticated and delivered in lieu of or in substitution for such Bonds pursuant to Article II hereof, regardless of variations in maturity, interest rate or other provisions.

“Series 2004 Bonds” shall mean the Puerto Rico Public Finance Corporation 2004 Series A Bonds and 2004 Series B Bonds.

“Sinking Fund” shall mean the “Puerto Rico Public Finance Corporation Restructuring Sinking Fund,” a special fund created and designated by Section 401 hereof.

“**Successor Letter of Credit**” shall have the meaning provided in Section 1306 hereof.

“**Supplemental Assignment Agreements**” shall have the meaning provided in the recitals hereof.

“**Surplus Account**” shall mean the account of that name established in the Sinking Fund under Section 401 hereof.

“**Swap Agreement**” shall mean any Interest Rate Swap Agreement between the Corporation and a Hedge Counterparty relating to the Bonds.

“**Term Bonds**” shall mean the Bonds designated as term bonds in the resolutions authorizing such Bonds.

“**Trustee**” shall mean the person named as the “Trustee” in the first paragraph of this Agreement until a successor Trustee shall have become such, and thereafter “Trustee” shall mean or include each person who is then a Trustee hereunder.

“**Valuation Date**” shall mean, with respect to any Capital Appreciation Bond or Capital Appreciation and Income Bond, the date or dates set forth in the resolution authorizing such bonds on which Accreted Values are assigned to the Capital Appreciation Bonds or Capital Appreciation and Income Bonds.

“**Variable Rate Bonds**” shall mean Bonds issued with a variable, adjustable, convertible or similar interest rate that is not fixed in percentage at the date of issue for the term thereof.

SECTION 102. Miscellaneous. Words of the masculine gender shall be deemed and construed to include correlative words of the feminine and neuter genders. Words defined in Section 101 hereof that appear in this Agreement in lower case shall have the meanings ascribed to them in the definitions in Section 101 unless the context shall otherwise indicate. The words “Bond,” “bond,” “Owner,” “Holder,” “holder” and “person” shall include the plural as well as the singular number unless the context shall otherwise indicate. The word “person” shall include corporations, firms and associations, including public bodies, as well as natural persons, unless the context shall otherwise indicate. The word “Bond” or “Bonds” shall mean any Bond or Bonds or all of the Bonds, as the case may be, issued under the provisions of this Agreement.

ARTICLE II.

FORM, EXECUTION, AUTHENTICATION, DELIVERY, EXCHANGE AND REGISTRATION OF BONDS

SECTION 201. Limitation on Issuance of Bonds. No Bonds may be issued under the provisions of this Agreement except in accordance with the provisions of this Article.

SECTION 202. Form of Bonds. The Bonds issued under the provisions of this Agreement shall be in the forms set forth in the resolution of the Board providing for the issuance of such Bonds, and may reflect, without limitation, provisions for Capital Appreciation Bonds, Capital Appreciation and Income Bonds, Interim Bonds, Variable Rate Bonds, and Put

Bonds. All such Bonds may have endorsed thereon such legends or text as may be necessary or appropriate to conform to any applicable rules and regulations of any governmental authority or of any securities exchange on which the Bonds may be listed or traded or any usage or requirement of law with respect thereto or as may be authorized by the Corporation and approved by the Trustee.

SECTION 203. Details of Bonds. The Bonds shall be issued in fully registered form.

The Bonds of a Series shall be payable, with respect to interest, principal and premium, if any, in any coin or currency of the United States of America which at the time of payment is legal tender for public and private debts (or other coin or currency provided for in the resolution authorizing the issuance of the particular Series). The principal of Bonds shall be payable only to the Holder or his legal representative at the principal corporate trust office of the Trustee and at such other office or agency of any paying agent as the Board may designate from time to time upon the presentation and surrender of the Bonds (except as otherwise contemplated in Section 212 hereof).

The Bonds of each Series shall be dated as provided in the resolution of the Board authorizing such Series; shall bear interest, which may be fixed or variable at the rates provided in the resolution of the Board authorizing such Series, from the Interest Payment Date next preceding the date on which they are authenticated, unless authenticated on an Interest Payment Date, in which event they shall bear interest from such Interest Payment Date, or unless authenticated before the first Interest Payment Date in which event they shall bear interest from their date; provided, however, that if at the time of authentication of any Bond interest is in default, such Bond shall bear interest from the date to which interest has been paid. Unless otherwise provided in the resolution of the Board approving any series of bonds, interest on the bonds shall be computed on the basis of a three hundred sixty (360) day year of twelve (12) thirty (30) day months.

Capital Appreciation Bonds shall bear interest as described under the defined term Accreted Value, payable only upon redemption or maturity thereof, and Capital Appreciation and Income Bonds shall bear interest as described under the defined term Appreciated Value, payable from and after the Interest Commencement Date or upon the prior redemption thereof.

Prior to the issuance of Variable Rate Bonds, the Board shall adopt a resolution specifying, without limitation, the interest rate calculation methods and any conversion features, and any Credit Facility or any Liquidity Facility which may be drawn upon to make principal and interest payments on the Variable Rate Bonds. The Variable Rate Bonds may provide that the Holder of any such Bond may demand payment of principal and interest within a stated period after delivering notice to a designated agent for the Corporation and providing a copy of the notice with the tender of the Variable Rate Bond to such agent. The designated agent for the Corporation, in accordance with the terms of a remarketing agreement, may provide for the resale or redelivery of the Variable Rate Bonds on behalf of the Corporation at a price provided for in such agreement. If the Variable Rate Bonds shall not be resold or redelivered within a stated period, the agent for the Corporation may be authorized to draw upon a previously executed Credit Facility or Liquidity Facility for payment of interest and principal for a particular series of Variable Rate Bonds to which such Credit Facility or Liquidity Facility shall

pertain. The particular form or forms of such demand provisions, the period or periods for payment of principal and interest after delivery of notice, the appointment of the agent for the Corporation, the terms and provisions for the remarketing agreement, and the terms and provisions of the Credit Facility or Liquidity Facility shall be as designated by a resolution of the Board pertaining to the Variable Rate Bonds to which such terms and provisions are applicable prior to the issuance thereof. Prior to the issuance of Put Bonds, the Board shall adopt a resolution which may provide for some of the above terms and provisions.

The interest rate of any Bonds shall not exceed the applicable maximum legal rate per annum. Subject to the provisions of Section 212 hereof, interest on the Bonds shall be payable by check mailed to the registered Holder thereof by the Trustee or any other paying agents appointed by the Corporation at the address shown on the registration books of the Corporation held by the Trustee at the close of business on the fifteenth (15th) day (whether or not a business day) of the calendar month preceding an Interest Payment Date or such other date as may be established by the resolution authorizing the issuance of such Bonds; provided that to the extent provided in the resolution authorizing the issuance of such Bonds interest shall be payable by wire transfer.

The Bonds shall be lettered and numbered in such manner and shall be in the denominations provided in the resolutions of the Board authorizing their issuance. In the event that interest is not punctually paid or duly provided for, such interest shall forthwith cease to be payable to the Holder shown on the registration books held by the Trustee at the close of business on the fifteenth (15th) day of the calendar month preceding such Interest Payment Date and may be paid to the person in whose name Bonds are registered at the close of business on a special record date to be fixed by the Trustee, on a special payment date designated by the Trustee, notice having been given by the Trustee to the Holders not less than ten (10) days prior to such special record date or may be paid at any time in any other lawful manner not inconsistent with the requirements of any securities exchange on which Bonds may be listed and upon such notice as may be required by such exchange, or as more fully provided for in the resolution of the Board authorizing the issuance of the Bonds. The above procedure for the payment of defaulted interest overdue may be varied in resolutions of the Board authorizing the issuance of particular Series of Bonds.

The Bonds shall be signed in the name of the Corporation by the President or with his facsimile signature or by the Executive Vice President or with his facsimile signature and the corporate seal of the Corporation shall be impressed or a facsimile of such seal shall be imprinted on the Bonds and attested by the Secretary or his facsimile signature. In case any officer whose signature or a facsimile of whose signature shall appear on any Bonds shall cease to be such officer before the delivery of such Bonds, such signature or such facsimile shall nevertheless be valid and sufficient for all purposes as if he had remained in office until such delivery, and also any Bonds may bear the facsimile signature of or may be signed by such persons as at the actual time of the execution of such Bonds shall be the proper officers to sign such Bonds although on the date of such Bonds such persons may not have been such officers.

SECTION 204. Authentication of Bonds. Only such of the Bonds as shall have endorsed thereon a certificate of authentication substantially in the form set forth in the resolution of the Board authorizing the issuance thereof, duly executed by the Trustee, shall be

entitled to any benefit or security under this Agreement. No Bond shall be valid or become obligatory for any purpose or be entitled to any benefit or security under this Agreement unless and until such certificate of authentication shall have been duly executed by the Trustee, and such certificate of the Trustee upon any such Bond shall be conclusive evidence that such Bond has been duly authenticated and delivered under this Agreement. The Trustee's certificate of authentication on any Bond shall be deemed to have been duly executed if signed by an authorized signatory of the Trustee, but it shall not be necessary that the same signatory sign the certificate of authentication on all of the Bonds that may be issued hereunder at any one time.

SECTION 205. Exchange and Registration of Transfer. Bonds, upon surrender thereof at the principal corporate trust office of the Trustee, together with an assignment duly executed by the Holder or his attorney or legal representative in the form set forth on the Bonds or such other form as may be satisfactory to the Trustee, may, at the option of the Holder thereof, be exchanged for an equal aggregate principal amount (maturity amount in the case of Capital Appreciation Bonds or Capital Appreciation and Income Bonds) of Bonds of the same Series and maturity, of any denomination or denominations authorized by this Agreement, and bearing interest at the same rate, in the same form as the Bonds surrendered for exchange.

The Trustee shall keep books at its principal corporate trust office for the registration of and for the registration of transfers of the Bonds as provided in this Agreement. The transfer of any Bond may be registered only upon the books kept for the registration of and registration of transfers of Bonds upon surrender thereof to the Trustee together with an assignment duly executed by the Holder or his attorney or legal representative in the form of the assignment set forth on the Bonds or such other form as may be satisfactory to the Trustee. Upon any such registration of transfer, the Corporation shall execute and the Trustee shall authenticate and deliver in exchange for such Bond a new Bond or Bonds registered in the name of the transferee, of any denomination or denominations authorized by this Agreement, in an aggregate principal amount equal to the principal amount (maturity amount in the case of Capital Appreciation Bonds or Capital Appreciation and Income Bonds) of such Bond, of the same Series and maturity and bearing interest at the same rate.

In all cases in which Bonds shall be exchanged or transferred hereunder, the Corporation shall execute and the Trustee shall authenticate and deliver at the earliest practicable time Bonds in accordance with the provisions of this Agreement. The Corporation or the Trustee may make a charge for every such exchange or registration of transfer of Bonds sufficient to reimburse it for any tax or other governmental charge required to be paid with respect to such exchange or registration of transfer, but no other charge shall be made to any Holder for exchanging or registering the transfer of Bonds. Any Bond surrendered in any such exchange or transfer shall be cancelled by the Trustee as provided in Section 304 hereof. Neither the Corporation nor the Trustee shall be required to make any such exchange or registration of transfer of any Bond during the fifteen (15) days immediately preceding the date of mailing of notice of any redemption of such Bond, or after a Bond or any portion thereof has been selected for redemption.

If any Bonds are issued for sale in any taxable market outside of the Commonwealth, the Trustee shall register such Bonds or any transfer or exchange thereof only in accordance with

any restrictions on transferability that may be set forth in the resolution of the Board providing for the issuance of such Bonds.

SECTION 206. Ownership of Bonds. As to any Bond, the person in whose name the same shall be registered shall be deemed and regarded as the absolute owner thereof for all purposes, and payment of or on account of the principal of and premium, if any, and interest on any such Bond shall be made only to the Holder thereof or his legal representative. All such payments shall be valid and effectual to satisfy and discharge the liability upon such Bond, including the premium, if any, and interest thereon, to the extent of the sum or sums so paid.

Any Holder of any Bond is hereby granted power to transfer absolute title thereto by assignment thereof to a bona fide purchaser for value (present or antecedent) without notice of prior defenses or equities or claims of ownership enforceable against his assignor or any person in the chain of title and before the maturity of such Bond. Every prior Holder of any Bond shall be deemed to have waived and renounced all of his equities or rights therein in favor of every such bona fide purchaser, and every such bona fide purchaser shall acquire absolute title thereto and to all rights represented thereby.

SECTION 207. Authorization of Initial Series of Bonds. There shall be initially issued under and secured by this Agreement two Series of Bonds of the Corporation. One Series shall be designated "Puerto Rico Public Finance Corporation 2004 Series A Bonds" (the "2004 Series A Bonds") and shall be issued in the aggregate initial principal amount of ONE BILLION TWO HUNDRED SIX MILLION ONE HUNDRED THIRTY THOUSAND DOLLARS (\$1,206,130,000). The second Series shall be designated "Puerto Rico Public Finance Corporation 2004 Series B Bonds" (the "2004 Series B Bonds") and shall be issued in the aggregate principal amount of ONE HUNDRED FORTY-SIX MILLION EIGHT HUNDRED NINETY-FIVE THOUSAND DOLLARS (\$146,895,000). The Series 2004 Bonds shall be issued for the purposes set forth in the resolutions of the Board authorizing the Series 2004 Bonds. The terms of such Bonds including, but not limited to, interest rates, Amortization Requirements, redemption provisions and maturity dates and the disposition of the proceeds of the Series 2004 Bonds shall be as provided in the resolutions of the Board authorizing the Series 2004 Bonds.

Each of the Series 2004 Bonds shall be executed in the form and manner set forth in the resolutions of the Board providing for the issuance thereof and shall be deposited with the Trustee for authentication, but before the Series 2004 Bonds shall be authenticated and delivered by the Trustee, there shall be filed with the Trustee the following:

- (i) a copy, certified by the Secretary, of the resolutions mentioned above;
- (ii) a copy, certified by the Secretary, of the resolutions directing the authentication and delivery of the Series 2004 Bonds to or upon the order of the purchasers therein named upon payment of the purchase price for each Series therein set forth;
- (iii) an opinion of counsel, who may be counsel for the Corporation, addressed to the Trustee, to the effect that (A) the Corporation has the legal right and power to enter

into this Agreement, the Supplemental Assignment Agreements, the Swap Agreement (if applicable) and the GDB Reimbursement Agreement and any other Reimbursement Agreement (if applicable) and has duly authorized and validly executed and delivered this Agreement, the Supplemental Assignment Agreements, the Swap Agreement (if applicable) and the GDB Reimbursement Agreement and any other Reimbursement Agreement (if applicable), and this Agreement, the Supplemental Assignment Agreements, the Swap Agreement (if applicable) and the GDB Reimbursement Agreement and any other Reimbursement Agreement (if applicable) are each legally valid and binding upon the Corporation and enforceable in accordance with their terms, (B) this Agreement creates a legally valid and effective pledge of the moneys, securities and funds (including the Notes and the payments thereunder) held or set aside under this Agreement as security for such Bonds, for the obligations of the Corporation under the GDB Reimbursement Agreement and any other Reimbursement Agreement (if applicable), the Swap Agreement (if applicable) and for the payment of any Reimbursement Obligation owed to the provider of any Credit Facility or Liquidity Facility (if applicable), subject to the application thereof as required and on the conditions permitted by this Agreement, and the Notes are not subject to any lien, charge or encumbrance whatsoever except the pledge of this Agreement, and no filing or recording of any document is necessary in order to make such pledge effective or to continue it in effect (or specifying the place or places, if any, where such filing or recording is necessary and furnishing any officially authenticated certificates, or other documents, by which such filing or recording is evidenced), (C) the issuance of such Bonds and the execution and delivery of this Agreement, the Supplemental Assignment Agreements, the Swap Agreement (if applicable) and the GDB Reimbursement Agreement and any other Reimbursement Agreement (if applicable) will not violate any provision of law or of the bylaws of the Corporation or result in the breach of, or constitute a default under, any agreement, indenture or other instrument known to such counsel to which the Corporation is a party or by which it may be bound, (D) no authorization, consent or approval or withholding of objection of any governmental body or regulatory authority is requisite to the legal issuance of such Bond or the execution or delivery of this Agreement, the Supplemental Assignment Agreements, the Swap Agreement (if applicable) and the GDB Reimbursement Agreement and any other Reimbursement Agreement (if applicable) (unless such opinion shall show that no authorization, consent or approval or withholding of objection is requisite to the legal issue of such Bonds or the execution or delivery of this Agreement, the Supplemental Assignment Agreements, the Swap Agreement (if applicable) and the GDB Reimbursement Agreement and any other Reimbursement Agreement (if applicable), it shall specify and furnish any officially authenticated certificates, or other documents, by which such authorization, consent or approval or withholding of objection is evidenced), (E) the form and terms of such Bonds have been established by or pursuant to one or more Board resolutions, in conformity with the provisions of this Agreement, (F) upon authentication by the Trustee, such Bonds will be legally valid and binding direct obligations of the Corporation enforceable in accordance with their terms and the terms of this Agreement and have been duly and validly authorized and issued in accordance with applicable law and this Agreement, and (G) all conditions precedent to the authentication and delivery of such Bonds have been fulfilled;

(iv) an opinion of counsel for Government Development Bank, addressed to the Trustee, to the effect that (A) Government Development Bank has the legal right and power to enter into the Supplemental Assignment Agreements and has duly authorized and validly executed and delivered the Supplemental Assignment Agreements, and the Supplemental Assignment Agreements are legally valid and binding upon Government Development Bank and enforceable in accordance with their terms, (B) the execution and delivery of the Supplemental Assignment Agreements will not violate any provision of law or of the bylaws of Government Development Bank or result in the breach of, or constitute a default under, any agreement, indenture or other instrument known to such counsel to which Government Development Bank is a party or by which it may be bound, (C) no authorization, consent or approval or withholding of objection of any governmental body or regulatory authority is requisite to the execution and delivery of the Supplemental Assignment Agreements (unless such opinion shall show that no authorization, consent or approval or withholding of objection is requisite to the execution and delivery of the Supplemental Assignment Agreements, it shall specify and furnish any officially authenticated certificates, or other documents, by which such authorization, consent or approval or withholding of objection is evidenced), and (D) the Existing Notes were acquired by Government Development Bank in good faith and for value, and immediately prior to the delivery thereof to the trustees under the trust agreements for the Prior Bonds, were not subject to any lien or encumbrances of any nature whatsoever and were not in default as to the payment of principal or interest;

(v) an opinion of counsel to each of the Authorized Debtors stating that (A) the Note of such Authorized Debtor is its valid obligation, (B) such Authorized Debtor has the legal right and power to enter into the Supplemental Assignment Agreement among such Authorized Debtor, Government Development Bank and the Corporation and has duly authorized and validly executed and delivered such Supplemental Assignment Agreement, and such Note and such Supplemental Assignment Agreement are legally valid and binding upon such Authorized Debtor and the Supplemental Assignment Agreement is enforceable in accordance with its terms, (C) the execution and delivery of such Note and such Supplemental Assignment Agreement will not violate any provision of law or of the bylaws of such Authorized Debtor or result in the breach of, or constitute a default under, any agreement, indenture or other instrument to which such Authorized Debtor is a party or by which it may be bound, (D) no authorization, consent or approval or withholding of objection of any governmental body or regulatory authority is requisite to the execution and delivery of such Note and such Supplemental Assignment Agreement (unless such opinion shall show that no authorization, consent or approval or withholding of objection is requisite to the execution and delivery of such Note and such Supplemental Assignment Agreement, it shall specify and furnish any officially authenticated certificates, or other documents, by which such authorization, consent or approval or withholding of objection is evidenced);

(vi) an opinion of counsel to Government Development Bank and the provider of any other Credit Facility or Liquidity Facility (if applicable), addressed to the Trustee, to the effect that each of the GDB Letters of Credit or any other Credit Facility or Liquidity Facility (if applicable), is a legal, valid and binding obligation of Government Development Bank or the provider of any other Credit Facility or Liquidity Facility (if

applicable) enforceable in accordance with its terms except to the extent that the enforceability of each of the GDB Letters of Credit or any other Credit Facility or Liquidity Facility (if applicable) may be limited by bankruptcy, insolvency or other laws affecting creditors' rights generally and subject to general principles of equity (regardless of whether said enforceability is considered in a proceeding in equity or at law).

- (vii) the Series 2004 Notes;
- (viii) the GDB Letters of Credit or any other Credit Facility or Liquidity Facility (if applicable), duly executed; and
- (ix) such additional legal opinions, certificates, proceedings, instruments and other documents as may be necessary to evidence due execution and issuance of the Series 2004 Bonds.

When the documents mentioned above in this Section shall have been filed with the Trustee and when said Series 2004 Bonds shall have been executed and authenticated as required by this Agreement, the Trustee shall deliver said Series 2004 Bonds to or upon the order of the purchasers named in the resolutions mentioned in clause (ii) of this Section, but only upon payment to the Trustee of the purchase price of said Series 2004 Bonds.

The opinions required by items (iii), (iv) and (v) relating to the enforceability of the Bonds, this Trust Agreement, the Supplemental Assignment Agreements, the GDB Reimbursement Agreements or any other Reimbursement Agreement (if applicable) and the Swap Agreement (if applicable) may be qualified by customary exceptions relating to bankruptcy and similar laws affecting creditors' rights generally and, as to enforceability, to general principles of equity (regardless of whether such enforcement is sought in a proceeding in equity or at law).

SECTION 208. Refunding Bonds. Bonds may be issued under and secured by this Agreement, subject to the conditions hereinafter provided in this Section, at any time or times solely for the purpose of (i) providing funds for refunding all or any part of the Outstanding Bonds of any one or more Series by payment at maturity or redemption at a selected redemption date or dates or combination of such payment at maturity and redemption, including the payment of any redemption premium thereon, (ii) making a deposit to the Reserve Account (if applicable), (iii) paying capitalized interest on such refunding Bonds, and (iv) paying the costs of issuance of such refunding Bonds. No refunding Bonds may be issued unless the amounts of principal and interest payable under the Notes (assuming timely payments under the Notes) after the issuance of such refunding Bonds are sufficient to pay the principal of and interest on all Bonds Outstanding after the issuance of such refunding Bonds, together with other amounts required to be paid by the Corporation with respect to the Bonds, any Credit Facility or Liquidity Facility relating thereto, any Corporation Swap Payments, and this Agreement. In addition, no refunding Bonds may be issued unless the aggregate of the stated amounts of each of the GDB Letters of Credit and Successor Letters of Credit is not less than the estimated Maximum Difference after the issuance of such refunding Bonds as certified by the President or any Executive Vice President of the Corporation.

Before any Bonds shall be issued under the provisions of this Section, the Board shall adopt a resolution authorizing the issuance of such Bonds, fixing the amount and the details of the Bonds, and describing the Bonds to be refunded. Such Bonds shall be designated separate from the Series 2004 Bonds and shall be dated, shall be in such denominations, shall be numbered, shall be issued in such form, shall bear interest until their payment at any rate or rates not exceeding the maximum rate permitted by applicable law, shall be stated to mature at such time or times, shall have such Amortization Requirements and shall be made subject to redemption, in whole or in part, at such times and prices (subject to the provisions of Article III of this Agreement), as may be determined by resolution of the Board adopted prior to the issuance of such Bonds. By said resolution, the Board may appoint one or more paying agents for such Bonds in addition to the Trustee. Except as to any differences in the maturities thereof or in the rate or rates of interest (or yield or yields) or the provisions for redemption, such refunding Bonds shall be on a parity with and shall be entitled to the same benefit and security of this Agreement as all other Bonds issued under this Agreement.

All refunding Bonds issued under the provisions of this Section shall be executed in the form and manner set forth in the resolution of the Board authorizing the issuance of such Bonds and deposited with the Trustee for authentication, but before such Bonds shall be authenticated and delivered by the Trustee, there shall be filed with the Trustee the following:

- (a) a copy, certified by the Secretary, of the resolution mentioned above;
- (b) a copy, certified by the Secretary, of the resolution directing the authentication of such Bonds, specifying the interest rate of each such Bond and directing the delivery of such Bonds to or upon the order of the purchasers therein named upon payment of the purchase price therein set forth;
- (c) an opinion of counsel for the Corporation dated the date of original issuance of such Bonds to the effect that:
 - (i) the issuance of such Bonds has been duly authorized and that all conditions precedent to the authentication and delivery of such Bonds have been fulfilled;
 - (ii) the form and terms of such Bonds have been established by or pursuant to one or more Board resolutions, in conformity with the provisions of this Agreement;
 - (iii) such Bonds, when issued by the Corporation and authenticated and delivered by the Trustee in the manner and subject to any conditions specified in such opinion of counsel, will constitute valid and legally binding obligations of the Corporation, enforceable in accordance with their terms, and will be entitled to the benefits of this Agreement;
 - (iv) the Corporation has the corporate power to issue such Bonds, and has duly taken all necessary corporate action with respect to such issuance; and
 - (v) all requirements of this Agreement applicable to the Corporation in respect of the execution and delivery by the Corporation of such Bonds have been complied with and assuming due authentication and delivery of such Bonds by the Trustee, no

authorization, approval or consent by any regulatory or statutory or other public authority which has not been obtained is required for the creation, issuance, authentication and delivery of such Bonds pursuant to this Agreement;

(d) such documents as shall be required by counsel of recognized standing in the field of law relating to municipal bonds to show that provision has been made in accordance with the provisions of this Agreement for the payment or redemption or combination of such payment and redemption of all the Bonds to be refunded;

(e) a certificate dated the date of original issuance of such Bonds, signed by the President, that (i) the sum of the net proceeds (excluding accrued interest but including any premium) of such Bonds, together with investment earnings on said proceeds, other moneys to be deposited and investment earnings on said moneys, shall not be less than an amount sufficient to pay the principal of, the redemption premium, if any, and interest accrued to the payment dates on the Bonds to be refunded, and the expenses incident to such financing, and (ii) the amounts of principal, interest and Additional Payments payable under the Notes (assuming timely payments under the Notes) after the issuance of such refunding Bonds are sufficient to pay the principal of and interest on all Bonds Outstanding after the issuance of such refunding Bonds, together with other amounts required to be paid by the Corporation with respect to the Bonds, any Credit Facility or Liquidity Facility relating thereto, any Corporation Swap Payments, and this Agreement;

(f) the applicable GDB Letters of Credit or Successor Letters of Credit, if necessary, duly executed, together with the reimbursement agreement relating thereto between the Corporation and Government Development Bank or the issuer of any such Successor Letter of Credit;

(g) any Swap Agreement (if applicable), duly executed;

(h) an opinion of counsel to Government Development Bank (if a new GDB Letter of Credit is issued or an existing GDB Letter of Credit is amended) and the provider of any other Credit Facility or Liquidity Facility (if applicable), addressed to the Trustee, to the effect that the applicable GDB Letter(s) of Credit or any other Credit Facility or Liquidity Facility (if applicable), is a legal, valid and binding obligation of Government Development Bank or the provider of any other Credit Facility or Liquidity Facility (if applicable) enforceable in accordance with its terms;

(i) an opinion of counsel to the Hedge Counterparty (if applicable), addressed to the Trustee, to the effect that the Swap Agreement is a legal, valid and binding agreement of the Hedge Counterparty, enforceable in accordance with its terms; and

(j) such documents as are required by Section 1306 of this Agreement in connection with the delivery of a Successor Letter of Credit (if a Successor Letter of Credit is delivered).

The opinions required by items (c), (h) and (i) relating to the enforceability of the Bonds, the GDB Letters of Credit, any Credit Facility or Liquidity Facility and the Swap Agreement (if applicable) may be qualified by customary exceptions relating to bankruptcy and similar laws

affecting creditors' rights generally and, as to enforceability, to general principles of equity (regardless of whether such enforcement is sought in a proceeding in equity or at law).

The proceeds of the Bonds issued under the provisions of this Section shall be applied by the Trustee as provided in a resolution of the Board adopted prior to the issuance of the Bonds, which may be supplemented or changed by a certificate of the President executed on the date of issuance of the Bonds and delivered to the Trustee, if provided for in said resolution. Simultaneously with the delivery of the Bonds, the Trustee may withdraw from the Sinking Fund amounts which are allocable to the Bonds to be refunded and shall transfer said amounts in accordance with the resolution of the Board authorizing the issuance of such Bonds.

The issuance of the Bonds to accomplish a crossover refunding, economic defeasance or other similar refunding shall be within the purview of this Section 208.

SECTION 209. Additional Bonds. Bonds may be issued under and secured by this Agreement, subject to the conditions hereinafter provided in this Section, at any time or times solely for the purpose of (i) refunding Parity Bonds of the Corporation, (ii) making a deposit to the Reserve Account (if applicable), (iii) paying capitalized interest on such additional Bonds, and (iv) paying the costs of issuance of such additional Bonds. No additional Bonds may be issued unless the amounts of principal, interest and Additional Payments payable under the Notes and the Parity Notes (assuming timely payments under the Notes and the Parity Notes) after the issuance of such additional Bonds are sufficient to pay the principal of and interest on all Bonds and Parity Bonds Outstanding after the issuance of such additional Bonds, together with other amounts required to be paid by the Corporation with respect to the Bonds, the Parity Bonds, any Credit Facility or Liquidity Facility relating thereto, any Corporation Swap Payments, and this Agreement. In addition, no additional Bonds may be issued unless the aggregate stated amounts of each of the GDB Letters of Credit and Successors Letter of Credit is not less than the estimated Maximum Difference after the issuance of such additional Bonds as certified by the President or any Executive Vice President of the Corporation.

Before any Bonds shall be issued under the provisions of this Section, the Board shall adopt a resolution authorizing the issuance of such Bonds, and fixing the amount and the details of the Bonds. Such Bonds shall be designated separate from the Series 2004 Bonds and shall be dated, shall be in such denominations, shall be numbered, shall be issued in such form, shall bear interest until their payment at any rate or rates not exceeding the maximum rate permitted by applicable law, shall be stated to mature at such time or times, shall have such Amortization Requirements and shall be made subject to redemption, in whole or in part, at such times and prices (subject to the provisions of Article III of this Agreement), as may be determined by resolution of the Board adopted prior to the issuance of such Bonds. By said resolution, the Board may appoint one or more paying agents for such Bonds in addition to the Trustee. Except as to any differences in the maturities thereof or in the rate or rates of interest (or yield or yields) or the provisions for redemption, such additional Bonds shall be on a parity with and shall be entitled to the same benefit and security of this Agreement as all other Bonds issued under this Agreement.

All additional Bonds issued under the provisions of this Section 209 shall be executed in the form and manner set forth in the resolution of the Board authorizing the issuance of such

Bonds and deposited with the Trustee for authentication, but before such Bonds shall be authenticated and delivered by the Trustee, there shall be filed with the Trustee the following:

- (a) a copy, certified by the Secretary, of the resolution mentioned above;
- (b) a copy, certified by the Secretary, of the resolution directing the authentication of such Bonds, specifying the interest rate of each such Bond and directing the delivery of such Bonds to or upon the order of the purchasers therein named upon payment of the purchase price therein set forth;
- (c) an opinion of counsel for the Corporation dated the date of original issuance of such Bonds, addressed to the Trustee, to the effect that:
 - (i) the issuance of such Bonds has been duly authorized and that all conditions precedent to the authentication and delivery of such Bonds have been fulfilled
 - (ii) the form and terms of such Bonds have been established by or pursuant to one or more Board resolutions, in conformity with the provisions of this Agreement;
 - (iii) such Bonds, when issued by the Corporation and authenticated and delivered by the Trustee in the manner and subject to any conditions specified in such opinion of counsel, will constitute valid and legally binding obligations of the Corporation, enforceable in accordance with their terms, and will be entitled to the benefits of this Agreement;
 - (iv) the Corporation has the corporate power to issue such Bonds, and has duly taken all necessary corporate action with respect to such issuance;
 - (v) all requirements of this Agreement applicable to the Corporation in respect of the execution and delivery by the Corporation of such Bonds have been complied with and, assuming due authentication and delivery of such Bonds by the Trustee, no authorization, approval or consent by any regulatory or statutory or other public authority which has not been obtained is required for the creation, issuance, authentication and delivery of such Bonds pursuant to this Agreement;
 - (vi) the Corporation has the legal right and power to enter into or amend the supplemental assignment agreement(s) to be entered into or amended by the Corporation with respect to any Notes to be amended, and has duly authorized and validly executed and delivered such new or amended supplemental assignment agreement(s), and such new or amended supplemental assignment agreement(s) is(are) legally valid and binding upon the Corporation and enforceable in accordance with its(their) terms;
 - (vii) the execution and delivery of such new or amended supplemental assignment agreement(s) will not violate any provision of law or of the bylaws of

the Corporation or result in the breach of, or constitute a default under, any agreement, indenture or other instrument to which the Corporation is a party or by which it may be bound; and

(viii) no authorization, consent or approval or withholding of objection of any governmental body or regulatory authority is requisite to the execution or delivery of any new or amended supplemental assignment agreement(s) (unless such opinion shall show that no authorization, consent or approval or withholding of objection is requisite to the execution or delivery of such new or amended supplemental assignment agreement(s), it shall specify and furnish any officially authenticated certificates, or other documents, by which such authorization, consent or approval or withholding of objection is evidenced);

(d) if any supplemental assignment agreement is entered into or amended by Government Development Bank, an opinion of counsel for Government Development Bank dated the date of original issuance of such Bonds, addressed to the Trustee, to the effect that (i) Government Development Bank has the legal right and power to enter into or amend such supplemental assignment agreement(s) and has duly authorized and validly executed and delivered such new or amended supplemental assignment agreement(s), and such new or amended supplemental assignment agreement(s) is(are) legally valid and binding upon Government Development Bank and enforceable in accordance with its(their) terms, (ii) the execution and delivery of such new or amended supplemental assignment agreement(s) will not violate any provision of law or of the bylaws of Government Development Bank or result in the breach of, or constitute a default under, any agreement, indenture or other instrument to which Government Development Bank is a party or by which it may be bound and (iii) no authorization, consent or approval or withholding of objection of any governmental body or regulatory authority is requisite to the execution and delivery of such new or amended supplemental assignment agreement(s) (unless such opinion shall show that no authorization, consent or approval or withholding of objection is requisite to the execution and delivery of such new or amended supplemental assignment agreement(s), it shall specify and furnish any officially authenticated certificates, or other documents, by which such authorization, consent or approval or withholding of objection is evidenced);

(e) an opinion of counsel to each of the Authorized Debtors of such additional Notes stating that (i) the Note of such Authorized Debtor is its valid obligation, (ii) such Authorized Debtor has the legal right and power to enter into or amend the supplemental assignment agreement among such Authorized Debtor, Government Development Bank and the Corporation and has duly authorized and validly executed and delivered such new or amended supplemental assignment agreement, and such Note and such new or amended supplemental assignment agreement are legally valid and binding upon such Authorized Debtor and the new or amended supplemental assignment agreement is enforceable in accordance with its terms, (iii) the execution and delivery of such Note and such new or amended supplemental assignment agreement will not violate any provision of law or of the bylaws of such Authorized Debtor or result in the breach of, or constitute a default under, any agreement, indenture or other instrument to which such Authorized Debtor is a party or by which it may be bound, (iv) no authorization, consent or approval or withholding of objection of any governmental body or regulatory authority is requisite to the execution and delivery of such Note and such new or amended

supplemental assignment agreement (unless such opinion shall show that no authorization, consent or approval or withholding of objection is requisite to the execution and delivery of such Note and such new or amended supplemental assignment agreement, it shall specify and furnish any officially authenticated certificates, or other documents, by which such authorization, consent or approval or withholding of objection is evidenced);

(f) the additional Notes and the new or amended Parity Notes;

(g) a certificate dated the date of original issuance of such Bonds, signed by the President, that the amounts of principal, interest and Additional Payments payable under the Notes and the Parity Notes (assuming timely payments under the Notes and the Parity Notes) after the issuance of such additional Bonds are sufficient to pay the principal of and interest on (i) all Bonds and Parity Bonds Outstanding after the issuance of such additional Bonds, (ii) all other amounts required to be paid by the Corporation with respect to the Bonds, any Credit Facility or Liquidity Facility relating thereto, any Corporation Swap Payments, and this Agreement, (iii) all Parity Bonds of the Corporation Outstanding after the issuance of such additional Bonds which Parity Bonds are secured by the Parity Notes and (iv) all other amounts required to be paid by the Corporation with respect to such Parity Bonds, any credit facility or liquidity facility relating thereto, any Corporation swap payments and the trust agreement pursuant to which such Parity Bonds were issued;

(h) the GDB Letters of Credit or Successor Letters of Credit, if necessary, duly executed, together with the reimbursement agreement relating thereto between the Corporation and Government Development Bank or the issuer of such Successor Letters of Credit;

(i) any Swap Agreement (if applicable), duly executed;

(j) an opinion of counsel to Government Development Bank (if a new GDB Letter of Credit is issued or an existing GDB Letter of Credit is amended) and the provider of any other Credit Facility or Liquidity Facility (if applicable), addressed to the Trustee, to the effect that the applicable GDB Letter of Credit, as amended, or any other Credit Facility or Liquidity Facility (if applicable), is a legal, valid and binding obligation of Government Development Bank or the provider of any other Credit Facility or Liquidity Facility (if applicable) enforceable in accordance with its terms;

(k) an opinion of counsel to the Hedge Counterparty (if applicable), addressed to the Trustee, to the effect that the Swap Agreement is a legal, valid and binding agreement of the Hedge Counterparty, enforceable in accordance with its terms;

(l) such documents as are required by Section 1306 of this Agreement in connection with the delivery of a Successor Letter of Credit (if a Successor Letter of Credit is delivered); and

(m) such additional legal opinions, certificates, proceedings, instruments and other documents as may be necessary to evidence due execution and issuance of such Bonds.

The opinions required by items (c), (d), (e), (j) and (k) relating to the enforceability of the Bonds, the supplemental assignment agreement(s), the Notes, the Parity Notes, the GDB Letters of Credit, any Credit Facility or Liquidity Facility and the Swap Agreement (if applicable) may

be qualified by customary exceptions relating to bankruptcy and similar laws affecting creditors' rights generally and, as to enforceability, to general principles of equity (regardless of whether such enforcement is sought in a proceeding in equity or at law).

The proceeds of the Bonds issued under the provisions of this Section 209 shall be applied by the Trustee as provided in a resolution of the Board adopted prior to the issuance of the Bonds, which may be supplemented or changed by a certificate of the President executed on the date of issuance of the Bonds and delivered to the Trustee, if provided for in said resolution.

SECTION 210. Temporary Bonds. Until definitive Bonds are ready for delivery, there may be executed, and upon request of the President of the Corporation the Trustee shall authenticate and deliver, in lieu of definitive Bonds and subject to the same limitations and conditions except as to identifying numbers, temporary printed, engraved, lithographed or typewritten Bonds in authorized denominations substantially of the tenor hereinabove recited, and with appropriate omissions, insertions and variations as may be required.

If temporary Bonds shall be issued, the Corporation shall cause the definitive Bonds to be prepared and to be executed and delivered to the Trustee, and the Trustee, upon presentation to it of any temporary Bond, shall cancel the same in the manner set forth in Section 304 hereof and authenticate and deliver in exchange therefor, at the place designated by the Holder, without expense to the Holder, a definitive Bond or Bonds of the same aggregate principal amount (maturity amount in the case of a Capital Appreciation Bond and a Capital Appreciation and Income Bond) and Series and having the same maturity and interest rate as the temporary Bond surrendered. Until so exchanged, the temporary Bonds shall in all respects be entitled to the same benefit and security of this Agreement as the definitive Bonds to be issued and authenticated hereunder.

SECTION 211. Mutilated, Destroyed, Stolen or Lost Bonds. In case any Bond secured hereby shall become mutilated or be destroyed, stolen or lost, the Corporation may execute, and thereupon the Trustee shall authenticate and deliver, a new Bond of like date, maturity and tenor in exchange and substitution for such Bond destroyed, stolen, mutilated or lost, upon the Holder's paying the reasonable expenses and charges of the Corporation and the Trustee in connection therewith. In the case of any mutilated Bond, such mutilated Bond shall first be surrendered to the Trustee and, in the case of a Bond destroyed, stolen or lost, there shall first be furnished to the Trustee evidence satisfactory to the Trustee and to the Corporation that such Bond was destroyed, stolen or lost, and there shall be furnished to the Corporation and the Trustee indemnity satisfactory to them.

In the event any such Bond shall be about to mature or have matured or have been called for redemption, instead of issuing a duplicate Bond, the Corporation may direct the Trustee to pay the same without surrender thereof. Any Bond surrendered for replacement shall be cancelled in the same manner as provided in Section 304 hereof.

Any such new Bonds issued pursuant to this Section shall constitute additional contractual obligations on the part of the Corporation, whether or not the mutilated, lost, stolen or destroyed Bonds be at any time enforceable by anyone, and shall be entitled to equal and

proportionate benefits and rights as to lien on and source and security for payment from the Pledged Revenues with all other Bonds.

SECTION 212. Book-Entry Bonds. (i) Except as provided in subparagraph (iii) of this Section 212, the registered owner of all Series 2004 Bonds shall be the Securities Depository and, as long as the Securities Depository shall be DTC, the Series 2004 Bonds shall be registered in the name of Cede & Co., as nominee for DTC or any other nominee for DTC. The Trustee is hereby authorized to enter into agreements with DTC and other depository trust companies, including but not limited to, agreements necessary for wire transfers of interest and principal payments with respect to the Bonds, utilization of electronic book entry data received from DTC and other depository trust companies in place of actual delivery of Bonds and provision of notices with respect to Bonds registered by DTC and other depository trust companies (or any of their designees identified to the Trustee) by overnight delivery, courier service, telegram, teletype or other similar means of communication. Payment of interest for any Bond registered in the name of Cede & Co. shall be made to the account of Cede & Co. at the address indicated for Cede & Co. in the registration books kept by the Trustee. The "Bonds" referred to in this Section 212 shall refer to all Book-Entry Bonds.

(ii) The Bonds shall be initially issued in the form of separate, single, authenticated fully-registered Bonds in the amount of each separately stated maturity. As long as certificates for the Bonds are not issued pursuant to this Section 212, the Trustee and the Corporation may treat the Securities Depository (or its nominee) as the sole and exclusive owner of the Bonds registered in its name for the purposes of payment of the principal or redemption premium, if any, or interest on the Bonds, selecting the Bonds or portions thereof to be redeemed, giving any notice permitted or required to be given to the owners of such Bonds hereunder, registering the transfer of Bonds, obtaining any consent or other action to be taken by Bondholders and for all other purposes whatsoever; and neither the Trustee nor the Corporation shall have any responsibility or obligation to any Participant, any Beneficial Owner or any other person claiming a beneficial ownership interest in the Bonds under or through the Securities Depository or any Participant, or any other person which is not shown on the registration books of the Trustee as being an owner of Bonds, with respect to the accuracy of any records maintained by the Securities Depository or any Participant; the payment to the Securities Depository or any Participant of any amount in respect of the principal or redemption premium, if any, or interest on the Bonds; any notice which is permitted or required to be given to Bondholder; the selection by the Securities Depository or any Participant of any person to receive payment in the event of a partial redemption of the Bonds; or any consent given or other action taken by the Securities Depository as owner of Bonds. The Trustee shall pay all principal and redemption premium, if any, and interest on the Bonds only to or "upon the order of" the Securities Depository (as that term is used in the Uniform Commercial Code as adopted in the State of New York), and all such payments shall be valid and effective to fully satisfy and discharge the Corporation's obligations with respect to the principal or redemption premium, if any, and interest on the Bonds to the extent of the sum or sums so paid. Except as provided in (iii) below, no person other than the Securities Depository shall receive an authenticated Bond for each separate stated maturity evidencing the obligation of the Corporation to make payments of the applicable redemption price. Upon delivery by the Securities Depository to the Trustee

of written notice to the effect that the Securities Depository has determined to substitute a new nominee in place of Cede & Co., the Bonds will be transferable to such new nominee in accordance with subparagraph (vi) below.

(iii) In the event the Corporation determines that it is in the best interest of the Corporation not to continue the Book-Entry system of transfer for the Bonds or that the interest of the owners of the Bonds might be adversely affected if the Book-Entry system of transfer is continued, the Corporation may notify the Securities Depository and the Trustee, whereupon the Securities Depository will notify the Participants, of the availability through the Securities Depository of certificates for the Bonds. In such event, the Trustee shall issue, transfer and exchange certificates for the Bonds as requested by the Securities Depository and any Participant or Beneficial Owner in appropriate amounts in accordance with subparagraph (vi) below. The Securities Depository may determine to discontinue providing its services with respect to the Bonds at any time by giving notice to the Corporation and the Trustee and discharging its responsibilities with respect thereto under applicable law, or the Corporation may determine that the Securities Depository is incapable of discharging its responsibilities and may so advise the Securities Depository. In either such event, the Corporation shall either establish its own Book-Entry system or use reasonable efforts to locate another Securities Depository. Under such circumstances (if there is no successor securities depository), the Corporation and the Trustee shall be obligated to deliver certificates for the Bonds as described in subparagraph (vi) below. In the event certificates for the Bonds are issued, the provisions of this Agreement shall apply to, among other things, the printing of certificates, the transfer and exchange of such certificates and the method of payment of principal or redemption premium, if any, and interest on such certificates. Whenever the Securities Depository requests the Corporation and the Trustee to do so, the Trustee and the Corporation will cooperate with the Securities Depository in taking appropriate action after reasonable notice (A) to make available one or more separate certificates evidencing the Bonds to any Participant having Bonds credited to its account with the Securities Depository, or (B) to arrange for another Securities Depository to maintain custody of certificates evidencing the Bonds.

(iv) Notwithstanding any other provision of this Agreement to the contrary, so long as any Bond is registered in the name of Cede & Co., as nominee of DTC, all payments with respect to the principal or redemption premium, if any, and interest on such Bond and all notices with respect to such Bond shall be made and given, respectively, to DTC as provided in the blanket representation letter of the Corporation with DTC.

(v) In connection with any notice or other communication to be provided to owners of Bonds pursuant to this Agreement by the Corporation or the Trustee or with respect to any consent or other action to be taken by owners of Bonds, the Corporation or the Trustee, as the case may be, shall establish a record date for such consent or other action and give the Securities Depository notice of such record date not less than is fifteen (15) calendar days in advance of such record date to the extent possible. Such notice to the Securities Depository shall be given only when the Securities Depository is the sole Bondholder.

(vi) In the event that any transfer or exchange of Bonds is permitted under subparagraph (ii) or (iii) hereof, such transfer or exchange shall be accomplished upon receipt, by the Trustee from the registered owner thereof of the Bonds to be transferred or exchanged, of appropriate instruments of transfer to the permitted transferee, all in accordance with the applicable provisions of this Agreement. Each Series 2004 Bond shall bear a legend substantially to the following effect: "Unless this certificate is presented by an authorized representative of The Depository Trust Company, a New York corporation ("DTC"), to the Corporation or its agent for registration of transfer, exchange, or payment, and any certificate issued is registered in the name of Cede & Co. or in such other name as is requested by an authorized representative of DTC (and any payment is made to Cede & Co. or to such other entity as is requested by an authorized representative of DTC), any transfer, pledge, or other use hereof for value or otherwise by or to any person is wrongful inasmuch as the registered owner hereof, Cede & Co., has an interest herein."

SECTION 213. Capital Appreciation Bonds; Capital Appreciation and Income Bonds. For purposes of determining the principal amount of a Capital Appreciation Bond or a Capital Appreciation and Income Bond for redemption, applying an Amortization Requirement or computation of the amount of Bonds held by the Holder thereof in giving to the Corporation any notice, covenant, request or demand pursuant to this Agreement for any purpose whatsoever, the principal amount of a Capital Appreciation Bond shall be deemed to be its Accreted Value and the principal amount of a Capital Appreciation and Income Bond shall be deemed to be its Appreciated Value. For purposes of determining the amount required to be deposited to the credit of any sub-account within the Reserve Account, reference herein to the principal amount shall mean in the case of Capital Appreciation Bonds, Capital Appreciation and Income Bonds and other Bonds which are sold to the public at a discount, the value of such Bonds at maturity. For purposes of the order of payments under Section 702 hereof, the principal amount of a Capital Appreciation Bond and a Capital Appreciation and Income Bond shall be the initial public offering price thereof.

SECTION 214. CUSIP Numbers. The Corporation in issuing the Bonds may use "CUSIP" numbers (if then generally in use), and, if so, the Trustee shall use "CUSIP" numbers in notices of redemption as a convenience to Holders; provided that any such notice may state that no representation is made as to the correctness of such numbers either as printed on the Bonds or as contained in any notice of a redemption and that reliance may be placed only on the other identification numbers printed on the Bonds, and any such redemption shall not be affected by any defect in or omission of such numbers. The Corporation will promptly notify the Trustee of any change in the "CUSIP" numbers.

ARTICLE III.

REDEMPTION OF BONDS

SECTION 301. Redemption of Bonds. The Bonds of each Series issued under the provisions of this Agreement may be made subject to redemption, both in whole and in part and at such times and prices, as may be provided in the resolution authorizing the issuance of such

Bonds. Term Bonds shall be made subject to redemption to the extent of any Amortization Requirements therefor.

If less than all of the Bonds of any one maturity of a Series shall be called for redemption, the particular Bonds or portions of Bonds to be redeemed shall be selected by the Trustee in such manner as it shall deem fair and appropriate; provided, however, that the portion of any Bond of any Series to be redeemed shall be in the principal amount equal to the lowest denomination authorized for such Series or some multiple thereof, and that, in selecting Bonds for redemption, the Trustee shall treat each Bond as representing that number of Bonds which is obtained by dividing the principal amount of such Bond by the amount of such lowest authorized denomination.

Anything in this Agreement to the contrary notwithstanding, if less than all of the Bonds are called for redemption and the Book-Entry system under Section 212 remains in effect, the Securities Depository shall reduce the credit balances of the applicable Participants in respect of the Bonds, and such Participants shall in turn select the Beneficial Owners whose ownership interests are to be extinguished by such partial redemption, each by such method as the Securities Depository or such Participants, as the case may be, in their sole discretion deem fair and appropriate.

SECTION 302. Redemption Notice. At least thirty (30) days (or such lesser number of days as may be provided in the resolution authorizing the issuance of the particular Bonds) before the redemption date of any Bonds, the Trustee shall cause a notice of any such redemption, either in whole or in part, on behalf of the Corporation to be mailed, by first class mail, postage prepaid, to any other paying agents for the Bonds to be redeemed and to all Holders of Bonds to be redeemed at their addresses as they appear upon the books of registration hereinabove provided for; but failure so to mail any such notice to any Holder or any defect in any notice so mailed shall not affect the validity of the proceedings for the redemption of other Bonds. Each such notice shall set forth (1) the date fixed for redemption, (2) the redemption price to be paid, (3) that on the date fixed for redemption the redemption price will become due and payable upon each Bond called for redemption, (4) if moneys for the payment of the redemption price shall be on deposit on such date, that interest thereon shall cease to accrue on and after said redemption date, (5) the place where such Bonds are to be surrendered for payment of such redemption price, (6) if less than all of the Bonds of a Series then Outstanding shall be called for redemption, the numbers of such Bonds and (7) the complete designation of the Series, including the CUSIP numbers. Each notice of redemption shall also contain (a) the date of issue of the Bond as originally issued; (b) the rate of interest borne by each Bond being redeemed; (c) the maturity date of each Bond being redeemed; and (d) the name, address and telephone number of a contact person, if any, representing the Trustee. In case any Bond is to be redeemed in part only, the notice of redemption which relates to such Bond shall state also the amount of such Bond to be redeemed and that on or after the redemption date, upon surrender of such Bond, a new Bond or Bonds of the same Series and maturity, bearing interest at the same rate and in principal amount equal to the unredeemed portion of such Bond will be issued. In the case of any redemption other than a redemption pursuant to any Amortization Requirements for Term Bonds, the Corporation shall, at least forty-five (45) days prior to the redemption date, notify the Trustee of such redemption date and the principal amount of Bonds to be redeemed.

In addition to the foregoing notice, further notice shall be given by the Trustee as set out below, but no defect in said further notice nor any failure to give all or any portion of such further notice shall be the basis for any liability of the Trustee or in any manner defeat the effectiveness of a call for redemption if notice thereof is given as above prescribed:

(a) Each further notice of redemption shall be sent by first class mail, postage prepaid, at least thirty (30) days (or such lesser number of days as applies to the notice given to the Holders of Bonds being redeemed) before the redemption date to the Rating Agencies and to registered securities depositories and national information services whose names and addresses are included in the most recent list thereof furnished to the Trustee by the Corporation; and

(b) The Trustee shall cause a second notice of redemption to be mailed in the manner and in the form required above for the initial notice of redemption to Holders of Bonds or portions thereof to be redeemed who have not surrendered their Bonds within sixty (60) days after the redemption date.

SECTION 303. Effect of Calling for Redemption. On the date so designated for redemption, notice having been given in the manner and under the conditions hereinabove provided, the Bonds or portions of Bonds so called for redemption shall become and be due and payable at the redemption price provided for the redemption of such Bonds or portions of Bonds on such date, and, if sufficient moneys for payment of the redemption price and accrued interest or Sufficient Government Obligations as defined in Section 305 hereof are held by the Trustee in trust for the Holders of Bonds to be redeemed, as provided in this Agreement, interest on the Bonds or portions of Bonds so called for redemption shall cease to accrue, such Bonds or portions of Bonds shall cease to be entitled to any benefit or security hereunder and shall no longer be Outstanding hereunder and the Holders of such Bonds or portions of Bonds shall have no rights in respect thereof except to receive payment of the redemption price thereof and accrued interest, and, to the extent provided in Section 306 hereof, to receive Bonds for any unredeemed portions of Bonds.

SECTION 304. Cancellation of Bonds. All Bonds paid, redeemed or purchased by the Corporation, either at or before maturity, shall be delivered to the Trustee when such payment, redemption or purchase is made and such Bonds shall thereupon be cancelled. The Trustee shall provide to the Corporation the details of all Bonds so cancelled. All Bonds cancelled under any of the provisions of this Agreement either shall be delivered to the Corporation or disposed of by the Trustee in accordance with its customary procedures, at the option of the Corporation.

SECTION 305. Bonds To Be Paid Not Outstanding. If (a) Bonds shall have been duly called for redemption under the provisions of this Article III or irrevocable instructions have been given by the Corporation to the Trustee to (i) call Bonds for redemption under the provisions of this Article III or (ii) pay Bonds at their maturity or maturities (the Bonds described in clause (a) are herein collectively called the "Bonds to be Paid"), and (b) sufficient moneys to provide for the payment of such Bonds or Sufficient Government Obligations (as defined below) are held in separate accounts by the Trustee or other appropriate fiduciary institution acting as escrow agent solely for the Holders of the Bonds to be Paid, then, notwithstanding any other provisions herein to the contrary, the Bonds to be Paid shall not be deemed to be Outstanding

under the provisions of this Agreement and shall cease to be entitled to any benefit or security under this Agreement.

For purposes of this Agreement "Sufficient Government Obligations" shall mean Government Obligations which are in such principal amounts, bear interest at such rate or rates and mature (without option of prior redemption) on such date or dates so that the proceeds to be received upon payment of such Government Obligations at their maturity and the interest to be received thereon, without any reinvestment thereof, will provide sufficient moneys on the dates required to pay the principal of and redemption premium, if any, and the interest on the Bonds to be Paid to the dates of their redemption or maturity.

SECTION 306. Partial Redemption. In case part but not all of an Outstanding Bond shall be selected for redemption, the Holder thereof or his attorney or legal representative shall present and surrender such Bond to the Trustee for payment of the principal amount thereof so called for redemption, and the Corporation shall execute and the Trustee shall authenticate and deliver to or upon the order of such Holder or his attorney or legal representative, without charge to the Holder therefor, for the unredeemed portion of the principal amount of the Bond so surrendered, a new Bond or Bonds of the same Series and maturity, bearing interest at the same rate and of any denomination or denominations authorized by this Agreement.

ARTICLE IV.

FUNDS AND ACCOUNTS

SECTION 401. Sinking Fund and Accounts. A special fund is hereby created and designated "Puerto Rico Public Finance Corporation Restructuring Sinking Fund" (herein sometimes called the "Sinking Fund") to be held by the Trustee. There are hereby created three separate accounts in the Sinking Fund which are designated "Bond Service Account," "Redemption Account," and "Surplus Account," and a separate and segregated sub-account within the Bond Service Account designated "Capitalized Interest Sub-account." Subject to the terms and conditions set forth in this Agreement, moneys held to the credit of the Sinking Fund shall be held in trust and applied by the Trustee solely for the purposes set forth below and pending such application shall be subject to the lien and charge created pursuant to this Agreement until paid out or transferred as provided herein.

The Corporation shall deposit in the Capitalized Interest Sub-account such amounts as may be necessary to pay interest on the Bonds of any Series through such date as may be set forth in a resolution of the Board authorizing such Series of Bonds.

The Corporation shall cause the Secretary of the Treasury of the Commonwealth to transfer to the Trustee, no later than July fifteen (15) of each Fiscal Year while the Bonds are Outstanding, funds representing the entire Legislative Appropriation for such Fiscal Year.

All funds received by the Trustee representing the Legislative Appropriation in respect of the Notes (or funds received in substitution therefor or in respect of the Notes, including any moneys received pursuant to a draw under the GDB Letters of Credit) and other funds received by the Trustee, including any Hedge Counterparty Swap Payments (other than moneys received

from draws made under any Credit Facility or Liquidity Facility, other than the GDB Letters of Credit, which moneys will be deposited in special sub-accounts as provided below), shall be deposited in the Sinking Fund in the following order:

first: to the credit of the Bond Service Account, such amount as may be required to make the total amount then to the credit of the Bond Service Account equal to the sum of (i) the amount of interest then or to become due and payable on the Bonds of each Series then Outstanding during the Bond Year commencing within the Fiscal Year with respect to which such Legislative Appropriation is made or such funds are received and (ii) the amount of principal then or to become due and payable not later than July thirty-first (31) of such Bond Year on the Serial Bonds of each Series then Outstanding;

second: to the credit of the Redemption Account, such amount as may be required to make the total amount then to the credit of the Redemption Account in the Bond Year commencing within the Fiscal Year with respect to which such Legislative Appropriation is made or such funds are received equal to the Amortization Requirement for such Bond Year for the Term Bonds of each Series then Outstanding; and

third: to the credit of the Surplus Account, any remaining amount.

If the Corporation issues Variable Rate Bonds pursuant to the provisions of Section 207, 208 or 209 of this Agreement, the assumptions for calculating interest for the current Bond Year to ensure a sufficient deposit for the payment of said interest shall be made on the basis established in the resolution authorizing the issuance of such Variable Rate Bonds.

If there is a Credit Facility or a Liquidity Facility issued by a provider in connection with the issuance of a Series of Bonds, any moneys received from draws under such Credit Facility or Liquidity Facility shall be deposited in separate sub-accounts in the Bond Service Account or the Redemption Account, as appropriate, and used to pay the principal of and interest on the Bonds secured thereby.

To the extent required by a resolution of the Board in connection with the issuance of any Series of Bonds, the Trustee shall establish one or more sub-accounts within the Bond Service Account and the Redemption Account to segregate amounts paid under any of the Notes and make withdrawals from such sub-accounts to make payments under any Series of Bonds designated in such resolution of the Board. Nothing in the foregoing sentence shall be deemed to affect the parity status of the Bonds.

SECTION 402. Withdrawals from Bond Service Account. (a) Subject to the provisions of paragraph (b) of this Section, on each Interest Payment Date or as otherwise provided in the resolution of the Board authorizing the issuance of a Series of Bonds, the Trustee shall withdraw from the Bond Service Account and (1) remit by mail (or by wire transfer, in the case of the Series 2004 Bonds or if so provided by resolution of the Board) to each Bondholder the amounts required for paying interest upon such Bonds as such interest becomes due and (2) set aside sufficient moneys for paying the principal of Serial Bonds as such principal becomes due. If paying agents other than the Trustee have been designated by the Corporation, the Trustee shall deposit in trust with such paying agents the amounts required to pay such principal

and interest. Notwithstanding any provision herein to the contrary, if principal of and premium, if any, and interest on the Bonds that would have been paid from the Bond Service Account or Redemption Account is paid instead by amounts drawn under a Credit Facility or a Liquidity Facility, amounts held to the credit of the Bond Service Account and the Redemption Account for such purposes shall be paid, to the extent required under any agreement with the issuer of such Credit Facility or Liquidity Facility, to such issuer. The Trustee shall establish one or more sub-accounts within the Bond Service Account and the Redemption Account, to the extent required by a resolution of the Board, to segregate amounts to be paid to the issuer of a Credit Facility or a Liquidity Facility or amounts received from a Credit Facility or a Liquidity Facility.

(b) Moneys in the Capitalized Interest Sub-account shall be applied exclusively by the Trustee to the payment of interest accruing on any Series of Bonds from which proceeds were deposited in the Capitalized Interest Sub-account pursuant to the resolution of the Board authorizing such Series of Bonds.

SECTION 403. Withdrawals from Redemption Account. Moneys held to the credit of the Redemption Account shall be applied to the retirement of Bonds as follows:

(a) Subject to the provisions of paragraph (c) of this Section, the Trustee shall endeavor to purchase Bonds or portions of Bonds, whether or not such Bonds or portions shall then be subject to redemption, at the most advantageous price obtainable by it with reasonable diligence, such price not to exceed the principal of such Bonds plus the amount of the premium, if any, that would be payable on the next redemption date to the holders of such Bonds under the provisions of Article III of this Agreement if such Bonds or portions of Bonds should be called for redemption on such date from the moneys in the Sinking Fund. The Trustee shall pay the interest accrued on such Bonds or portions of Bonds to the date of delivery thereof from the Bond Service Account and the principal portion of such purchase price from the Redemption Account. No such purchase shall be made by the Trustee within the period of forty-five (45) days immediately preceding the date on which such Bonds are subject to call for redemption under the provisions of this Agreement except from moneys in excess of the amounts set aside or deposited for such redemption of Bonds.

(b) Subject to the provisions of paragraph (c) of this Section, the Trustee shall call for redemption on each date on which Bonds are subject to redemption from moneys in the Sinking Fund such amount of Bonds or portions of Bonds then subject to redemption as, with the redemption premium, if any, will exhaust the moneys then held for the credit of the Redemption Account as nearly as may be; provided, however, that not less than ONE HUNDRED THOUSAND DOLLARS (\$100,000) principal amount of Bonds shall be called for redemption at any one time. Such redemption shall be made pursuant to the provisions of Article III of this Agreement. Prior to calling Bonds or portions of Bonds for redemption, the Trustee shall withdraw from the Bond Service Account and from the Redemption Account (including moneys transferred from the Reserve Account (if applicable) to the credit of the Redemption Account) and set aside in separate accounts or deposit with the paying agents the respective amounts required for paying the interest on, and the principal and redemption premium, if any, of the Bonds or portions of Bonds so called for redemption.

(c) Moneys in the Redemption Account shall be applied by the Trustee in each Bond Year to the retirement of Bonds of each Series then Outstanding in the following order:

first, the Term Bonds to the extent of the Amortization Requirement, if any, for such Bond Year for such Term Bonds of each such Series then Outstanding, plus the applicable premium, if any, and, if the amount available in such Bond Year shall not be sufficient therefor, then in proportion to the Amortization Requirement, if any, for such Bond Year for such Term Bonds of each such Series then Outstanding, plus the applicable premium, if any;

second, any balance then remaining shall be applied to the purchase of any Bonds then Outstanding whether or not such Bonds shall then be subject to redemption, in accordance with the provisions of paragraph (a) of this Section; and

third, any balance then remaining shall be applied to the retirement of Bonds of each Series as directed by the Corporation.

SECTION 404. Withdrawals from Surplus Account. (a) Moneys held to the credit of the Surplus Account shall be applied by the Trustee to make payments in the following order: (i) to make up any deficiency in the Bond Service Account and the Redemption Account; (ii) to pay the compensation of the Trustee and other amounts payable to the Trustee under Section 804 hereof upon the written request of the Corporation; (iii) to make Corporation Swap Payments (if applicable), if any; (iv) to pay any fees and expenses payable to the providers of any Credit Facility, Liquidity Facility, Reserve Account Insurance Policy or Reserve Account Letter of Credit (if applicable) upon the written request of the Corporation; and (v) to reimburse or pay any provider of such facilities (if applicable) for any other amounts due under the agreement with such provider.

(b) Any moneys held to the credit of the Surplus Account after all amounts described in paragraph (a) above required to be paid in respect of a Bond Year have been paid shall, upon the written request of the Corporation, be transferred to the credit of the Bond Service Account or the Redemption Account.

SECTION 405. Reserve Account. If the resolution of the Board providing for the issuance of Bonds under this Agreement requires that a Reserve Account be established, a separate account in the Sinking Fund designated "Reserve Account" is hereby authorized to be created in accordance with such resolution, in which Reserve Account there shall be established separate sub-accounts as provided in such resolution. In such event, the Trustee shall, from the funds received by the Trustee in accordance with Section 401, prior to depositing any amounts to the credit of the Surplus Account, deposit to the credit of each sub-account within the Reserve Account such amount as may be required to make the amount then on deposit to the credit of each such sub-account equal to the amount established in such resolution of the Board. Any Reserve Account created under the Trust Agreement will be applicable to one or more Series of Bonds issued under the Trust Agreement as provided in the resolution of the Board authorizing any such Series.

In lieu of any required deposit or in substitution of moneys on deposit to the credit of any sub-account within the Reserve Account (if applicable), the Corporation may cause to be

deposited to the credit of such sub-account within the Reserve Account a Reserve Account Insurance Policy or a Reserve Account Letter of Credit in an amount equal to such required deposit, which Reserve Account Insurance Policy or Reserve Account Letter of Credit shall be satisfactory in form and substance to the Trustee and shall (i) be payable or available to be drawn upon, as the case may be (upon the giving of notice as required thereunder), on any payment date for the Bonds on which a withdrawal from such sub-account within the Reserve Account would be required under Section 404 hereof, and (ii) give the Trustee the right to draw on any Reserve Account Insurance Policy or Reserve Account Letter of Credit prior to the expiration thereof unless the Corporation has furnished a replacement Reserve Account Insurance Policy or Reserve Account Letter of Credit or has provided sufficient moneys to make the amounts then on deposit to the credit of such sub-account within the Reserve Account equal to the amount required therefor. If a disbursement is made under a Reserve Account Insurance Policy or a Reserve Account Letter of Credit, the funds thereafter becoming available for deposit to the credit of the related sub-account within the Reserve Account shall be used by the Trustee to reinstate the amounts available to be drawn under such Reserve Account Insurance Policy or Reserve Account Letter of Credit in an amount at least equal to the amount being reimbursed to the provider of such Reserve Account Insurance Policy or Reserve Account Letter of Credit or, if such reinstatement is not available, to deposit to the credit of such sub-account within the Reserve Account moneys in the amount of the disbursement made under such Reserve Account Insurance Policy or Reserve Account Letter of Credit or a combination of such alternatives.

Moneys held to the credit of any sub-account within the Reserve Account (if applicable) shall be used by the Trustee for the purpose of paying interest on the Series of Bonds secured thereby and maturing principal of such Bonds when moneys held to the credit of the Bond Service Account shall be insufficient for such purpose and thereafter for the purpose of making deposits to the credit of the Redemption Account pursuant to the requirements of clause second of Section 401 of this Agreement whenever and to the extent that the Legislative Appropriation or the moneys received in respect of the Notes are insufficient therefor.

Any moneys held to the credit of any sub-account within the Reserve Account in excess of the amount required to be on deposit therein pursuant to the resolution of the Board shall, upon the written request of the Corporation, be transferred to the credit of the Bond Service Account or the Redemption Account.

SECTION 406. Moneys Set Aside Held in Trust. All moneys which the Trustee shall have withdrawn from the accounts of the Sinking Fund, or shall have received from any other source and set aside or deposited with any paying agent for the purpose of paying the principal of or the interest on any of the Bonds hereby secured, either at the maturity thereof or upon call for redemption, or for the purpose of paying any other obligation of the Corporation secured hereunder, shall be held in trust for the respective Holders of such Bonds, the provider of the Credit Facility or Liquidity Facility (if applicable) or the Hedge Counterparty (if applicable). Any moneys which shall be set aside or deposited by the Trustee or any paying agent and which shall remain unclaimed by the Holders of such Bonds or such other person entitled to receive a payment hereunder for the period of two (2) years after the date on which such Bonds or the interest thereon or such other obligation shall have become payable shall, upon request in writing, be paid to the Corporation or to such officer, board or body as may then be entitled by law to receive the same, and thereafter the Holders of such Bonds or such other person entitled to

receive a payment hereunder, shall look only to the Corporation or to such officer, board or body, as the case may be, for payment and then only to the extent of the amounts so received without any interest thereon, and the Trustee and any other paying agents shall have no responsibility for such moneys.

SECTION 407. Establishment of Sub-accounts in the Redemption Account. The Trustee shall establish one or more sub-accounts in the Redemption Account for deposits of funds to be used for extraordinary mandatory redemptions of one or more Series of Bonds and shall deposit and withdraw moneys from such sub-accounts, if and as required by resolutions of the Board adopted prior to the issuance of such Series of Bonds.

ARTICLE V.

DEPOSITORIES OF MONEYS, SECURITY FOR DEPOSITS AND INVESTMENTS OF FUNDS

SECTION 501. Security for Deposits. All moneys deposited under the provisions of this Agreement with the Trustee shall be held in trust under the terms hereof, and shall not be subject to lien or attachment by any creditor of the Corporation.

All moneys deposited with the Trustee hereunder in excess of the amount insured by the Federal Deposit Insurance Corporation, or other Federal agency shall be continuously secured for the benefit of the Trustee, the Holders of the Bonds, the provider of any Credit Facility or Liquidity Facility and the Hedge Counterparty, if any, either (a) by depositing with a bank or trust company approved by the Corporation and by the Trustee, as custodian, or, if then permitted by law, by setting aside under control of the trust department of the bank holding such deposit, as collateral security, securities described in clause (i) of the definition of Government Obligations, or, with the approval of the Trustee, other marketable securities eligible as security for the deposit of trust funds under applicable regulations of the Comptroller of the Currency of the United States of America and applicable Commonwealth laws or regulations, having a market value (exclusive of accrued interest) not less than the amount of such deposit, or, (b) if the furnishing of security as provided in clause (a) of this Section is not permitted by applicable law, in such other manner as may then be required or permitted by applicable Commonwealth and Federal laws or regulations regarding the security for, or granting a preference in the case of, the deposit of trust funds; provided, however, that it shall not be necessary for the Trustee to give security for the deposits of any moneys set aside for the payment of the principal of or the redemption premium or the interest on any Bonds issued hereunder, or for the Trustee to give security for any moneys which shall be represented by obligations purchased under the provisions of this Article as an investment of such moneys.

All moneys deposited with the Trustee shall be credited to the particular fund or account to which such moneys belong.

SECTION 502. Investment of Moneys. Moneys held to the credit of the Bond Service Account and the Redemption Account (except the Capitalized Interest Sub-account and any sub-accounts established by one or more resolutions of the Board to segregate amounts received from a Credit Facility or a Liquidity Facility, which resolution or resolutions may

provide for the investment of moneys deposited to the credit of any such sub-account) shall, as nearly as may be practicable, be continuously invested and reinvested, at the written direction of the Corporation specifying the particular investment to be made, in (i) Government Obligations, that shall mature, or that shall be subject to redemption by the holder thereof at the option of such holder, not later than the respective dates when moneys held for the credit of said accounts will be required for the purposes intended or (ii) Investment Agreements pursuant to which funds would be available not later than the respective dates when moneys held for the credit of said accounts would be required for the purposes intended. Anything in this Agreement to the contrary notwithstanding, moneys held to the credit of the Capitalized Interest Sub-account may be invested, in addition to any other permitted investments of moneys in the Bond Service Account, in investment agreements with Government Development Bank pursuant to which funds would be available not later than the respective dates when moneys held to the credit of the Capitalized Interest Sub-account would be required for the purposes intended. Moneys held to the credit of the Surplus Account shall be continuously invested and reinvested at the written direction of the Corporation in any Investment Obligations selected by it. Moneys held to the credit of the Reserve Account (if applicable) shall, as nearly as may be practicable, be continuously invested and reinvested at the written direction of the Corporation specifying the particular investment to be made, in Investment Obligations that shall mature no later than the final maturity of the Bonds.

Obligations so purchased as an investment of moneys in any such funds or accounts shall be deemed at all times to be a part of such funds or accounts, and any investment earnings and profit or loss realized on the sale or maturity thereof, shall be credited or debited to such funds or accounts; provided, however, that if the deposits to any account required by Section 401 hereof have been made for the current Bond Year, the investment earnings on moneys held to the credit of such account shall be deposited in the order set forth in said Section 401 to the credit of any other account of the Sinking Fund for which such required deposit has not been made, and if all such required deposits have been made, such earnings shall be deposited to the credit of such account in the Sinking Fund as shall be directed by the Corporation. The Trustee, at the written direction of the Corporation, shall sell any obligations so purchased as an investment whenever it shall be necessary to do so in order to provide moneys to meet any payments or transfers from such funds or accounts. Neither the Trustee nor the Corporation shall be liable or responsible for any loss, fee, tax or other charge resulting from any such investment, reinvestment or liquidation of an investment.

In the case of investments in the obligations described in clauses (iii) of the definition of Investment Obligations in Section 101 hereof, the Corporation shall deliver to the Trustee, if the Trustee so requests, an opinion of counsel acceptable to the Trustee as to the perfection and priority of the security interests in the collateral described therein.

SECTION 503. Valuation of Investments. In computing the amount in any fund or account created pursuant to the provisions of this Agreement, obligations purchased as an investment of moneys therein shall be valued at par if purchased at par or at amortized value if purchased at other than par, plus, in each case, accrued interest. Amortized value, when used with respect to an obligation purchased at a premium above or a discount below par, means the value as of any given time obtained by dividing the total premium or discount at which such obligation was purchased by the number of days remaining to maturity on such obligation at the

date of such purchase and by multiplying the amount thus calculated by the number of days having passed since such purchase; and (1) in the case of an obligation purchased at a premium by deducting the product thus obtained from the purchase price, and (2) in the case of an obligation purchased at a discount by adding the product thus obtained to the purchase price. Valuation on any particular date shall include the amount of interest then earned or accrued to such date on any moneys or investments in such fund or account. The computation of the amount on deposit in or credited to any fund and account created under this Agreement and the valuation of the investments of such amount shall be performed by the Trustee for such fund and account held by the Trustee on the last day of each Bond Year, and such computation and valuation shall not be required to be performed at other times, except upon the written request of the Corporation.

ARTICLE VI. PARTICULAR COVENANTS

SECTION 601. Payment of Principal, Interest and Premium; Limited Obligation; Pledge of Notes and Pledged Revenues. The Corporation covenants that it will promptly pay the principal of and the interest on every Bond issued hereunder and secured hereby at the places, on the dates and in the manner specified herein and in said Bonds and any premium required for the retirement of said Bonds by purchase or redemption, according to the true intent and meaning thereof. Such principal, interest and premium, if any, are payable solely from the payments received in respect of the Notes and the Pledged Revenues, which Notes and Pledged Revenues are hereby pledged to the payment thereof in the manner and to the extent hereinabove particularly specified.

Nothing in the Bonds or in this Agreement shall be deemed to constitute the Bonds a debt or obligation of the Commonwealth or any of its instrumentalities (other than the Corporation) or political subdivisions, and neither the Commonwealth nor any of its instrumentalities (other than the Corporation) or political subdivisions shall be liable for the payment of the principal of or the interest on the Bonds.

Nothing in the Bonds or in this Agreement shall be deemed to establish or grant any rights to a holder of any bond, note or other obligation of the Corporation which was not issued under or secured by the lien of this Agreement.

SECTION 602. No Impairment. The Corporation covenants and agrees that, so long as any of the Bonds shall be Outstanding and so long as any of its other obligations under any Reimbursement Agreement (if applicable) or the Swap Agreement (if applicable) secured hereunder shall remain unpaid, none of the Pledged Revenues will be used for any purpose other than as provided in this Agreement, and that no contract or contracts will be entered into or any action taken by which the rights of the Trustee, the Holders or such other parties secured by this Agreement to such Pledged Revenues might be impaired or diminished. Any resolution adopted by the Board authorizing the issuance of a Series of Bonds shall, for all purposes, be deemed part of this Agreement and shall constitute a contract for the benefit of the Holders of said Series. This Agreement and any such resolution may be supplemented and amended only in accordance with Article X hereof, except for supplements and amendments to any such resolution adopted or

entered into prior to the issuance of the applicable Series of Bonds, which may be adopted or entered into without restriction.

SECTION 603. Inclusion of Principal and Interest Requirement in Budget. Each year while any Bonds are Outstanding, the Corporation shall file a timely request with the Director of the Office of Management and Budget of Puerto Rico to include in the annual budget of capital improvements and operating expenses of Puerto Rico for the next Fiscal Year the necessary Legislative Appropriation so that payments in respect of the Notes shall be sufficient to cover the principal and interest payable with respect to the Bonds and all other amounts payable in respect of the Bonds or payable under this Agreement during the next Bond Year commencing within such Fiscal Year.

SECTION 604. Covenant to Enforce Payment of Note. The Corporation agrees to take any and all action available to it under the laws of the Commonwealth to assure that all amounts due and payable under the Notes will be timely paid, and that if any such payment shall not be made when the same shall become due and payable, the Corporation agrees to take any and all action available to it under the laws of the Commonwealth to enforce such payment.

SECTION 605. Faithful Performance; Due Authority. The Corporation covenants that it will faithfully perform at all times any and all covenants, undertakings, stipulations and provisions contained in this Agreement and in any and every Bond executed and delivered hereunder. The Corporation represents and warrants that it is duly authorized to issue the Bonds authorized hereby, to execute and deliver this Agreement, and that all action on its part for the issuance of the Bonds issued hereunder and the execution and delivery of this Agreement have been duly and effectively taken.

SECTION 606. Tax Covenant. The Corporation hereby covenants and agrees that, to the extent permitted by the Constitution and laws of the Commonwealth, it shall comply with the requirements of the Internal Revenue Code of 1986, as amended, and the regulations promulgated thereunder so that interest on the Corporation's 2004 Series A Bonds and any refunding Bonds or additional Bonds the interest on which is intended to be excluded from gross income of the recipients thereof for Federal income tax purposes will remain excluded from gross income for Federal income tax purposes and, in furtherance thereof, the Corporation will comply with the requirements of the Tax Certificate as to Arbitrage and Provisions of Sections one hundred forty-one (141) through one hundred fifty (150) of the Internal Revenue Code of 1986.

ARTICLE VII.

REMEDIES

SECTION 701. Enforcement of Remedies. At the request of the Holders of not less than twenty percent (20%) of the aggregate principal amount of Bonds then Outstanding, the Trustee shall proceed, subject to the provisions of Sections 802 hereof, to protect and enforce its rights and the rights of the Holders under the laws of Puerto Rico or under this Agreement, including all rights with respect to the Notes and the Pledged Revenues, by such suits, actions or special proceedings in equity or at law, or by proceedings in the office of any board or officer

having jurisdiction, either for the specific performance of any covenant or agreement contained herein or in aid or execution of any power herein granted or for the enforcement of any proper legal or equitable remedy, as the Trustee, being advised by counsel, shall deem most effectual to protect and enforce such rights.

In the enforcement of any remedy under this Agreement the Trustee shall be entitled to sue for, enforce payment of and recover judgment for, in its own name and as trustee of an express trust, any and all amounts then or after any default becoming, and at any time remaining, due from the Corporation for principal, premium, if any, interest or otherwise under any of the provisions of this Agreement or of the Bonds and unpaid, together with any and all costs and expenses of collection and of all proceedings hereunder and under the Bonds, and to exercise all rights and remedies under the Notes, all without prejudice to any other right or remedy of the Trustee or of the Holders, and to recover and enforce any judgment or decree against the Corporation, but solely as provided herein and in the Bonds for any portion of such amounts remaining unpaid and interest, costs and expenses as above provided, and to collect, in any manner provided by law, the moneys adjudged or decreed to be payable. Anything in this Agreement to the contrary notwithstanding, the Trustee may not sell or otherwise dispose of the Notes.

SECTION 702. Pro Rata Application of Funds. Anything in this Agreement to the contrary notwithstanding, if at any time the moneys in the Sinking Fund shall not be sufficient to pay the interest on or the principal of the Bonds as the same shall become due and payable, such moneys (except for any moneys obtained from a drawing on a Credit Facility, other than the GDB Letters of Credit, or Liquidity Facility (if applicable) and deposited in a separate sub-account which shall secure only one or more specified Series of Bonds or moneys deposited in any sub-account within the Reserve Account that secures only one or more specified Series of Bonds), together with any moneys then available or thereafter becoming available for such purpose, whether through the exercise of the remedies provided for in this Article or otherwise, shall be applied as follows:

first: to the payment to the persons entitled thereto of all installments of interest then due and payable in the order in which such installments became due and payable and, if the amount available shall not be sufficient to pay in full any particular installment, then to the payment, ratably, according to the amounts due on such installment, to the persons entitled thereto, without any discrimination or preference except as to any difference in the respective rates of interest specified in such Bonds;

second: to the payment to the persons entitled thereto of the unpaid principal of any of the Bonds which shall have become due and payable (other than the Bonds called for redemption for the payment of which moneys are held pursuant to the provisions of this Agreement) in the order of their due dates, with interest on such Bonds at the respective rates specified therein from the respective dates upon which such Bonds became due and payable, and, if the amount available shall not be sufficient to pay in full the principal of such Bonds due and payable on any particular date, together with such interest, then to the payment first of such interest, ratably, according to the amount of such interest due on such date, and then to the payment of such principal, ratably, according to the amount of such principal due on such date, to the persons

entitled thereto without any discrimination or preference except as to any difference in the respective rates of interest specified in the Bonds;

third: to the payment of the interest on and the principal of the Bonds, to the purchase and retirement of Bonds and to the redemption of Bonds, all in accordance with the provisions of Article IV of this Agreement;

fourth: to the payment of any amounts then due and owing to a provider of a Credit Facility or a Liquidity Facility (if applicable); and

fifth: to the payment of any amounts then due and payable owing to a Hedge Counterparty under a Swap Agreement (if applicable).

Whenever moneys are to be applied pursuant to the provisions of this Section, such moneys shall be applied by the Trustee at such times, and from time to time, as the Trustee in its sole discretion shall determine, having due regard to the amount of such moneys available for application and the likelihood of additional moneys becoming available for such application in the future; the setting aside of such moneys in trust for the proper purpose shall constitute proper application by the Trustee; and the Trustee shall incur no liability whatsoever to the Corporation, to any Holder, the provider of a Credit Facility or a Liquidity Facility (if applicable), a Hedge Counterparty (if applicable) or to any other person for any delay in applying any such moneys, so long as the Trustee acts with reasonable diligence, having due regard to the circumstances, and ultimately applies the same in accordance with such provisions of this Agreement as may be applicable at the time of application by the Trustee. Whenever the Trustee shall exercise such discretion in applying such moneys, it shall fix the date (which shall be an Interest Payment Date unless the Trustee shall deem another date more suitable) upon which such application is to be made and upon such date interest on the amounts of principal to be paid on such date shall cease to accrue. The Trustee shall give notice as it may deem appropriate of the fixing of any such date, and shall not be required to make payment to the holder of any Bond until such Bond shall be surrendered to it for appropriate endorsement, or for cancellation if fully paid.

SECTION 703. Effect of Discontinuance of Proceeding. In case any proceeding taken by the Trustee shall have been discontinued or abandoned for any reason, then and in every such case the Corporation, the Trustee and the Holders shall be restored to their former positions and rights hereunder, respectively, and all rights, remedies, powers and duties of the Trustee shall continue as though no such proceeding had been taken.

SECTION 704. Majority of Bondholders May Control Proceeding. Anything in this Agreement to the contrary notwithstanding, Holders of a majority in principal amount of the Bonds Outstanding shall have the right, subject to the provisions of Section 802 hereof, by an instrument in writing executed and delivered to the Trustee, to direct the time, method and place of conducting all remedial proceedings to be taken by the Trustee hereunder or exercising any trust or power conferred upon the Trustee, provided that (i) such direction shall not be otherwise than in accordance with law and the provisions of this Agreement, and (ii) subject to the provisions of Section 801 hereof, that the Trustee may take any other action deemed proper by the Trustee which is not inconsistent with such direction. In the event that particular Bonds are secured by a Credit Facility or Liquidity Facility and the provider of the Credit Facility or

Liquidity Facility has not defaulted in its obligations under such Credit Facility or Liquidity Facility, the provider of such Credit Facility or Liquidity Facility shall have the right, in lieu of the Holders of the Bonds secured thereby, to direct the method and place of conducting such remedial proceedings and to give any consents or waivers to such remedial proceedings under Article VII.

SECTION 705. Restrictions Upon Actions by Individual Bondholders. No Holder of any of the Bonds shall have any right to institute, appear in or defend any suit, action or proceeding in equity or at law on any Bond or for the execution of any trust hereunder or for any other remedy hereunder. It is understood and intended that no one or more Holders of the Bonds hereby secured shall have any right in any manner whatever by his or their action to affect, disturb, or prejudice the security of this Agreement, or to enforce any right hereunder, that all suits, actions and proceedings at law or in equity shall be instituted, had and maintained in the manner herein provided and for the benefit of all Holders of such outstanding Bonds, and that any individual right of action or other right given to one or more of such Holders by law is restricted by this Agreement to the rights and remedies herein provided.

SECTION 706. No Remedy Exclusive. No remedy herein conferred upon or reserved to the Holders of the Bonds is intended to be exclusive of any other remedy or remedies herein provided, and each and every such remedy shall be cumulative and shall be in addition to every other remedy given hereunder.

SECTION 707. No Delay or Omission Construed to be a Waiver. No delay or omission of the Trustee, or any Holder of the Bonds to exercise any right or power accruing upon any default shall impair any such right or power or shall be construed to be a waiver of any such default or an acquiescence therein; and every power and remedy given by this Agreement to the Trustee and to the Holders may be exercised from time to time and as often as may be deemed expedient.

SECTION 708. Actions of Trustee. All rights of action under this Agreement or under any of the Bonds enforceable by the Trustee, may be enforced by it without the possession of any of the Bonds or the production thereof in the trial or other proceeding relative thereto, and any such suit, action or proceeding instituted by the Trustee shall be brought in its name for the benefit of all the Holders of such Bonds, subject to the provisions of this Agreement.

ARTICLE VIII.

CONCERNING THE TRUSTEE

SECTION 801. Acceptance of Trusts. The Trustee accepts and agrees to execute the trusts imposed upon it by this Agreement, but only upon the terms and conditions set forth in this Article and subject to the provisions of this Agreement, to all of which the parties hereto and the respective Holders of the Bonds agree.

The Trustee undertakes to perform such duties and only such duties as are specifically set forth in this Agreement, and no implied covenants or obligations shall be read into this Agreement against the Trustee.

SECTION 802. Trustee Entitled to Indemnity. The Corporation shall indemnify the Trustee for, and hold it harmless against, any loss, liability or reasonable expense (including, without limitation, fees and expenses of its agents and counsel) incurred without negligence on its part, arising out of or in connection with the acceptance or administration of the trust or trusts hereunder or in connection with the exercise or performance of any of its powers or duties hereunder, all such obligations of the Corporation being payable solely from Pledged Revenues. Any other provisions of this Agreement to the contrary notwithstanding, the Trustee shall be under no obligation to institute any suit, or to take any remedial proceeding under this Agreement, or to enter any appearance or in any way defend in any suit in which it may be made defendant, or to take any steps in the execution of the trusts hereby created or in the enforcement of any rights and powers hereunder, until it shall be indemnified to its satisfaction against any and all costs and expenses, outlays and counsel fees and expenses and other reasonable disbursements, and against all liability; the Trustee may, nevertheless, begin suit, or appear in and defend suit, or do anything else in its judgment proper to be done by it as such Trustee, without prior indemnity and in such case it shall be indemnified and reimbursed by the Corporation for all liabilities, costs and expenses, outlays and counsel fees and expenses and other reasonable disbursements properly incurred in connection therewith. The provisions of this Section shall survive the termination of this Agreement.

SECTION 803. Limitation on Trustee's Liabilities. The Trustee shall have no responsibility in respect of the validity, sufficiency, due execution or acknowledgment of this Agreement or the validity or sufficiency of the security provided hereunder, or except as to the authentication thereof, in respect of the validity of the Bonds or the due execution or issuance thereof. The Trustee shall not be liable or responsible because of the loss of any deposit of moneys arising through the insolvency or the act or default or omission of any other bank or trust company in which such deposit shall have been made by the Trustee under the provisions of this Agreement or by the Corporation. The Trustee shall not be responsible for the application of any of the proceeds of the Bonds, or the application of any other moneys deposited with it and paid out, withdrawn or transferred hereunder, if the application by the Trustee of such proceeds and such other moneys and such payment, withdrawal or transfer shall be made in accordance with the provisions of this Agreement. The Trustee shall not be liable in connection with the performance of its duties hereunder or for any error of judgment made in good faith by it, except for its own negligence or willful misconduct. The Trustee may confer with competent legal counsel of its selection and shall not be liable for any action taken or suffered by it in good faith in accordance with an opinion of counsel. The immunities and exemptions from liability of the Trustee hereunder shall extend to its directors, officers, employees and agents.

The Trustee may execute any of the trusts or powers hereunder or perform any duties hereunder either directly or by or through agents or attorneys and the Trustee shall not be responsible for any misconduct or negligence on the part of any agent or attorney appointed with due care by it hereunder.

No provision of this Agreement shall require the Trustee to expend or risk its own funds or otherwise incur any financial liability in the performance of any of its duties hereunder, or in the exercise of any of its rights or powers, if it shall have reasonable grounds for believing that repayment of such funds or adequate indemnity against such risk or liability is not reasonably assured to it.

The Trustee shall not be liable for any action taken, suffered, or omitted to be taken by it in good faith and reasonably believed by it to be authorized or within the discretion or rights or powers conferred upon it by this Agreement, unless it shall be proved that the Trustee was negligent in ascertaining the pertinent facts.

The rights, privileges, protections, immunities and benefits given to the Trustee, including, without limitation, its right to be indemnified, are extended to, and shall be enforceable by, the Trustee in each of its capacities hereunder, and each agent, custodian and other person employed to act hereunder.

SECTION 804. Compensation. Subject to the provisions of any contract between the Corporation and the Trustee and to Sections 401 and 601 hereof, the Corporation shall pay to the Trustee such compensation as shall be agreed in writing between the Corporation and the Trustee for all services rendered by it hereunder and also all of its reasonable expenses, charges and other disbursements and those of its attorneys, agents and employees incurred in and about the acceptance, administration and execution of the trusts hereby created, and the performance of its powers and duties hereunder. The provisions of this Section shall survive the termination of this Agreement.

SECTION 805. Trustee May Rely on Certificates. In case at any time it shall be necessary or desirable for the Trustee to make any investigation respecting any fact preparatory to taking or not taking any action or doing or not doing anything as such Trustee, and in any case in which this Agreement provides for permitting or taking any action, and whenever in the administration of this Agreement the Trustee shall deem it desirable that a matter be proved or established prior to taking, suffering or omitting any action hereunder, the Trustee may, in the absence of bad faith, rely conclusively upon any certificate, requisition, opinion or other instrument required or permitted to be filed with it under the provisions of this Agreement, and any such instrument shall be conclusive evidence of such fact to protect the Trustee in any action that it may or may not take or in respect of anything it may or may not do, in good faith, by reason of the supposed existence of such fact. Except as otherwise provided in this Agreement, any request, notice, certificate or other instrument from the Corporation to the Trustee shall be deemed to have been signed by the proper party or parties if signed by the President or by any officer or employee of the Corporation who shall be designated by the Corporation by resolution for the purpose, and the Trustee may accept and rely upon a certificate signed by the President or any other officer or employee of the Corporation as to any action taken by the Corporation.

SECTION 806. Notice of Default. The Trustee shall mail to the Holders of the Bonds then Outstanding, at their addresses as they appear on the registration books, within thirty (30) days after the Trustee shall have actual knowledge of such default, and to any provider of a Credit Facility or a Liquidity Facility, at its address as known by the Trustee, within fifteen (15) days after the Trustee shall have actual knowledge of such default, written notice of any default in the payment of principal of and interest and premium on any Bond, and any other default actually known to the Trustee unless such default shall have been cured or waived. Except for such payment defaults, the Trustee shall not be deemed to have knowledge of any default hereunder unless specifically notified in writing by the Holders of not less than ten percent (10%) in principal amount of the Bonds Outstanding.

Notwithstanding the foregoing, except for any default in the payment of principal of and interest and premium on any Bond, the Trustee may withhold and shall be protected in withholding any notice to the Holders if and so long as the Trustee in good faith determines that the withholding of such notice is in the interests of the Holders.

SECTION 807. Trustee May Be Bondholder. The bank or trust company acting as Trustee under this Agreement, and its directors, officers, agents or employees in their respective individual or other capacities, may buy, sell, own, hold and deal in any of the Bonds issued under and secured by this Agreement, and may join in any action which any Holder of Bonds may be entitled to take with like effect and may otherwise deal with the Corporation as if such bank or trust company were not the Trustee under this Agreement, may engage or be interested in any financial or other transaction with the Corporation, and may maintain any and all of the general banking and business relations with the Corporation with like effect and in the same manner as if the Trustee were not a party to this Agreement; and no implied covenant shall be read into this Agreement against the Trustee in respect of such matters.

SECTION 808. Trustee Not Responsible for Recitals. The recitals, statements and representations contained herein and in the Bonds (excluding the Trustee's certificate of authentication on the Bonds) shall be taken and construed as made by and on the part of the Corporation and not by the Trustee, and the Trustee assumes and shall be under no responsibility for the correctness of the same. The Trustee makes no representation as to the validity or sufficiency of this Agreement or the Bonds.

SECTION 809. Trustee Protected in Relying on Papers. The Trustee shall be protected in acting or proceeding, or in not acting or not proceeding, in good faith, upon any resolution, order, notice, request, consent, waiver, certificate, statement, affidavit, requisition, bond or other paper or document which it shall in good faith believe to be genuine and to have been passed or signed by the proper board or person or to have been prepared and furnished pursuant to any of the provisions of this Agreement, or upon the written opinion or other advice of any attorney believed by the Trustee to be qualified in relation to the subject matter, and the Trustee shall be under no duty to make any investigation or inquiry as to any statements contained or matters referred to in any such instrument.

The Trustee may request that the Corporation deliver an officer's certificate setting forth the names of individuals and/or titles of officers authorized at such time to take specified actions pursuant to this Agreement, which officer's certificate may be signed by any person authorized to sign an officer's certificate, including any person specified as so authorized in any such certificate previously delivered and not superseded.

SECTION 810. Resignation of Trustee. The Trustee may resign and thereby become discharged from the trusts hereby created, by notice in writing to be given to the Corporation not less than sixty (60) days before such resignation is to take effect, but such resignation shall take effect immediately upon the appointment of a new Trustee hereunder, if such new Trustee shall be appointed before the time limited by such notice and shall then accept the trusts hereof.

No resignation by the Trustee under this Section, no removal of the Trustee under Section 811 hereof and no appointment of a successor Trustee under Section 812 hereof shall become effective until the acceptance of appointment by the successor Trustee under Section 813 hereof.

SECTION 811. Removal of Trustee. The Trustee may be removed at any time by an instrument or concurrent instruments in writing, signed by the Holders of not less than a majority in principal amount of the Bonds hereby secured and then outstanding and filed with the Corporation. A photo-static copy of each such instrument shall be delivered promptly by the Corporation to the Trustee. The Trustee may also be removed at any time for any breach of trust or for acting or proceeding in violation of, or for failing to act or proceed in accordance with, any provision of this Agreement with respect to the duties and obligations of the Trustee by any court of competent jurisdiction upon the application of the Corporation pursuant to resolution of the Holders of not less than ten percent (10%) in aggregate principal amount of the Bonds then Outstanding under this Agreement.

SECTION 812. Appointment of Successor Trustee. If at any time hereafter the Trustee shall resign, be removed, be dissolved or otherwise become incapable of acting, or the bank or trust company acting as Trustee shall be taken over by any governmental official, agency, department or board, the position of Trustee shall thereupon become vacant. If the position of Trustee shall become vacant for any reason, the Corporation shall appoint a Trustee to fill such vacancy.

At any time within one year after any such vacancy shall have occurred, the Holders of a majority in principal amount of the Bonds hereby secured and then Outstanding, by an instrument or concurrent instruments in writing, signed by such Bondholders or their attorneys in fact thereunto duly authorized and filed with the Corporation, may appoint a successor Trustee, which shall supersede any Trustee theretofore appointed by the Corporation. Photo-static copies of each such instrument shall be delivered promptly by the Corporation to the predecessor Trustee and to the Trustee so appointed by the Bondholders.

If no appointment of a successor Trustee shall be made pursuant to the foregoing provisions of this Section within ten (10) days after the vacancy shall have occurred, the Holder of any Bond Outstanding hereunder or any retiring Trustee may apply, at the expense of the Corporation, to any court of competent jurisdiction to appoint a successor Trustee. Such court may thereupon, after such notice, if any, as such court may deem proper and prescribe, appoint a successor Trustee.

Any Trustee hereafter appointed shall be a corporation duly authorized to exercise corporate trust powers and subject to examination by Federal, state or Commonwealth authority and in good standing and having at the time of its appointment a combined capital and surplus aggregating at least FIFTY MILLION DOLLARS (\$50,000,000).

Within thirty (30) days after the appointment of a successor Trustee, the Trustee shall notify the Rating Agencies of such appointment, provided that failure to mail such notice shall not affect the validity of such appointment.

SECTION 813. Vesting of Trust with Successor Trustee. Every successor Trustee appointed hereunder shall execute, acknowledge and deliver to its predecessor, and also to the Corporation, an instrument in writing accepting such appointment hereunder, and thereupon such successor Trustee, without any further act, shall become fully vested with all the rights, immunities, powers and trusts, and subject to all the duties and obligations, of its predecessor; but such predecessor shall, nevertheless, on the written request of its successor or of the Corporation and upon payment of the expenses, charges and other disbursements of such predecessor which are payable pursuant to the provisions of Section 804 hereof, execute and deliver an instrument transferring to such successor Trustee all the rights, immunities, powers and trusts of such predecessor hereunder; and every predecessor Trustee shall deliver all property and moneys held by it hereunder to its successor. Should any instrument in writing from the Corporation be required by any successor Trustee for more fully and certainly vesting in such Trustee the rights, immunities, power and trusts hereby vested or intended to be vested in the predecessor Trustee, any such instrument in writing shall and will, on request, be executed, acknowledged and delivered by the Corporation.

SECTION 814. Reporting Requirements. The Trustee shall, on a semiannual basis, file with the Corporation a statement setting forth in respect of the preceding six calendar months:

(a) the amount withdrawn or transferred by it and the amount deposited with it on account of each Fund and Account held by it under the provisions of this Agreement;

(b) the amount on deposit with it at the end of such month to the credit of each such Fund and Account;

(c) a brief description of all obligations held by it as an investment of moneys in each such Fund and Account and of any Reserve Account Letter of Credit or Reserve Account Insurance Policy in the Reserve Account (if applicable);

(d) the amount applied to the purchase or redemption of Bonds under Section 403 of this Agreement and a description of Bonds or portions of Bonds so purchased or redeemed; and

(e) any other information which the Corporation may reasonably request.

All records and files pertaining to the trusts hereunder in the custody of the Trustee shall be open at all reasonable times to the Corporation and its agents and representatives.

ARTICLE IX.

EXECUTION OF INSTRUMENTS BY BONDHOLDERS AND PROOF OF OWNERSHIP OF BONDS

SECTION 901. Proof of Execution of Documents and Ownership (a) Any request, direction, consent or other instrument in writing required by this Agreement to be signed or executed by Bondholders may be in any number of concurrent instruments of similar tenor and may be signed or executed by such Bondholders in person or by their attorneys or legal representatives appointed by an instrument in writing. Proof of the execution of any such

instrument and of the ownership of Bonds shall be sufficient for any purpose of this Agreement and shall be conclusive in favor of the Trustee with regard to any action taken by it under such instrument if made in the following manner:

(1) The fact and date of the execution by any person of any such instrument may be proved by the verification of any officer in any jurisdiction who, by the laws thereof, has power to take affidavits within such jurisdiction, to the effect that such instrument was subscribed and sworn to before him, or by an affidavit of a witness to such execution. Where such execution is on behalf of a person other than an individual, such verification shall also constitute sufficient approval of the authority of the signor thereof.

(2) The ownership of Bonds shall be proved by the registration books required to be maintained pursuant to the provisions of Article II of this Agreement.

Nothing contained in this Article shall be construed as limiting the Trustee to such proof, it being intended that the Trustee may accept any other evidence of the matters herein stated which it may deem sufficient.

(b) If the Corporation shall solicit from the Holders any request, direction, consent or other instrument in writing required or permitted by this Agreement to be signed or executed by the Holders, the Corporation may, at its option, fix in advance a record date for determination of Holders entitled to give each request, direction, consent or other instrument, but the Corporation shall have no obligation to do so. If such a record date is fixed, such request, direction, consent or other instrument may be given before or after such record date, but only the Holders of record at the close of business on such record date shall be deemed to be Holders for the purposes of determining whether Holders of the requisite proportion of Bonds have authorized or agreed or consented to such request, direction, consent or other instrument, and for that purpose the Bonds shall be computed as of such record date.

(c) Any request or consent of the Holder of any Bond shall bind every future Holder of the same Bond or any Bond issued in place thereof in respect of anything done by the Trustee pursuant to such request or consent.

ARTICLE X. SUPPLEMENTAL AGREEMENTS

SECTION 1001. Supplemental Agreements Without Bondholders' Consent. The Corporation and the Trustee may, without the consent or approval of, or notice to, any of the Bondholders, from time to time and at any time, enter into such agreements supplemental hereto as shall not be inconsistent with the terms and provisions hereof (which supplemental agreements shall thereafter form a part hereof):

(a) to cure any ambiguity or formal defect or omission in this Agreement or in any supplemental agreement or to correct or supplement any provision contained herein that may be defective or inconsistent with any other provisions contained herein; or

(b) to grant to or confer upon the 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 Trustee; or

(c) to add to the conditions, limitations and restrictions on the issuance of Bonds under the provisions of this Agreement, other conditions, limitations and restrictions thereafter to be observed; or

(d) to add to the covenants and agreements of the Corporation in this Agreement other covenants and agreements thereafter to be observed by the Corporation or to surrender any right or power herein reserved to or conferred upon the Corporation; or

(e) to permit the issuance of Bonds in coupon form; or

(f) to qualify the Bonds or any of the Bonds for registration under the Securities Act of 1933, as amended, or the Securities Exchange Act of 1934, as amended; or

(g) to qualify this Agreement as an "indenture" under the Trust Indenture Act of nineteen hundred thirty-nine (1939), as amended; or

(h) to make such changes as may be necessary to adjust the terms hereof so as to facilitate the issuance of Variable Rate Bonds, Capital Appreciation Bonds, Capital Appreciation and Income Bonds, Put Bonds, Interim Bonds and such other Bonds as may be marketable from time to time; or

(i) to make such changes as may be necessary to comply with the provisions of Puerto Rico law relating to the exclusion of interest on the Bonds from gross income thereunder; or

(j) to make such changes as may evidence the right and interest of an issuer of a Credit Facility or a Liquidity Facility that secures any Series of Bonds.

(k) to make such changes as may be necessary to create a Reserve Account for any Bonds.

SECTION 1002. Modification with Consent of Holders of Majority of Bonds.

Subject to the terms and provisions contained in this Section, and not otherwise, the Holders of not less than a majority in aggregate principal amount of the Bonds at the time Outstanding (or in case less than all of several Series of Bonds then Outstanding are affected by the supplement hereto, the Holders of not less than a majority in principal amount of the Bonds of each Series so affected and Outstanding at the time the consent is given) shall have the right, from time to time, anything contained in this Agreement to the contrary notwithstanding, to consent to and approve the execution by the Corporation and the Trustee of such agreement or agreements supplemental hereto as shall be deemed necessary or desirable by the Corporation for the purpose of modifying, altering, amending, adding to or rescinding, in any particular, any of the terms or provisions contained in this Agreement or in any supplemental agreement; provided, however, that nothing herein contained shall permit, or be construed as permitting, without the consent of the Holders of one hundred percent (100%) of the Bonds Outstanding affected by the proposed

supplemental agreement (a) an extension of the time for the payment of the principal of or the interest on any Bond, or (b) a reduction in the principal amount of any Bond or the redemption premium or the rate of interest thereon, or (c) the creation of any lien or a pledge of funds other than the lien and pledge created by this Agreement, or (d) a preference or priority of any Bond or Bonds over any other Bond or Bonds, or (e) a reduction in the aggregate principal amount of the Bonds required for consent to such supplemental agreement or any waiver hereunder. Nothing herein contained, however, shall be construed as making necessary the approval by Bondholders of the execution of any supplemental agreement authorized by Section 1001 of this Article. The provider of any Credit Facility or Liquidity Facility (if applicable) shall have the right in lieu of the Holders of the Bonds secured thereby, to give consent to any supplemental agreement for which consent of the Holders of such Bonds is required under this Article and all references to Bondholder for purposes of such consent shall mean instead the provider of such Credit Facility or Liquidity Facility; provided, however, that such provider of a Credit Facility or Liquidity Facility shall not be in default on its obligations in connection with such Credit Facility or Liquidity Facility.

If at any time the Corporation shall request the Trustee to enter into any supplemental agreement for any of the purposes of this Section, the Trustee shall cause a notice to be mailed, postage prepaid, to all Bondholders then Outstanding at their addresses as they appear on the registration books, to any provider of a Credit Facility or Liquidity Facility and to the Rating Agencies. Such notice shall briefly set forth the nature of the proposed supplemental agreement and shall state that a copy thereof is on file at the principal corporate trust office of the Trustee for inspection by all Bondholders. The Trustee shall not, however, be subject to any liability to any Bondholder by reason of its failure to mail the notice required by this Section, and any such failure shall not affect the validity of such supplemental agreement when consented to or approved as provided in this Section.

Whenever, at any time within a year after the date of the mailing of such notice, the Corporation shall deliver to the Trustee an instrument or instruments purporting to be executed by the Holders of at least a majority in aggregate principal amount of the Bonds then Outstanding, which instrument or instruments shall refer to the proposed supplemental agreement described in such notice and shall specifically consent to and approve the execution thereof, thereupon, but not otherwise, the Trustee may execute such supplemental agreement without liability or responsibility to any Holder of any Bond, whether or not such Holder shall have consented thereto. It shall not be necessary for the consent of the Holders to approve the particular form of any proposed supplemental agreement, but it shall be sufficient if such consent shall approve the substance thereof.

If the Holders of not less than a majority in aggregate principal amount of the Bonds of each Series affected and Outstanding at the time of the execution of such supplemental agreement or any record date established in connection therewith pursuant to Section 901(b) hereof shall have consented to and approved the execution thereof as herein provided, no Holder shall have any right to object to the execution of such supplemental agreement, or to object to any of the terms and provisions therein contained, or the operation thereof, or in any manner to question the propriety of the execution thereof, or to enjoin or restrain the Trustee or the Corporation from executing the same or from taking any action pursuant to the provisions thereof.

The consent of the Holders of any additional Series of Bonds to be issued hereunder shall be deemed given if the underwriters or initial purchasers for resale consent in writing to such supplemental agreement and the nature of the amendment effected by such supplemental agreement is disclosed in the official statement or other offering document pursuant to which such additional Series of Bonds is offered and sold to the public.

Upon the execution of any supplemental agreement pursuant to the provisions of this Section, this Agreement shall be and be deemed to be modified and amended in accordance therewith, and the respective rights, duties and obligations under this Agreement of the Corporation, the Trustee, and all Holders of Outstanding Bonds shall thereafter be determined, exercised and enforced hereunder, subject in all respects to such modifications and amendments.

SECTION 1003. Trustee Joining in Supplemental Agreements. The Trustee is authorized to join with the Corporation in the execution of any such supplemental agreement and to make the further agreements and stipulations which may be contained therein, but the Trustee may, but shall not be obligated (except to the extent required in the case of a supplemental agreement entered into pursuant to Section 1001(g) hereof) to, enter into any such supplemental agreement which affects its rights, duties, or immunities under this Agreement. Any supplemental agreement executed in accordance with the provisions of this Article shall thereafter form a part of this Agreement; and all the terms and conditions contained in any such supplemental agreement as to any provision authorized to be contained therein shall be and be deemed to be part of the terms and conditions of this Agreement for any and all purposes. In case of the execution and delivery of any supplemental agreement, express reference may be made thereto in the text of any Bonds issued thereafter, if deemed necessary or desirable by the Trustee.

SECTION 1004. Responsibilities of Trustee under this Article. The Trustee shall not be under any responsibility or liability to the Corporation or to any Bondholder or to anyone whomsoever for its refusal in good faith to enter into any such supplemental agreement if such agreement is deemed by the Trustee to be contrary to the provisions of this Article. The Trustee shall be entitled to receive, and shall be fully protected in relying upon, the opinion of any counsel, including counsel for the Corporation, as conclusive evidence that any such supplemental agreement complies with the provisions of this Agreement, and that it is proper for the Trustee, under the provisions of this Article, to join in the execution of such supplemental agreement.

SECTION 1005. Bond Resolution May Be Supplemented or Modified. Resolutions of the Board authorizing the issuance of any Series of Bonds may be supplemented or modified by subsequent resolution of the Board; provided that the provisions of this Article shall apply, except as otherwise provided in Section 602 hereof, to each supplementing or modifying resolution with the same force and effect as if the same were supplemental or amendatory of this Agreement.

ARTICLE XI.

AMENDMENTS TO THE NOTES

SECTION 1101. Amendments Not Requiring Consent. The Trustee (as assignee of the Notes) may, without the consent or approval of, or notice to, any of the Bondholders, enter into, from time to time and at any time, such amendments to the Notes in form satisfactory to the Trustee, as shall not be inconsistent with the terms and provisions thereof to:

(a) cure any ambiguity or formal defect or omission in the Notes, provided such action shall not materially adversely affect the interests of the Bondholders, or

(b) grant to or confer upon the Corporation or 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 Corporation or Bondholders or the Trustee, or

(c) provide for the substitution of any Notes for other notes of Authorized Debtors, provided that such substitution does not restrict, limit or reduce the obligation of the Authorized Debtors to make payments sufficient to pay the principal of and interest on the Bonds, or otherwise impair the security of the Bondholders of any Series of Bonds under this Agreement, or

(d) change the Allocable Share and/or the Applicable Percentage (as defined in the Notes) with respect to any Notes, provided that such change does not restrict, limit or reduce the obligation of the Authorized Debtors to make payments sufficient to pay the principal of and interest on the Bonds, or

(e) permit the refunding of all or any portion of the Bonds issued hereunder, provided that such refunding does not restrict, limit or reduce the obligation of the Authorized Debtors to make payments sufficient to pay the principal of and interest on the Bonds, or otherwise impair the security of the Bondholders of any Series of Bonds under this Agreement

(f) make any other change which, in the judgment of the Trustee, based upon an opinion of counsel, will not restrict, limit or reduce the obligation of the Authorized Debtors to make payments under the Notes sufficient to pay the principal of or interest on the Bonds, or otherwise impair the security of the Bondholders under this Agreement.

SECTION 1102. Amendments Requiring Consent of Holders of a Majority in Principal Amount of Bonds. Except for amendments provided for in Section 1101, the Trustee shall not enter into any amendment to the Notes unless notice of the proposed amendment shall have been given and the holders of not less than a majority in aggregate principal amount of the Bonds then Outstanding shall have consented to and approved the execution thereof, all as provided for in Section 1002 hereof in the case of supplements and amendments to this Agreement; and provided further that without the consent of all of the holders of the Bonds Outstanding affected by such change, no such amendment shall be entered into by the Trustee which would restrict, limit or reduce the obligations of the Authorized Debtors with respect to the Bonds.

ARTICLE XII.

DEFEASANCE

SECTION 1201. Defeasance. If all the Outstanding Bonds shall have been paid or deemed to have been paid as provided below, and the Trustee shall have received written notice from each provider of a Credit Facility or Liquidity Facility or any Hedge Counterparty that all amounts then due and owing to such providers of a Credit Facility, Liquidity Facility or Rate Swap have been paid, then and in that case the right, title and interest of the Trustee hereunder (except under Section 804 of this Agreement) shall cease, terminate and become void, and such Bonds shall cease to be entitled to any benefit or security under this Agreement except for Sections 205, 206 and 211 of this Agreement. In such event, the Trustee shall transfer and assign to the Corporation all property then held by the Trustee, shall execute such documents as may be reasonably required by the Corporation to evidence such transfer and assignment and shall turn over to the Corporation any surplus in any account in the Sinking Fund.

Any Outstanding Bond shall be deemed to have been paid within the meaning and with the effect expressed in this Section 1201 when the whole amount of the principal of and interest on such Bond shall have been paid or when (a) there shall have been deposited with the Trustee or another fiduciary institution acting as escrow agent for the Holder of such Bond either moneys in an amount that shall be sufficient, or Government Obligations, which shall not contain provisions permitting the redemption thereof at the option of the issuer, the principal of and interest on which when due, and without any reinvestment thereof, will provide moneys which, together with the moneys, if any, deposited with or held by the Trustee available therefor, shall be sufficient, to pay when due the principal of and premium, if any, and interest due and to become due on such Bond on or prior to the redemption date or maturity date thereof, as the case may be, and (b) in the event such Bond does not mature and is not to be redeemed within the next succeeding sixty (60) days, the Corporation shall have given the Trustee irrevocable instructions to give, as soon as practicable, a notice to the Holder of such Bond by first-class mail, postage prepaid, stating that the deposit of moneys or Government Obligations has been made with the Trustee or another fiduciary institution acting as escrow agent for the Holder of such Bond, and that such Bond is deemed to have been paid in accordance with this Section and stating such maturity or redemption date upon which moneys are to be available for the payment of the principal of and premium, if any, and interest on such Bond. Neither the moneys nor Government Obligations deposited with the Trustee or other fiduciary institution acting as escrow agent nor principal or interest payments on any such obligations shall be withdrawn or used for any purpose other than, and shall be held in trust for, the payment of the principal of and premium, if any, and interest on such Bonds. The Trustee shall be entitled to request and rely upon a verification report of an independent third party as to the sufficiency of the moneys or Government Obligations to pay such Bonds.

As to Variable Rate Bonds, the amount required for the interest thereon shall be calculated at the maximum rate permitted by the resolution of the Board authorizing the issuance of the Variable Rate Bonds; provided, however, that if on any date the total amount of moneys and Government Obligations on deposit for the payment of interest on such Variable Rate Bonds is in excess of the total amount which would have been required to be deposited on such date in respect of such Variable Rate Bonds in order to fully discharge and satisfy such Bonds pursuant

to the provisions of this Section, the Corporation may use the amount of such excess, free and clear of any trust, lien, security interest, pledge or assignment securing said Variable Rate Bonds or otherwise existing under this Agreement.

Notwithstanding any of the provisions of this Agreement to the contrary, Put Bonds may only be fully discharged and satisfied either by paying the principal of and interest on said Bonds as they become due and payable or by depositing moneys which shall be sufficient at the time of such deposit to pay when due the maximum amount of principal of and redemption premium, if any, and interest on such Put Bonds which could become payable to the Holders of such Bonds upon the exercise of any options provided to the Holders of such Bonds and the Corporation; provided, however, that if, at the time a deposit is made pursuant to this paragraph, the options originally exercisable are no longer exercisable, such Bonds shall not be considered Put Bonds for these purposes.

If any portion of the moneys deposited for the payment of the principal of and redemption premium, if any, and interest on any Bond is not required for such purpose, the Corporation may use the amount of such excess, free and clear of any trust, lien, security interest, pledge or assignment securing such Bond. Within thirty (30) days after the defeasance of Bonds, the Trustee shall notify the Rating Agencies of such defeasance, provided that failure to mail such notice shall not affect the defeasance of such Bonds.

ARTICLE XIII.

GDB LETTERS OF CREDIT; DRAWS

SECTION 1301. Draws on GDB Letters of Credit. If (i) the Trustee has not received by the close of business on the third Business Day preceding August 1 of any Fiscal Year during the term of the Bonds written notice signed by the President that an operating budget for the Commonwealth for such Fiscal Year has been duly adopted by the Legislature of Puerto Rico and approved by the Governor of Puerto Rico and is then in effect and (ii) the Trustee has not otherwise received funds representing the full amount of the principal and interest due with respect to the Bonds for the Bond Year commencing within such Fiscal Year, the Trustee shall draw, before 5:00 p.m. on the second Business Day preceding August 1, under the GDB Letters of Credit in accordance with the respective terms thereof an amount which, together with all the amounts on deposit in the Sinking Fund on that date, is sufficient to pay the principal of or interest on the Bonds due during such Bond Year and shall deposit the proceeds in the Sinking Fund, in the order established in Section 401 hereof.

SECTION 1302. Enforcement by Trustee; No Reduction of Obligations. (a) In the event that Government Development Bank shall fail to make lawful payment under a GDB Letter of Credit of a drawing made and presented in strict compliance with the terms thereof, the Trustee is hereby authorized and required to enforce all of its rights under such GDB Letter of Credit by such actions at law or in equity as it deems necessary in order to protect the interest of the Holders of the Bonds.

(b) No failure by Government Development Bank to comply with the terms of a GDB Letter of Credit shall relieve or reduce any obligations of the Corporation under this Trust Agreement.

SECTION 1303. Compliance with Procedures. The Trustee shall comply with the procedures set forth in the GDB Letters of Credit.

SECTION 1304. Supplements and Amendments to the GDB Letter of Credit Not Requiring Consent. Anything in this Trust Agreement to the contrary notwithstanding, the Trustee, the Corporation and Government Development Bank may, without the consent or approval of, or notice to, any of the Bondholders, agree to and execute, from time to time and at any time, such amendments and supplements to any GDB Letter of Credit as shall not be inconsistent with the terms and provisions thereof, which amendments or supplements in the opinion of the Trustee, based upon an opinion of counsel, shall not be detrimental to the interests of the Holders of the Bonds (which supplements and amendments shall thereafter form a part thereof), to

(a) cure any ambiguity or formal defect or omission in a GDB Letter of Credit or in any supplement thereto,

(b) grant to or confer upon the Trustee for the benefit of the Holders of the Bonds any additional rights, remedies, powers, authority or security that may lawfully be granted to or conferred upon the Holders of the Bonds or the Trustee, or

(c) reduce the stated amount of a GDB Letter of Credit to the extent that the Maximum Difference relating to the Bonds that have the benefit of such GDB Letter of Credit is reduced, as certified by the President or any Executive Vice President of the Corporation, or increase the stated amount of such GDB Letter of Credit, or

(d) make any other change which, in the judgment of the Trustee, based upon an opinion of counsel, will not restrict, limit or reduce the obligation of Government Development Bank to make the payments under the GDB Letters of Credit to pay the principal of or interest on the Bonds or otherwise impair the security of the Holders of the Bonds under this Trust Agreement.

SECTION 1305. Supplements and Amendments to the GDB Letters of Credit Requiring Consent of Holders of a Majority of Bonds. Anything in this Trust Agreement to the contrary notwithstanding, except for supplements or amendments provided for in Section 1304, the Trustee shall not agree to any supplement or amendment to any of the GDB Letters of Credit unless notice of the proposed execution of such supplement or amendment shall have been given to the Holders of the Bonds that have the benefit of the GDB Letter of Credit to be amended or supplemented and the Holders of not less than a majority in aggregate principal amount of such Bonds at the time Outstanding shall have consented to and approved the execution thereof, all as provided for in Section 1002 in the case of supplements and amendments to this Trust Agreement and with the same effect as provided in Section 1002; provided that the Trustee shall be entitled to exercise its discretion in consenting or not consenting to any such supplement or amendment in the same manner as provided for in Section

1004. Nothing herein contained shall permit or be construed as permitting any amendment or modification of any provision of the GDB Letters of Credit which would reduce the amount of any payment required to be made thereunder to the Trustee, or would postpone the time of any such payment, or would alter the conditions under which any such payment is made, or any other amendment or modification which would adversely affect the security of the Holders of the Bonds that have the benefit of such GDB Letter of Credit, as the case may be.

SECTION 1306. Successor Letters of Credit. At any time prior to the expiration of a GDB Letter of Credit or any Successor Letter of Credit (as defined below) then outstanding, the Corporation may at its option provide for the delivery to the Trustee of a successor letter of credit in the same stated amount as the GDB Letter of Credit or the Successor Letter of Credit which is being replaced, issued by a bank, banking association or trust company whose long-term debt obligations are rated at the time of issuance of such successor letter of credit in any of the three highest rating categories (without regard to any gradations within any such category) by Moody's and S&P (the "Successor Letter of Credit"). Any Successor Letter of Credit must be for a term at least as long as the remaining term of the GDB Letter of Credit or the Successor Letter of Credit which is being replaced, and shall contain administrative provisions substantially similar to those of the GDB Letter of Credit and reasonably acceptable to the Trustee.

The Trustee shall not accept delivery of any Successor Letter of Credit unless it shall have received on or prior to the delivery thereof the following documents:

(a) an executed copy of the Reimbursement Agreement authorizing such Successor Letter of Credit;

(b) an opinion or opinions of counsel to the effect that (i) either (A) the acceptance by the Trustee of the Successor Letter of Credit will not require that the Bonds or the Successor Letter of Credit be registered under the Securities Act of 1933, as amended, or the qualification of any indenture under the Trust Indenture Act of 1939, as amended, or (B) any registration statement required to be filed under the Securities Act of 1933, as amended, with respect to the Bonds or the Successor Letter of Credit is effective under such Act, and any such indenture has been duly qualified under the Trust Indenture Act of 1939, as amended, and (ii) the Successor Letter of Credit is a legal, valid and binding obligation of the issuer of the Successor Letter of Credit enforceable in accordance with its terms except to the extent that the enforceability of the Successor Letter of Credit may be limited by bankruptcy, insolvency or other laws affecting creditors' rights generally and subject to general principles of equity (regardless of whether said enforceability is considered in a proceeding in equity or at law);

(c) an opinion of a recognized firm of municipal bond attorneys that the delivery of such Successor Letter of Credit is authorized by and complies with this Agreement;

(d) a written notice from each rating agency then rating the Bonds confirming that the rating on such Bonds will not be lowered or withdrawn as a result of the delivery of the Successor Letter of Credit; and

(e) such other documents and opinions as the Trustee may reasonably request.

If at any time prior to the expiration of a GDB Letter of Credit or any Successor Letter of Credit there shall have been delivered to the Trustee a Successor Letter of Credit and the documents mentioned above, then the Trustee shall accept such Successor Letter of Credit and surrender the applicable GDB Letter of Credit or any previously held Successor Letter of Credit to its issuer for cancellation in accordance with its terms. The Trustee shall cause a notice stating that a Successor Letter of Credit has been delivered in accordance with this Agreement and setting forth the name of the issuer of the Successor Letter of Credit to be mailed, postage prepaid, to all Holders of Bonds then Outstanding entitled to the benefit of such Successor Letter of Credit at their addresses as they appear on the registration books. If at any time all the Bonds entitled to the benefit of a particular GDB Letter of Credit or Successor Letter of Credit shall be deemed to have been paid within the meaning and with the effect expressed in this Agreement, the Trustee shall surrender the applicable GDB Letter of Credit or any Successor Letter of Credit to Government Development Bank or the issuer of such Successor Letter of Credit for cancellation in accordance with its terms. The Trustee shall comply with the procedures set forth in the applicable GDB Letter of Credit or Successor Letter of Credit relating to the termination thereof.

ARTICLE XIV.

MISCELLANEOUS PROVISIONS

SECTION 1401. Covenants of Corporation and Trustee Bind Their Successors. All the covenants, stipulations, obligations and agreements contained in this Agreement by or on behalf of or for the benefit of the Corporation or the Trustee shall bind or inure to the benefit of the successor or successors of the Corporation or the Trustee from time to time and any officer, board, body or commission to whom or to which any power or duty affecting such covenants, stipulations, obligations and agreements shall be transferred by or in accordance with law. Any bank or trust company having power to execute the trusts of this Agreement and otherwise qualified to act as Trustee hereunder with or into which the Trustee may be merged, converted or consolidated, or to which all or substantially all the corporate trust assets and business of the Trustee may be sold, shall be deemed to be the successor of the Trustee. Any bank or trust company with or into which any of the paying agents may be merged, converted or consolidated, or to which all or substantially all the corporate trust assets and business of such paying agents may be sold, shall be deemed the successor of such paying agents for the purposes of this Agreement.

SECTION 1402. Notices. Any notice, demand, direction, request or other instrument authorized or required by this Agreement to be given to or filed with the Corporation, the Rating Agencies or the Trustee shall be deemed to have been sufficiently given or filed for all purposes of this Agreement if mailed, by registered or certified mail, return receipt requested, postage prepaid, addressed as follows:

if to the Corporation: President, Puerto Rico Public Finance Corporation c/o Government Development Bank for Puerto Rico, Minillas Government Center Stop twenty-two (22), Santurce, Puerto Rico zero zero nine zero seven (00907) or at such other address as it may designate in writing;

if to the Rating Agencies: Standard & Poor's Ratings Services, twenty-five (25) Broadway, twenty-first (21st) Floor, New York, NY one zero zero three four (10034) or at such other address as it may designate in writing, and Moody's Investors Service, Inc., ninety-nine (99) Church Street, Ninth (9th) Floor, New York, NY one zero zero zero seven (10007), or at such other address as it may designate in writing; and

if to the Trustee: The Bank of New York, c/o The Bank of New York Trust Company of Florida, N.A., one zero one six one (10161) Centurion Parkway, Jacksonville, Florida three two two five six (32256), Attention: Corporate Trust Department or at such other address as it may designate in writing, or to any successor Trustee, if addressed to its principal corporate trust office.

All documents received by the Trustee under the provisions of this Agreement shall be retained in its possession, subject at all reasonable times to the inspection of the Corporation, any Bondholders, and the agents and representatives thereof.

SECTION 1403. Substitute Publication and Mailing. If, because of the temporary or permanent suspension of publication of any newspaper or financial journal or for any other reason, the Trustee or the Corporation shall be unable to publish in a newspaper or financial journal any notice required to be published by the provisions of this Agreement, the Trustee or the Corporation, as the case may be, shall give such notice in such other manner as in its judgment shall most effectively approximate such publication thereof, and the giving of such notice in such manner shall for all purposes of this Agreement be deemed to be compliance with the requirement for the publication thereof.

In case, by reason of the suspension of regular mail service as a result of a strike, work stoppage or similar activity, it shall be impractical to mail notice of any event to Bondholders when such notice is required to be given pursuant to any provision of this Agreement, any manner of giving notice as shall be satisfactory to the Trustee and the Corporation shall be deemed to be a sufficient giving of such notice.

SECTION 1404. No Third Party Rights. Except as herein otherwise expressly provided, nothing in this Agreement expressed or implied is intended or shall be construed to confer upon any person other than the parties hereto, the Holders of the Bonds issued under and secured by this Agreement, the provider of any Credit Facility or Liquidity Facility securing the Bonds any right, remedy or claim, legal or equitable, under or by reason of this Agreement or any provision hereof, this Agreement and all its provisions intended to be and being for the sole and exclusive benefit of the parties hereto, the Holders from time to time of the Bonds issued hereunder, the provider of any Credit Facility or Liquidity Facility securing the Bonds.

SECTION 1405. Effect of Partial Invalidity. In case any one or more of the provisions of this Agreement or of the Bonds issued hereunder shall for any reason be held to be illegal or invalid, such illegality or invalidity shall not affect any other provision of this Agreement or of the Bonds, but this Agreement and said Bonds shall be construed and enforced as if such illegal or invalid provision had not been contained therein. In case any covenant, stipulation, obligation or agreement contained in the Bonds or in this Agreement shall for any reason be held to be in violation of law, then such covenant, stipulation, obligation or agreement

shall be deemed to be the covenant, stipulation, obligation or agreement of the Corporation to the full extent permitted by law.

SECTION 1406. Effect of Covenants. All covenants, stipulations, obligations and agreements of the Corporation contained in this Agreement shall be deemed to be covenants, stipulations, obligations and agreements of the Corporation and of the Board to the full extent authorized by the Act.

Except as otherwise provided in this Agreement, all rights, powers and privileges conferred and duties and obligations imposed upon the Corporation or upon the Board by the provisions of this Agreement shall be exercised or performed by the Corporation, the Board or by such other officers, board, body or commission as may be required by law to exercise such rights, powers and privileges or to perform such duties and obligations.

No covenant, stipulation, obligation or agreement herein contained shall be deemed to be a covenant, stipulation, obligation or agreement of any member, agent or employee of the Corporation in his individual capacity, and neither the members of the Corporation nor any officer thereof executing the Bonds shall be liable personally on the Bonds or be subject to any personal liability or accountability by reason of the issuance thereof.

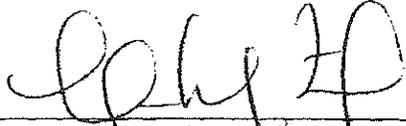
SECTION 1407. Governing Law. This Agreement shall be governed by and construed in accordance with the laws of the Commonwealth, except that the rights, limitations of rights, immunities, duties and obligations of the Trustee shall be governed by the laws of the jurisdiction of its incorporation or in the case of any Trustee which is incorporated under the laws of the United States, the laws of the jurisdiction in which its principal corporate trust office is located.

SECTION 1408. Payments Due on Saturdays, Sundays and Holidays. In any case where the date of payment of interest on or principal of the Bonds or the date fixed for redemption of any Bonds shall be a Saturday, Sunday or other day on which commercial banking institutions in the Commonwealth and in the Borough of Manhattan, City and State of New York are closed, then payment of interest or principal, and premium, if any, need not be made on such date but may be made on the next succeeding Business Day with the same force and effect as if made on said date of payment or the date fixed for redemption, and no interest on such payment shall accrue for the period after such date.

SECTION 1409. Headings, etc. Not Part of Agreement. Any headings preceding the texts of the several articles hereof and any table of contents appended to copies hereof shall be solely for convenience of reference and shall not constitute a part of this Agreement, nor shall they affect its meaning, construction or effect.

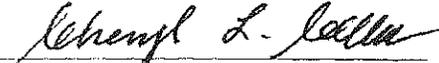
IN WITNESS WHEREOF, the Corporation and the Trustee have caused this Trust Agreement to be executed by their respective duly authorized officers, all as of the date and year first written above.

PUERTO RICO PUBLIC FINANCE
CORPORATION



Executive Vice President

U.S. BANK TRUST NATIONAL
ASSOCIATION



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