

NEW ISSUE - BOOK-ENTRY ONLY

See "Book-Entry Only System" under *The Bonds*

In the opinion of Quiñones & Sánchez PSC, Special Tax Counsel, as described herein, under existing statutes, the Bonds, and the interest thereon, are exempt from Commonwealth of Puerto Rico taxation. Under most circumstances, interest on the Bonds are exempt from United States income taxation to residents of Puerto Rico. Interest on the 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 herein.

\$91,200,000

**COMMONWEALTH OF PUERTO RICO
Public Improvement Bonds of 2007, Series B
(General Obligation Bonds)**

Dated: Date of Delivery

Due: July 1, as shown on the inside cover

The Bonds are issuable as registered bonds without coupons and will be initially registered only in the name of Cede & Co., as nominee of The Depository Trust Company, New York, New York ("DTC"), which will act as securities depository for the Bonds. Bonds will be available to purchasers in denominations of \$5,000 and whole multiples thereof only under the book-entry system maintained by DTC through brokers and dealers who are, or act through, DTC Participants. **Purchasers will not receive delivery of the Bonds. So long as any purchaser is the beneficial owner of a Bond, he must maintain an account with a broker or dealer who is, or acts through, a DTC Participant to receive payment of principal and interest on such Bond.** See "Book-Entry Only System" under *The Bonds*. Interest on the Bonds will accrue from their date of issuance at the annual rates described on the inside front cover, and will be payable monthly commencing on November 1, 2007. The Bonds are subject to redemption prior to maturity as set forth herein, the earliest possible date of redemption being July 1, 2012.

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

The Bonds are offered for delivery when, as and if issued and accepted by the Underwriters subject to the approval of legality by Squire, Sanders & Dempsey L.L.P., Miami, Florida, Bond Counsel, and certain other conditions. Certain legal matters will be passed upon by Quiñones & Sánchez PSC, San Juan, Puerto Rico, as Underwriters' Counsel and Special Tax Counsel. It is expected that the Bonds will be available for delivery through the facilities of DTC on or about October 4, 2007.

This cover page contains certain information for quick reference only. It is not a summary of this issue. Investors must read the entire Official Statement to obtain information essential to the making of an informed investment decision.

Popular Securities

Santander Securities

UBS Financial Services Incorporated of Puerto Rico

BBVAPR MSD

Citi

Lehman Brothers

Merrill Lynch & Co.

Oriental Financial Services

Samuel A. Ramirez & Co., Inc.

TCM Capital, Inc.

Wachovia Capital Markets, LLC

\$91,200,000
COMMONWEALTH OF PUERTO RICO
Public Improvement Bonds of 2007, Series B
(General Obligation Bonds)

Maturity July 1,	Amount	Interest Rate	Yield	CUSIP
2009	\$ 7,750,000	5.15%	5.15%	74514L LK1
2010	8,150,000	5.25	5.25	74514L LL9
2011	8,550,000	5.40	5.40	74514L LM7
2012	9,050,000	5.45	5.45	74514L LN5
2013	9,500,000	5.50	5.50	74514L LP0
2014	10,050,000	5.55	5.55	74514L LQ8
2015	10,600,000	5.60	5.60	74514L LR6
2016	11,200,000	5.65	5.65	74514L LS4
2017	11,850,000	5.70	5.70	74514L LT2
2018	4,500,000	5.75	5.75	74514L LU9

Commonwealth of Puerto Rico

Governor

ANÍBAL ACEVEDO VILÁ

Members of the Cabinet

JORGE P. SILVA-PURAS
Chief of Staff

FERNANDO J. BONILLA
Secretary of State

ROBERTO J. SÁNCHEZ RAMOS
Secretary of Justice

JUAN C. MÉNDEZ TORRES
Secretary of the Treasury

RAFAEL ARAGUNDE TORRES
Secretary of Education

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

ROSA PÉREZ PERDOMO
Secretary of Health

SALVADOR RODRÍGUEZ
Acting Secretary of Agriculture

CARLOS GONZÁLEZ MIRANDA
*Secretary of Transportation
and Public Works*

RICARDO RIVERA CARDONA
*Secretary of Economic
Development and Commerce*

FÉLIX MATOS
Secretary of Family Affairs

JORGE RIVERA JIMENEZ
Secretary of Housing

JAVIER VÉLEZ AROCHO
*Secretary of Natural and
Environmental Resources*

VÍCTOR SUÁREZ
*Acting Secretary of
Consumer Affairs*

DAVID E. BERNIER RIVERA
Secretary of Sports and Recreation

MIGUEL A. PEREIRA
*Secretary of Corrections
and Rehabilitation*

Legislative Officers

KENNETH D. MCCLINTOCK
President, Senate

JOSÉ F. APONTE
Speaker, House of
Representatives

Fiscal Officers

JOSÉ GUILLERMO DÁVILA
Director, Office of
Management and Budget

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

No dealer, broker, sales representative, or other person has been authorized by the Commonwealth to give any information or to make any representations other than those contained herein and, if given or made, such other information or representations must not be relied upon as having been authorized by the Commonwealth. This Official Statement does not constitute an offer to sell or the solicitation of an offer to buy, nor shall there be any sale of the Bonds, by any person in any jurisdiction in which it is unlawful for such person to make such an offer, solicitation, or sale. The information set forth herein has been obtained from the Commonwealth and other official sources that are believed to be reliable. The information and expressions of opinion herein are subject to change without notice, and neither the delivery of this Official Statement nor any sale made hereunder shall, under any circumstances, create any implication that there has been no change in the affairs of the Commonwealth since the date hereof. The Underwriters have provided the following sentence and paragraph for inclusion in this Official Statement. The Underwriters have reviewed the information in this Official Statement in accordance with, and as part of, their respective responsibilities to investors under the federal securities laws as applied to the facts and circumstances of this transaction, but the Underwriters do not guarantee the accuracy or completeness of such information.

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

CERTAIN STATEMENTS CONTAINED IN THIS OFFICIAL STATEMENT REFLECT NOT HISTORICAL FACTS BUT FORECASTS AND "FORWARD-LOOKING STATEMENTS." THESE STATEMENTS ARE BASED UPON A NUMBER OF ASSUMPTIONS AND ESTIMATES THAT ARE SUBJECT TO SIGNIFICANT UNCERTAINTIES, MANY OF WHICH ARE BEYOND THE CONTROL OF THE COMMONWEALTH OF PUERTO RICO. IN THIS RESPECT, THE WORDS "ESTIMATES," "PROJECTS," "ANTICIPATES," "EXPECTS," "INTENDS," "BELIEVES" AND SIMILAR EXPRESSIONS ARE INTENDED TO IDENTIFY FORWARD-LOOKING STATEMENTS. ALL PROJECTIONS, FORECASTS, ASSUMPTIONS, EXPRESSIONS OF OPINIONS, ESTIMATES AND OTHER FORWARD-LOOKING STATEMENTS ARE EXPRESSLY QUALIFIED IN THEIR ENTIRETY BY THIS CAUTIONARY STATEMENT: ACTUAL RESULTS MAY DIFFER MATERIALLY FROM THOSE EXPRESSED OR IMPLIED BY FORWARD-LOOKING STATEMENTS.

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\$91,200,000
COMMONWEALTH OF PUERTO RICO
Public Improvement Bonds of 2007, Series B
(General Obligation Bonds)

INTRODUCTORY STATEMENT

This Official Statement of the Commonwealth of Puerto Rico (the "Commonwealth" or "Puerto Rico"), which includes the cover page, the inside cover page, the table of contents and the appendices, provides certain information in connection with the sale of \$91,200,000 Commonwealth of Puerto Rico Public Improvement Bonds of 2007, Series B (the "Bonds").

The Bonds are being issued under the provisions of Act No. 74 of the Legislature of Puerto Rico (the "Legislature"), approved on July 23, 2007, as amended by Act No. 115 of the Legislature, approved on August 31, 2007, and as supplemented by Joint Resolution No. 116 of the Legislature, approved on July 23, 2007 and Joint Resolution No. 117 of the Legislature, approved on July 23, 2007 (collectively, the "Act"), and pursuant to a resolution authorizing the issuance of the Bonds (the "Bond Resolution") adopted in accordance with the Act by the Acting Secretary of the Treasury of the Commonwealth and approved by the Governor of Puerto Rico on September 19, 2007.

Concurrently with the issuance of the Bonds, the Commonwealth is issuing its \$408,800,000 Commonwealth of Puerto Rico Public Improvement Bonds of 2007, Series A (the "Series A Bonds"), under the provisions of the Act.

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

This Official Statement includes the Commonwealth's Financial Information and Operating Data Report, dated July 1, 2007 (the "Commonwealth Report"), attached hereto as *Appendix I* and the Comprehensive Annual Financial Report of the Commonwealth for the fiscal year ended June 30, 2006, as amended, prepared by the Department of the Treasury of the Commonwealth (the "Commonwealth's Annual Financial Report"), attached hereto as *Appendix II*. The Commonwealth Report attached hereto as *Appendix I* includes important operating and financial information about the Commonwealth, including information about its economy, historical revenues and expenditures of its General Fund, the estimated year-end results for fiscal year 2007, the budget for fiscal year 2007 and 2008, and the debt of the Commonwealth's public sector, and should be read in its entirety and in conjunction with the *Recent Developments* herein. The Commonwealth's Annual Financial Report includes the basic financial statements of the Commonwealth as of and for the fiscal year ended June 30, 2006, together with the independent auditor's report thereon, dated August 1, 2007, of KPMG LLP, certified public accountants. KPMG LLP did not audit the financial statements of the Public Buildings Authority's capital project fund or the Children's Trust special revenue fund (major funds), and certain activities, funds, and component units separately identified in its report. Those financial

statements were audited by other auditors whose reports have been furnished to KPMG LLP, and its opinion as to the basic financial statements, insofar as it relates to the amounts included in the basic financial statements pertaining to such activities, funds, and component units, is based solely on the reports of the other auditors. The report of KPMG LLP contains an emphasis paragraph for the adoption of Governmental Accounting Standards Board (GASB) Statement No. 42, *Accounting and Financial Reporting for Impairment of Capitals Assets and for Insurance Recoveries*, as of June 30, 2006. The Commonwealth's Annual Financial Report has been filed by the Commonwealth with each nationally recognized municipal securities information repository ("NRMSIR").

Any appendix of an Official Statement of the Commonwealth or of any instrumentality of the Commonwealth containing any revision to the Commonwealth Report or to the Commonwealth's Annual Financial Report that is filed with each NRMSIR and the Municipal Securities Rulemaking Board, or any new or revised Commonwealth Report or Commonwealth Annual Financial Report or other document containing information that modifies or supersedes the information contained in the Commonwealth Report or in the Commonwealth's Annual Financial Report that is filed with each NRMSIR, in each case after the date hereof and prior to the termination of the offering of the Bonds, shall be deemed to be incorporated by reference into this Official Statement and to be part of this Official Statement from the date of filing of such document. Any statement contained in the Commonwealth's Annual Financial Report shall be deemed to be modified or superseded for purposes of this Official Statement to the extent that a statement contained herein or in any such subsequently filed document modifies or supersedes such statement. Any statement contained in the Commonwealth Report or elsewhere herein shall also be deemed to be modified or superseded to the extent that a statement contained in any such subsequently filed document modifies or supersedes such statement. Any such statement so modified or superseded shall not be deemed, except as so modified or superseded, to constitute a part of this Official Statement.

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

The Commonwealth will provide without charge to any person to whom this Official Statement is delivered, on the written or oral request of such person, a copy of the Commonwealth's Annual Financial Report incorporated herein by reference. Requests should be directed to Director – New York Office, Government Development Bank for Puerto Rico, 666

Fifth Avenue, 15th Floor, New York, New York 10103-1599, telephone number (212) 422-6420, or to Director – General Obligations Division, Government Development Bank for Puerto Rico, P.O. Box 42001, San Juan, Puerto Rico 00940, telephone number (787) 722-7060.

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

OVERVIEW

Puerto Rico is located approximately 1,600 miles southeast of New York City. According to the United States Census Bureau, its population was 3,808,610 in 2000. Puerto Rico's political status is that of a commonwealth. The United States and the Commonwealth share a common defense, market, currency, and citizenship. The Commonwealth government exercises virtually the same control over its internal affairs as is exercised by the state governments of each of the fifty states over their respective internal affairs, with similar separation of powers among the executive, legislative, and judicial branches. It differs from the states, however, in its relationship with the federal government. The people of Puerto Rico are citizens of the United States but do not vote in national elections. They are represented in Congress by a Resident Commissioner who has a voice in the House of Representatives but no vote. Most federal taxes, except those such as Social Security taxes, which are imposed by mutual consent, are not levied in Puerto Rico. No federal income tax is collected from Puerto Rico residents on income earned in Puerto Rico, except for certain federal employees who are subject to taxes on their salaries. The official languages of Puerto Rico are Spanish and English.

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

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

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

Additional information about the Commonwealth can be found in the Commonwealth Report attached hereto as *Appendix I*, including information about the economy, historical

revenues and expenditures of the Commonwealth's General Fund, the estimated year-end results of fiscal year 2007, the budget for fiscal year 2007 and for fiscal year 2008, and the debt of the Commonwealth's public sector. The Commonwealth Report should be read in its entirety.

RECENT DEVELOPMENTS

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

Under Act No. 117 of the Legislature, approved on July 4, 2006, as amended (the "Sales Tax Act"), a general sales and use tax of 5.5% is imposed by the central government (the "Central Government Sales Tax") and of 1.5% is imposed by each municipality (the "Municipal Sales Tax" and, together with the Central Government Sales Tax, the "Sales Tax"). In general, the Municipal Sales Tax has the same tax base, exemptions (except for unprocessed foods) and limitations as those contained in the Central Government Sales Tax. The Sales Tax Act also provides certain income tax reductions to address the regressive effect of the Sales Tax on taxpayers in lower income tax brackets.

Pursuant to Act No. 91 of the Legislature, approved on May 13, 2006, as amended (the "Sales Tax Financing Corporation Act"), Puerto Rico Sales Tax Financing Corporation (the "Sales Tax Financing Corporation") was created for the purpose of refinancing certain debt obligations of the Commonwealth outstanding as of June 30, 2006, which obligations are payable solely from Commonwealth budgetary appropriations and are generally referred to as "extra constitutional debt."

Under the Sales Tax Financing Corporation Act, 1% of the 5.5% Central Government Sales Tax (subject to an annually inflated minimum amount if greater) is deposited by the Secretary of the Treasury of the Commonwealth (the "Secretary of the Treasury") upon receipt into the dedicated sales tax fund (the "Sales Tax Fund"), which is held and owned by the Sales Tax Financing Corporation separate and apart from the Commonwealth's General Fund. Amounts on deposit in the Sales Tax Fund are applied to the payment of debt issued by the Sales Tax Financing Corporation to refinance the above extra constitutional debt outstanding. On July 31, 2007, the Sales Tax Financing Corporation issued \$2,667,603,572.60 Sales Tax Revenue Bonds, Series 2007A and \$1,333,101,779.90 Sales Tax Revenue Bonds, Series 2007B (collectively, the "Sales Tax Bonds"), the proceeds of which were used as the first installment in the refinancing of the Commonwealth's extra constitutional debt.

PLAN OF FINANCING

The net proceeds of the Bonds and the Series A Bonds will be deposited in the 2007 Public Improvements Fund established under the Act and will be used, together with other available funds, to carry out certain capital improvements programs authorized by the Legislature in the Act.

Sources and Uses of Funds

Sources:

Principal amount of the Bonds.....	\$ 91,200,000.00
Total sources	<u>\$ 91,200,000.00</u>

Uses:

Deposit into the 2007 Public Improvements Fund*	\$ 90,380,000.00
Underwriting discount, legal, printing and other financing expenses	820,000.00
Total uses	<u>\$ 91,200,000.00</u>

- * Of such amount, \$90,115,000.00 will be transferred directly to the Bank to repay a portion of certain outstanding loans obtained by the Commonwealth from the Bank in advance of the issuance of the Bonds.

THE BONDS

General

The Bonds will be dated, bear interest at such rates, be payable at such times, and mature on the dates and in the principal amounts set forth on the cover and inside cover of this Official Statement. The Bonds are subject to redemption at the times and at the prices set forth below in "Redemption." Banco Popular de Puerto Rico will serve as paying agent and registrar (the "Registrar") for the Bonds.

Book-Entry Only System

The following information concerning The Depository Trust Company ("DTC"), New York, New York and DTC's book-entry system has been obtained from DTC. The Commonwealth does not take any responsibility for the accuracy thereof.

DTC will act as securities depository for the Bonds. The Bonds will be issued as fully registered bonds registered in the name of Cede & Co. (DTC's partnership nominee) or such other nominee as may be requested by an authorized representative of DTC. One fully registered bond will be issued for each maturity of the Bonds, each in the aggregate principal amount of such maturity, and will be deposited with DTC.

DTC, the world's largest depository, is a limited-purpose trust company organized under the New York Banking Law, a "banking organization" within the meaning of the New York Banking Law, a member of the Federal Reserve System, a "clearing corporation" within the meaning of the New York Uniform Commercial Code, and a "clearing agency" registered pursuant to the provisions of Section 17A of the Securities Exchange Act of 1934, as amended. DTC holds and provides asset servicing for over 2.2 million issues of U.S. and non-U.S. equity,

corporate and municipal debt, and money market instruments from over 100 countries that DTC's participants ("Direct Participants") deposit with DTC. DTC also facilitates the post-trade settlement among Direct Participants of sales and other securities transactions in deposited securities through electronic computerized book-entry transfers and pledges between Direct Participants' accounts. This eliminates the need for physical movement of securities certificates. Direct Participants include both U.S. and non-U.S. securities brokers and dealers, banks, trust companies, clearing corporations, and certain other organizations. DTC is a wholly-owned subsidiary of The Depository Trust & Clearing Corporation ("DTCC"). DTCC, in turn, is owned by a number of Direct Participants of DTC and Members of the National Securities Clearing Corporation, Fixed Income Clearing Corporation, and Emerging Markets Clearing Corporation (NSCC, FICC, and EMCC, also subsidiaries of DTCC), as well as by the New York Stock Exchange, Inc., the American Stock Exchange LLC, and the National Association of Securities Dealers, Inc. Access to the DTC system is also available to others such as both U.S. and non-U.S. securities brokers and dealers, banks, trust companies, and clearing corporations that clear through or maintain a custodial relationship with a Direct Participant, either directly or indirectly ("Indirect Participants"). DTC has the highest rating issued by S&P: "AAA." The DTC Rules applicable to its Participants are on file with the Securities and Exchange Commission. More information about DTC can be found at www.dtcc.com and www.dtc.org.

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

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

Conveyance of notices and other communications by DTC to Direct Participants, by Direct Participants to Indirect Participants, and by Direct Participants and Indirect Participants to Beneficial Owners will be governed by arrangements among them, subject to any statutory or regulatory requirements as may be in effect from time to time. Beneficial Owners may wish to take certain steps to augment the transmission to them of notices of significant events with respect to the Bonds, such as redemptions, tenders, defaults, and proposed amendments to the

bond documents. For example, Beneficial Owners may wish to ascertain that the nominee holding the Bonds for their benefit has agreed to obtain and transmit notices to Beneficial Owners. In the alternative, Beneficial Owners may wish to provide their names and addresses to the Registrar and request that copies of notices be provided directly to them.

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

Neither DTC nor Cede & Co. (nor such other DTC nominee) will consent or vote with respect to the Bonds unless authorized by a Direct Participant in accordance with DTC's procedures. Under its usual procedures, DTC mails an Omnibus Proxy to the Commonwealth as soon as possible after the record date. The Omnibus Proxy assigns Cede & Co.'s consenting or voting rights to those Direct Participants to whose accounts the Bonds are credited on such record date (identified in a listing attached to the Omnibus Proxy).

Redemption proceeds and interest payments on the Bonds will be made to Cede & Co., or such other nominee as may be requested by an authorized representative of DTC. DTC's practice is to credit Direct Participants' accounts upon DTC's receipt of funds and corresponding detail information from the Commonwealth, on the payable date in accordance with their respective holdings shown on DTC's records. Payments by Participants to Beneficial Owners will be governed by standing instructions and customary practices, as is the case with securities held for the accounts of customers in bearer form or registered in "street name," and will be the responsibility of such Participant and not of DTC, its nominee, or the Commonwealth, subject to any statutory or regulatory requirements as may be in effect from time to time. Payment of principal, redemption premium, if any, and interest to Cede & Co. (or such other nominee as may be requested by an authorized representative of DTC) is the responsibility of the Commonwealth, disbursement of such payments to Direct Participants will be the responsibility of DTC, and disbursement of such payments to the Beneficial Owners will be the responsibility of Direct and Indirect Participants.

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

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

Payments and Transfers

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

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

Discontinuance of the Book-Entry Only System

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

Authorization

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

Redemption

At the option of the Secretary of the Treasury and upon at least 30 days' notice, the Bonds maturing on or after July 1, 2013 may be redeemed prior to their respective maturities, from any moneys that may be available for that purpose, on and after July 1, 2012, either in whole or in part (and if in part, in such order of maturity as directed by the Secretary of the Treasury), on any date, at the redemption prices (expressed as percentages of the principal amount to be redeemed) set forth below plus accrued interest to the redemption date:

<u>Redemption Period</u> <u>(Both Dates Inclusive)</u>	<u>Redemption Price</u>
July 1, 2012 through June 30, 2013	101.5%
July 1, 2013 through June 30, 2014	101.0
July 1, 2014 through June 30, 2015	100.5
July 1, 2015 and thereafter	100.0

Notice of Redemption; Effect of Redemption

Any redemption of the Bonds, either in whole or in part, shall be made upon at least a 30-day prior notice by mail to DTC or, if the book-entry only system described above has been discontinued, by first class mail, postage prepaid, to all registered owners of the Bonds to be redeemed in the manner and under the terms and conditions provided in the Bond Resolution.

On the date designated for redemption, notice having been given as provided in the Bond Resolution and moneys for payment of the principal of and accrued interest on the Bonds or portions thereof so called for redemption being held by the Registrar, interest on the Bonds or portions thereof so called for redemption shall cease to accrue.

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

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

Security

Provision for Payment of Public Debt

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

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

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

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

In 2006, the Commonwealth allocated a portion of the Sales Tax to service the bonds issued by the Sales Tax Financing Corporation to refinance a portion of the Commonwealth's outstanding extra constitutional debt (including the Sales Tax Bonds). The legislation making such allocation provides that the portion so set aside is not "available Commonwealth resources" for purposes of the above Constitutional provision. No ruling from the Puerto Rico Supreme Court has been solicited as to the validity of such "set aside" vis-à-vis the Constitutional provision referred to above, and the Commonwealth cannot to give any assurance that the Puerto Rico Supreme Court when faced with this issue in a properly briefed and litigated proceeding would agree that such segregated sales tax revenues are "unavailable."

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

Special Fund for the Bonds (General Obligation) Debt Service

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

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

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

Payment Record

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

Debt Limitation

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

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

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

Act No. 39 of the Legislature, approved August 1, 2005, as amended ("Act No. 39 of 2005"), authorizes the Commonwealth to enter into interest rate exchange agreements with respect to its general obligation bonds, subject to certain conditions, including that the agreements are entered into to reduce certain financial risks associated with issuing variable rate obligations. In August 2006, the Commonwealth issued its \$500,000,000 Public Improvement Bonds of 2006, Series A, a portion of which bonds bear interest at a rate that will change periodically based on changes in the United States consumer price index, and in connection with such consumer price index floating rate bonds (said portion, the "2006 CPI Bonds") entered into an interest rate exchange agreement, the effect of which on said bonds will economically enable the Commonwealth to pay a fixed rate of interest in respect thereof. Act No. 39 of 2005 allows the Commonwealth to calculate the constitutional debt limit in a manner identical to that utilized in Joint Resolution No. 2104. In addition, the Commonwealth has also executed under the authority granted in Act No. 39 of 2005, interest rate exchange agreements in which the Commonwealth is making payments (1) on \$1,698,370,000 notional amount of public improvement bonds based on a short-term interest rate index published by Securities Industry and Financial Markets Association ("SIFMA") and is receiving from its counterparties payments on the same notional amount based on the published three-month London Interbank Offered Rate index (the "basis swap") and (2) on \$850,000,000 notional amount of public improvement bonds based on the published short-term SIFMA municipal swap rate and is receiving from its counterparties payments on the same notional amount based on a published index of municipal bonds having a maturity of 10 years (the "constant maturity swap").

After giving effect to the issuance of the Bonds and the Series A Bonds, future maximum annual debt service for the Commonwealth's outstanding general obligation debt is \$802,519,875 in the fiscal year ending June 30, 2020 (based on the assumption that (i) the bonds refunded with non-eligible investments are treated as being outstanding, (ii) the Series 2004 A Bonds bear interest at their actual rate per annum through July 1, 2012 and thereafter at 12% per annum, (iii) the Series 2004 B Bonds and the 2006 CPI Bonds bear interest at 12% per annum and (iv) the public improvement bonds to which the basis swap and the constant maturity swap relate bear interest at their stated interest rates rather than the rates set forth in said swaps). This amount \$802,519,875 is equal to 9.618% of \$8,334,210,500, which is the average of the adjusted internal revenues for the fiscal year ended June 30, 2006 and the currently estimated adjusted internal revenues for the fiscal year ended June 30, 2007. If the bonds refunded with non-eligible investments were treated as not being outstanding, and the interest on the Series 2004 B Bonds and the 2006 CPI Bonds is calculated using the fixed rate paid by the Commonwealth under the interest rate exchange agreements executed in connection with such bonds, the percentage referred to in the preceding sentence would be 8.56%.

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

Maturity Limitation

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

PUBLIC SECTOR DEBT OF THE COMMONWEALTH

Public Sector Debt

The following table presents a summary of the public sector debt of the Commonwealth as of May 31, 2007. The table also shows the public sector debt as further adjusted by the following bond issuances and events that have occurred after said date: (i) the issuance of the Sales Tax Bonds, and (ii) the issuance of the Bonds and the Series A Bonds. The table should be read in conjunction with the information set forth under *Debt* in *Appendix I*.

	May 31, 2007	As Adjusted
Puerto Rico direct debt ⁽¹⁾	\$11,433,326	\$11,933,326
Municipal debt	2,448,771	2,448,771
Public corporations debt		
Puerto Rico guaranteed debt	800,044	800,044
Debt supported by Puerto Rico appropriations or taxes	16,969,012	16,969,012
Other non-guaranteed debt	11,919,124	11,919,124
Total public corporations debt	29,688,180	29,688,180
Total public sector debt	\$43,570,277	\$44,070,277

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

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

Source: Government Development Bank

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

The following table presents the debt service requirements for (i) Commonwealth general obligation bonds outstanding on May 31, 2007; (ii) debt service on the Bonds; and (iii) total debt service adjusted for the issuance of the Bonds and the Series A Bonds. The table excludes debt service on Commonwealth general obligation bonds that have been refunded with the proceeds

of refunding bonds invested in non-eligible investments, notwithstanding that such bonds will be considered to be outstanding under their authorizing resolution and for purposes of calculating the Commonwealth's debt limitation. Debt service requirements for each fiscal year, as shown in the following table, include principal and interest due on July 1 immediately following the close of such fiscal year.

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

Fiscal Year Ending June 30	Outstanding Bonds Total Debt Service ⁽¹⁾	The Bonds		Grand Total ⁽²⁾
		Principal	Interest	
2008	\$642,786	\$	\$19,324	\$662,110
2009	650,393	7,750	26,054	684,197
2010	650,522	8,150	25,655	684,327
2011	648,085	8,550	25,227	681,862
2012	647,925	9,050	24,766	681,741
2013	647,934	9,500	24,273	681,706
2014	649,978	10,050	23,750	683,778
2015	649,853	10,600	23,192	683,645
2016	650,216	11,200	22,599	684,015
2017	649,830	11,850	21,966	683,646
2018	650,216	12,550	21,290	684,056
2019	650,574	13,050	20,629	684,253
2020	680,742	13,700	19,977	714,419
2021	528,547	14,400	19,292	562,238
2022	438,396	15,100	18,572	472,068
2023	394,603	15,850	17,817	428,270
2024	371,320	16,650	17,024	404,994
2025	371,411	17,500	16,192	405,103
2026	362,584	18,350	15,317	396,251
2027	362,198	19,250	14,399	395,847
2028	361,841	20,250	13,437	395,527
2029	361,373	21,250	12,424	395,047
2030	360,589	22,350	11,309	394,247
2031	359,778	23,550	10,135	393,463
2032	180,153	24,750	8,899	213,802
2033	146,625	26,050	7,599	180,274
2034	107,614	27,450	6,232	141,295
2035	72,413	28,850	4,791	106,054
2036		30,400	3,276	33,676
2037		32,000	1,680	33,680
Total	\$13,248,498	\$500,000	\$497,094	\$14,245,592

* Totals may not add due to rounding.

(1) Since fiscal year 1997, the Commonwealth has made annual debt service payment of approximately \$30 million pursuant to its guaranty of PRASA bonds. On January 1, 2006, PRASA began making annual debt service

payments under its bonds as a result of anticipated increased revenues from its rate increases. Thus, the Commonwealth has ceased making annual debt service payments on guaranteed PRASA bonds. See "Other Public Corporations – Aqueduct and Sewer Authority" under Public Corporations in Appendix I. In the event PRASA is unable to make any portion of the future debt service payments on its guaranteed bonds, the Commonwealth would be required to make such payments under its guarantee from the General Fund. Also, debt service requirements on all general obligation bonds outstanding on May 31, 2007 are adjusted to exclude debt service on all general obligation bonds refunded with proceeds invested in non-eligible investments, notwithstanding that such bonds will be considered to be outstanding under their authorizing resolution and for purposes of calculating the Commonwealth's debt limitation. Interest on the Series 2004 A Bonds is calculated at their actual rate per annum through July 1, 2012 and thereafter at 12% per annum. Interest on the Series 2004 B Bonds and the 2006 CPI Bonds is calculated using the respective fixed interest rates to be paid by the Commonwealth under the respective interest rate exchange agreements executed in connection with such bonds. Interest on the public improvement bonds to which the basis swap and the constant maturity swap relate is calculated using the respective fixed interest rates on said bonds rather than the payments exchanged under said swaps.

- (2) Debt service requirements on all general obligation bonds outstanding, adjusted as discussed in footnote 1 above and further adjusted to include the issuance of the Bonds.

Sources: Government Development Bank and Department of the Treasury

TAX MATTERS

The following is a summary of the opinion of Quiñones & Sánchez PSC, Special Tax Counsel, regarding certain Puerto Rico tax and United States federal tax consequences of the ownership of the Bonds. This section does not purport to cover all of the Puerto Rico tax and United States federal income tax consequences arising from the purchase and ownership of the Bonds. The following is based upon laws and regulations now in effect and is subject to change.

Prospective owners of the Bonds, including, but not limited to, financial institutions, should be aware that ownership of the Bonds may result in having a portion of their interest and other expenses attributable to interest on the Bonds disallowed as deductions for purposes of computing the regular tax and the alternative minimum tax for Puerto Rico income tax purposes.

In the opinion of Special Tax Counsel, based on the provisions of the Code now in force:

1. Interest on the Bonds received by, or "original issue discount" (within the meaning of Sections 1272 and 1273 of the U.S. Code) accrued to, a corporation (i) organized under the laws of the Commonwealth and subject to income tax under the U.S. Code as a corporation, or (ii) otherwise constituting a foreign corporation that is subject to income tax under the U.S. Code as a corporation, is not, in the hands of such corporation, subject to income taxation under the U.S. Code provided such interest or "original issue discount" is not effectively connected, or treated as effectively connected, with or attributable to the conduct of a trade or business within the United States by such corporation.

2. Interest on the Bonds received by, or "original issue discount" (within the meaning of Sections 1272 and 1273 of the U.S. Code) accrued to, an individual who is a *bona fide* resident of the Commonwealth (within the meaning of Sections 933 and 937(a) of the U.S. Code and the regulations issued thereunder) during the entire taxable year in which such interest is received or "original issue discount" is accrued will constitute gross income from sources within the Commonwealth and, therefore, is excludable from gross income pursuant to Section 933(1) of the U.S. Code, provided such interest and original issue discount are not effectively connected with the conduct of a trade or business within the United States by such individual.

3. Interest on the Bonds and any original issue discount accrued or received thereon is not excludable from the gross income of the recipient thereof for United States federal income tax purposes under Section 103(a) of the U.S. Code.

4. Pursuant to Notice 89-40 issued by the United States Internal Revenue Services on March 27, 1989, gain on the sale, or exchange or redemption of the Bonds by an individual who is a *bona fide* resident of the Commonwealth (within the meaning of Sections 933 and 937(a) of the U.S. Code and the regulations issued thereunder) during the entire taxable year will constitute income from sources within the Commonwealth and, therefore, qualify for the exclusion from gross income provided in Section 933(1) of the U.S. Code, provided such Bonds do not constitute inventory in the hands of such individual and at the time that the Bonds were acquired by such individual, such individual was a *bona fide* resident of the Commonwealth (within the meaning of Sections 933 and 937(a) of the U.S. Code and the regulations issued thereunder).

5. The Transfer of the Bonds by death or gift will not be subject to estate or gift tax under the U.S. Code in the case of decedents or donors who, at the time of death or gift, are (i) residents of the Commonwealth and (ii) United States citizens that acquired such citizenship solely by reason of birth or residence in the Commonwealth.

Prospective owners of the Bonds should also be aware that the U.S. Code provides special rules for the taxation of shareholders of foreign corporations that qualify as "controlled foreign corporations," "personal holding companies," or "passive foreign investment companies," as such terms are defined by the U.S. Code.

FINANCIAL ADVISOR

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

APPROVAL OF LEGAL PROCEEDINGS

Legal matters incident to the authorization and issuance of the Bonds are subject to the approval of Squire, Sanders & Dempsey L.L.P., Miami, Florida, Bond Counsel, the proposed form of whose opinion is included herein as *Appendix III*. Certain legal matters will be passed upon by Quiñones & Sánchez PSC, San Juan, Puerto Rico, as Special Tax Counsel. Certain legal matters will be passed upon for the Underwriters by Quiñones & Sánchez PSC, San Juan, Puerto Rico, as Underwriters' Counsel.

LEGAL INVESTMENT

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

UNDERWRITING

The Underwriters have jointly and severally agreed, subject to certain conditions, to purchase the Bonds from the Commonwealth at an aggregate discount of \$550,265.83 from the initial offering prices of the Bonds set forth or derived from information set forth on the inside cover hereof. The obligation of the Underwriters to purchase the Bonds is subject to certain conditions precedent, and they will be obligated to purchase all the Bonds if any Bonds are purchased. The Underwriters may offer to sell the Bonds to certain dealers and others at prices lower than the initial public offering prices. The offering prices may be changed, from time to time, by the Underwriters.

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

GOVERNMENT DEVELOPMENT BANK FOR PUERTO RICO

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

RATINGS

Moody's and Standard & Poor's have given the Bonds ratings of "Baa3" and "BBB-," respectively. Ratings reflect only the respective views of the rating agencies and an explanation of the significance of each rating may be obtained only from the respective rating agency. Such rating agencies were provided with materials relating to the Commonwealth and the Bonds and other relevant information, and no application has been made to any other rating agency for the purpose of obtaining a rating on the Bonds.

There is no assurance that such ratings will remain in effect for any given period of time or that they will not be revised downward or withdrawn entirely by either or both of such rating agencies, if in the judgment of either or both, circumstances so warrant. Any such downward revision or withdrawal of such ratings, or either of them, may have an adverse effect on the market prices of the Bonds.

CONTINUING DISCLOSURE

In accordance with the requirements of Rule 15c2-12, as amended (the "Rule"), promulgated by the Securities and Exchange Commission (the "SEC"), the Commonwealth has covenanted in the Bond Resolution for the benefit of the Beneficial Owners (as defined in the Bond Resolution):

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

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

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

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

Event (h). The Commonwealth does not undertake to provide the above-described event notice of a mandatory scheduled redemption, not otherwise contingent upon the occurrence of an event, if the terms, dates and amounts of redemption are set forth in detail in this Official Statement under "*The Bonds — Redemption*," the only open issue is which Bonds will be redeemed in the case of a partial redemption, notice of redemption is given to the Bondholders as required under the terms of the Bonds, and public notice of the redemption is given pursuant to Securities Exchange Act of 1934 Release No. 34-23856 of the SEC, even if the originally scheduled amounts are reduced by prior optional redemptions or purchases of Bonds.

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

The Commonwealth has made similar continuing disclosure covenants in connection with prior bond issuances, and has complied with all such covenants, except as hereinafter noted. The Commonwealth's audited financial statements for the fiscal year ended June 30, 2002 were filed after the Commonwealth's filing deadline of May 1, 2003 because of delays in finalizing such financial statements resulting from the implementation of Governmental Accounting Standards Board 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 and 2006 were also filed after the Commonwealth's respective filing deadlines of May 1, 2005 and 2007, because various governmental agencies did not submit their audited financial statements to the central government's external auditors on time, thereby delaying submission of the Commonwealth's audited financial statements.

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

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

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

its undertaking shall be limited to a right to obtain specific enforcement of the Commonwealth's obligations thereunder.

No Beneficial Owner may institute any suit, action or proceeding at law or in equity ("Proceeding") for the enforcement of the foregoing covenants (the "Covenants") or for any remedy for breach thereof, unless such Beneficial Owner shall have filed with the Commonwealth written notice of any request to cure such breach, and the Commonwealth shall have refused to comply within a reasonable time. All Proceedings shall be instituted only in a Commonwealth court located in the Municipality of San Juan, Puerto Rico for the equal benefit of all Beneficial Owners of the outstanding Bonds benefited by the Covenants, and no remedy shall be sought or granted other than specific performance of any of the Covenants at issue. Moreover, Proceedings filed by Beneficial Owners against the Commonwealth may be subject to the sovereign immunity provisions of Section 2 and 2A of Act No. 104, approved June 29, 1955, as amended, which governs the scope of legal actions against the Commonwealth, substantially limits the amount of monetary damages that may be awarded against the Commonwealth and provides certain notice provisions, the failure to comply with which may further limit any recovery.

The Covenants may only be amended if:

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

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

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

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

MISCELLANEOUS

The foregoing summaries of or references to the Act, the Bonds, the Bond Resolution and the summaries of or references to the various acts contained in the Commonwealth Report, are made subject to all the detailed provisions thereof to which reference is hereby made for further information and do not purport to be complete statements of any or all of such provisions.

Appended to and constituting a part of this Official Statement are the Commonwealth Report (*Appendix I*), the Commonwealth's Annual Financial Report (*Appendix II*), the proposed form of opinion of Bond Counsel (*Appendix III*) and the proposed form of opinion of Special Tax Counsel (*Appendix IV*).

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

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

COMMONWEALTH OF PUERTO RICO

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

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

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

INTRODUCTION

Geographic Location and Demography

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

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

Relationship with the United States

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

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

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

The official languages of Puerto Rico are Spanish and English.

Governmental Structure

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

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

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

Principal Officials Responsible for Fiscal Matters

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

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

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

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

Political Trends

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

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

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

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

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

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

THE ECONOMY

General

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

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

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

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

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

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

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

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

(1) Preliminary.

(2) In current dollars.

Sources: Puerto Rico Planning Board and Global Insight Inc.

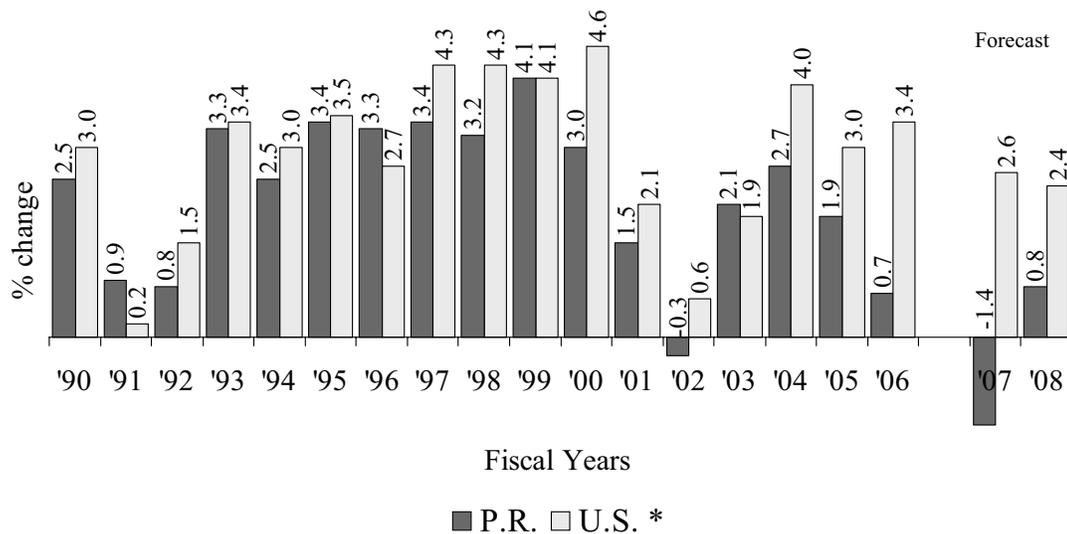
The economy of Puerto Rico is closely linked to the United States economy, as most of the external factors that affect the Puerto Rico economy (other than the price of oil) are determined by the policies and performance of the economy of the United States. These external factors include exports, direct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

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

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

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

Real GNP Growth Rate



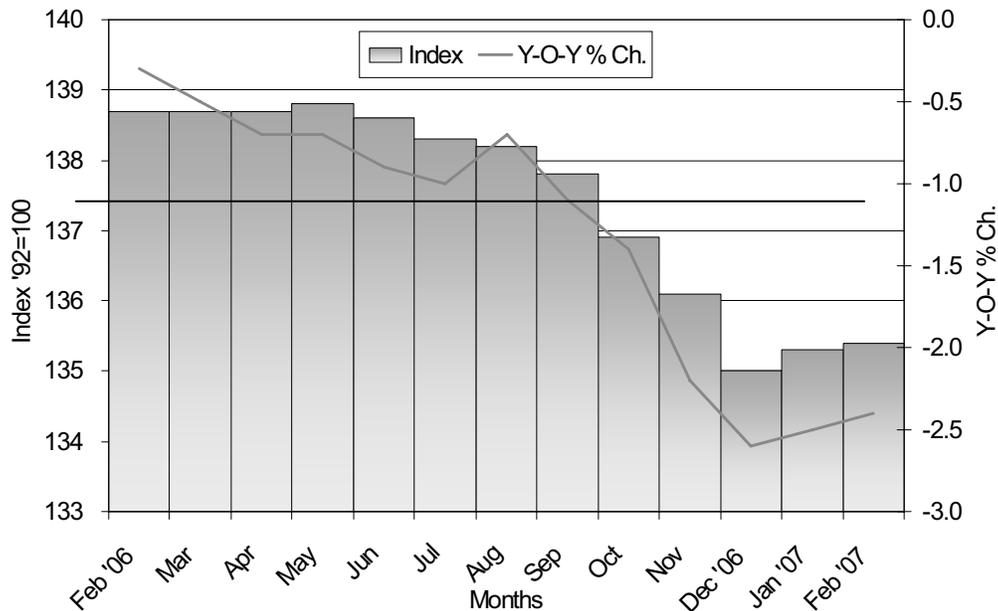
* Global Insight 7/07.

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

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

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

Coincident Economic Activity Index



Forecast for Fiscal Year 2007

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

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

Fiscal Year 2006

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

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

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

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

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

Fiscal Year 2005

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

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

Economic Development Program

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

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

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

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

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

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

Puerto Rico Tax Incentives

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

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

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

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

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

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

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

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

Reduction of the Costs of Doing Business

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

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

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

Federal Tax Incentives

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

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

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

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

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

Employment and Unemployment

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

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

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

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

(1) Totals may not add due to rounding.

(2) Unemployed as percentage of labor force.

Source: Department of Labor and Human Resources – Household Survey

Economic Performance by Sector

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

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

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

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

(1) Preliminary.

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

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

(4) Includes mining.

(5) Totals may not add due to rounding.

Source: Planning Board

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

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

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

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

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

(2) Preliminary.

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

Manufacturing

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

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

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

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

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

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

(1) Preliminary.

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

(3) Totals may not add due to rounding.

Source: Planning Board

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

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

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

* Totals may not add due to rounding.

(1) Preliminary.

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

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

Services

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

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

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

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

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

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

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

* Totals may not add due to rounding.

(1) Preliminary.

(2) Includes tourism.

Source: Planning Board.

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

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

* Totals may not add due to rounding.

(1) Preliminary.

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

Hotels and Related Services – Tourism

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

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

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

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

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

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

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

Sources: Puerto Rico Tourism Company and the Planning Board

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

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

Government

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

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

Transportation

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

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

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

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

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

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

Construction

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

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

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

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

Agriculture

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

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

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

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

Higher Education

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

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

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

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

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

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

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

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

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

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

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

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

Tax Incentives

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

Industrial Incentives Program

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

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

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

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

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

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

Tourism Incentives Program

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

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

Incentives under the U.S. Code

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

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

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

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

Controlled Foreign Corporations

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

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

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

DEBT

Public Sector Debt

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

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

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

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

Future maximum annual debt service for the Commonwealth’s outstanding general obligation debt is \$768,843,250 in the fiscal year ending June 30, 2020 (based on the assumption that the Public Improvement Refunding Bonds, Series 2004 A, which are variable rate bonds, bear interest at their actual rate per annum through July 1, 2012 and thereafter at 12% per annum, and the Public Improvement Refunding Bonds, Series 2004 B and a portion of the Public Improvement Bonds of 2006, Series A, each of which are also variable rate bonds, bear interest at 12% per annum). This amount (\$768,843,250) is equal to 9.21% of \$8,346,104,000, which is the average of the adjusted internal revenues for the fiscal years ended June 30, 2005 and June 30, 2006. If bonds refunded with non-eligible investments described in the preceding paragraph were treated as not being outstanding, and the interest on the Public Improvement Refunding Bonds, Series 2004 B and the above portion of the Public Improvement Bonds of 2006, Series A, was calculated using the effective fixed interest rate payable by the Commonwealth under the interest rate exchange agreements entered into in respect thereof, the percentage referred to in the preceding sentence would be 8.186% and future maximum annual debt service for the Commonwealth’s outstanding general obligation debt would be \$680,742,340 in the fiscal year ending June 30, 2020. Annual debt service payments on the PRASA guaranteed bonds have been paid by PRASA since fiscal year 2006 and, thus, such payments are not now included now in the calculation of the 15% debt limitation. In the event PRASA is unable to make any portion of the future debt service payments on its guaranteed bonds, the Commonwealth would be required to make such payments under its guarantee from the General Fund, and such debt service would be included in the calculation of the 15% debt limitation.

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

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

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

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

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

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

Source: Government Development Bank for Puerto Rico

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

Debt Service Requirements for Commonwealth General Obligation Bonds

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

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

Puerto Rico Debt Service Requirements*
(in thousands)

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

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

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

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

Ratings of Commonwealth General Obligation Bonds

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

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

Commonwealth Guaranteed Debt

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

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

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

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

Trends of Public Sector Debt

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

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

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

* Totals may not add due to rounding.

(1) In current dollars.

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

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

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

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

Source: Government Development Bank for Puerto Rico

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

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

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

* Totals may not add due to rounding.

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

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

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

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

Source: Government Development Bank for Puerto Rico

PUBLIC CORPORATIONS

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

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

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

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

Source: Government Development Bank for Puerto Rico

Government Development Bank for Puerto Rico

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Other Public Corporations

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

INSURANCE MATTERS

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

RETIREMENT SYSTEMS

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

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

Covered Employees. The Teachers Retirement System covers public school teachers and certain private school teachers, as well as teachers working in administrative positions. Substantially all active teachers of the Commonwealth’s Department of Education are covered by Act No. 91 of March 29, 2004

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

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

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

Actuarial Valuation of Teachers Retirement System. According to the most recent actuarial valuation of the Teachers Retirement System submitted by a firm of independent consulting actuaries, as of June 30, 2004 the accrued actuarial liability of the system was \$4.7 billion and the value of its assets amounted to \$2.4 billion, representing a funding ratio of 51%, and the resulting unfunded accrued liability was \$2.3 billion. This funding ratio takes into account the recent turn-around in the equities market and

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

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

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

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

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

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

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

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

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

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

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

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

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

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

* Totals may not add due to rounding.

⁽¹⁾ Rounded to the nearest thousand.

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

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

* Totals may not add due to rounding.

⁽¹⁾ Rounded to the nearest thousand.

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

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

* Totals may not add due to rounding.

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

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

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

* Totals may not add due to rounding.

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

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

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

* Totals may not add due to rounding.

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

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

* Totals may not add due to rounding.

COMMONWEALTH FINANCIAL STATEMENTS

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

The Comprehensive Annual Financial Report of the Commonwealth ("CAFR") for fiscal year 2006, which includes the basic financial statements of the Commonwealth for fiscal year 2006, was filed by the Commonwealth with each nationally recognized municipal securities information repository (each, a "NRMSIR") on August 16, 2007, and an amendment thereto was filed with each NRMSIR on or about September 13, 2007.

PUERTO RICO TAXES, OTHER REVENUES, AND EXPENDITURES

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

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

Summary and Management's Discussion of General Fund Results

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

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

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

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

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

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

(*) Preliminary.

(+) Estimated.

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

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

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

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

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

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

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

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

Source: Department of the Treasury

Fiscal Year 2007

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

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

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

Fiscal Year 2006

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

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

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

Fiscal Year 2005

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

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

Fiscal Year 2004

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

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

Fiscal Year 2003

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

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

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

Tax Reform

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

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

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

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

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

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

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

Major Sources of General Fund Revenues

Income Taxes

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

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

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

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

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

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

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

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

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

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

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

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

Sales and Use Taxes

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

Excise Taxes

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

Other Taxes and Revenues

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

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

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

Property Taxes

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

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

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

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

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

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

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

Source: Municipal Revenues Collection Center

Collections of Income, Sales and Excise Taxes

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

Transfers to General Obligation Redemption Fund

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

Components of General Fund Expenditures

Grants and Subsidies

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

Personal Services

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

Other Services

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

Materials and Supplies

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

Equipment Purchases

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

Capital Outlays and Other Debt Service

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

Transfers to Agencies

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

Other Expenditures

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

Federal Grants

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

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

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

(1) Estimated.

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

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

(4) Recommended

Source: Office of Management and Budget

BUDGET OF THE COMMONWEALTH OF PUERTO RICO

Office of Management and Budget

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

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

Budgetary Process

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

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

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

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

Fiscal Reform

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

Financial Control and Adjustment Procedures

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

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

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

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

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

Appropriations

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

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

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

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

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

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

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

Budget for Fiscal Year 2007

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

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

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

* Totals may not add due to rounding.

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

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

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

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

Budget for Fiscal Year 2008

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

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

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

* Totals may not add due to rounding.

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

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

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

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

Differences between Budget and Basic Financial Statements

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

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

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

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

LITIGATION

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

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

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

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

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

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

COMMONWEALTH OF PUERTO RICO

Comprehensive Annual Financial Report

Fiscal Year Ended June 30, 2006

COMPREHENSIVE ANNUAL FINANCIAL REPORT

Fiscal Year Ended June 30, 2006



Commonwealth of Puerto Rico

***Honorable Aníbal Acevedo Vilá
Governor***

Prepared by:

Puerto Rico Department of the Treasury

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Assistant Secretary of Central Accounting***

*This document is available on the Puerto Rico Department of the Treasury homepage
On the World Wide Web: <http://www.hacienda.gobierno.pr>*

COMMONWEALTH OF PUERTO RICO
Comprehensive Annual Financial Report
Year ended June 30, 2006

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INTRODUCTORY SECTION



Juan C. Méndez Torres, Esq., CPA
Secretary

August 6, 2007

To the Honorable Governor of Puerto Rico,
Members of the Legislature, and People of Puerto Rico:

It is a pleasure to submit, for your information, the Comprehensive Annual Financial Report (CAFR) of the Commonwealth of Puerto Rico (the Commonwealth) as of and for the fiscal year ended June 30, 2006. This report, presented in three sections, Introductory, Financial, and Statistical, is the primary means of reporting the Commonwealth's financial activities.

The introductory section, which is not audited, includes this letter of transmittal, general information about the Commonwealth, a list of the Commonwealth's principal elected and appointed officials at the balance sheet date, an organizational chart, and a reproduction of the Certificate of Achievement for Excellence in Financial Reporting that the Commonwealth received for its June 30, 2005 CAFR. The financial section contains the independent auditors' report, management's discussion and analysis (MD&A), and the basic financial statements as listed in the table of contents. The financial section also includes the notes to the basic financial statements, required supplementary information, and other supplementary information. The statistical section, which is not audited, includes selected financial and demographic information, generally presented on a multiyear basis.

PROFILE OF THE COMMONWEALTH

The Puerto Rico Department of the Treasury is responsible for the preparation of this report. The responsibility for the accuracy of presented data and the completeness and fairness of the presentation, including all of the disclosures, rests on the Commonwealth's management. To the best of our knowledge and belief, the following data, as presented, is accurate in all material respects, and is presented in a manner designed to set forth the financial position and the results of operations of the governmental activities, the business-type activities, the aggregate discretely presented component units, each major fund, and the aggregate remaining fund information of the Commonwealth as of June 30, 2006 and the respective changes in financial position and cash flows, where applicable, thereof and the respective budgetary comparison for the general fund for the year then ended in conformity with accounting principles generally accepted in the United States of America. We have included all the necessary disclosures to enable the reader to gain a thorough understanding of the Commonwealth's activities.

Honorable Governor of Puerto Rico,
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The financial reporting entity includes all funds of the Commonwealth, which comprises the primary government, as well as all its component units. In accordance with Governmental Accounting Standards Board's Statement No. 14, the Commonwealth's financial reporting entity includes 48 component units: 6 are blended component units including 3 fiduciary component units, 7 major discretely presented component units, and 35 nonmajor discretely presented component units. Component units are legally separate entities for which the primary government is financially accountable, or other organizations; the nature and significance of whose relationship with the Commonwealth are such that exclusion would cause the Commonwealth's basic financial statements to be misleading and incomplete. Blended component units, although legally separate entities, are, in substance, part of the primary government's operations and are included as part of the primary government. Discretely presented component units, both major and nonmajor, are reported in a separate column in the government-wide financial statements to emphasize that they are not part of the primary government and to differentiate their financial position and results of operations from those of the primary government.

Generally, each component unit issues audited financial statements, which can be obtained from the component unit's administrative offices. The basic financial statements included in the financial section of this CAFR provide descriptions of the operations of each of the following component units of the Commonwealth:

Blended Component Units:

Public Buildings Authority
Puerto Rico Maritime Shipping Authority
The Children's Trust

Discretely Presented Component Units:

Agricultural Services and Development Administration
Automobile Accident Compensation Administration
Cardiovascular Center Corporation of Puerto Rico and the Caribbean
Caribbean Basin Projects Financing Authority
Economic Development Bank for Puerto Rico
Employment and Training Enterprises Corporation
Farm Insurance Corporation of Puerto Rico
Fine Arts Center Corporation
Governing Board of the 9-1-1 Service
Government Development Bank for Puerto Rico
Institutional Trust of the National Guard of Puerto Rico
Musical Arts Corporation
National Parks Company of Puerto Rico
Public Corporation for the Supervision and Deposit Insurance of Puerto Rico Cooperatives



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Puerto Rico Aqueduct and Sewer Authority
Puerto Rico Conservatory of Music Corporation
Puerto Rico Convention Center District Authority
Puerto Rico Council on Higher Education
Puerto Rico Electric Power Authority
Puerto Rico Government Investment Trust Fund
Puerto Rico Health Insurance Administration
Puerto Rico Highway and Transportation Authority
Puerto Rico Industrial Development Company
Puerto Rico Industrial, Tourist, Educational, Medical, and Environmental Control Facilities
Financing Authority
Puerto Rico Infrastructure Financing Authority
Puerto Rico Land Administration
Puerto Rico Land Authority
Puerto Rico Maritime Transportation Authority
Puerto Rico Medical Services Administration
Puerto Rico Metropolitan Bus Authority
Puerto Rico Municipal Finance Agency
Puerto Rico Ports Authority
Puerto Rico Public Broadcasting Corporation
Puerto Rico Solid Waste Authority
Puerto Rico Telephone Authority
Puerto Rico Trade and Export Company
Right to Employment Administration
Special Communities Perpetual Trust
State Insurance Fund Corporation
Tourism Company of Puerto Rico
University of Puerto Rico

Fiduciary Component Units:

Employees Retirement System of the Government of Puerto Rico and its Instrumentalities
Puerto Rico Judiciary Retirement System
Puerto Rico System of Annuities and Pensions for Teachers



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Independent Auditors

Commonwealth statutes require an annual audit by independent certified public accountants. The firm of KPMG LLP was selected by the Commonwealth to perform the audit of the basic financial statements in accordance with auditing standards generally accepted in the United States of America for the fiscal year 2005-2006. The goal of the independent audit was to provide reasonable assurance that the financial statements of the Commonwealth for the fiscal year ended June 30, 2006 are free of material misstatements. The independent auditors' report on the basic financial statements is included in the financial section of this report.

Internal Controls

The management of the Commonwealth is responsible for establishing and maintaining internal controls to ensure that assets of the Commonwealth are protected from loss, theft, or misuse, and that adequate accounting data is compiled for the preparation of financial statements in conformity with accounting principles generally accepted in the United States of America. The internal controls are designed to provide reasonable, but not absolute, assurance that these objectives are met. The concept of reasonable assurance recognizes that: (1) the cost of a control should not exceed the benefits likely to be derived, and (2) the valuation of costs and benefits requires estimates and judgments by management.

As a recipient of federal assistance, the Commonwealth is also responsible for ensuring that internal controls are in place to ensure that documents and processes are in compliance with applicable laws and regulations related to such federal financial assistance programs.

Certain departments, agencies, and political subdivisions are subject to the requirements of the U.S. Office of Management and Budget Circular A-133. As a result, these entities are audited for compliance with the requirements of the federal financial assistance programs. These audits are performed at the department or agency level. The Commonwealth has provided for the possible cost disallowance that may arise from these audits, as well as from other audits that may be performed by federal grantors.

Budget and Fiscal Policy

The fiscal year of the Commonwealth begins each July 1. The Governor is constitutionally required to submit to the Legislature an annual balanced budget of capital improvements and operating expenses of the Central Government for the ensuing fiscal year.

The annual budget is prepared by the Puerto Rico Office of Management and Budget, working with the Puerto Rico Planning Board, the Puerto Rico Department of the Treasury, and other government offices and agencies. Section 7 of Article 6 of the Constitution provides that "*The appropriations made for any fiscal year shall not exceed the total revenue, including available surplus, estimated for said fiscal year unless the imposition of taxes sufficient to cover said appropriations is provided by law.*"



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The Commonwealth maintains extensive budgetary controls. The objective of these controls is to ensure compliance with legal provisions embodied in the annual appropriated budget approved by the Legislature. Activities of the general fund are included in the annual appropriated budget. Budgetary control resides at the department level. The Commonwealth also maintains an encumbrance accounting system as one method of maintaining budgetary control.

The annual budget, which is developed using elements of performance-based program budgeting and zero-based budgeting, includes an estimate of revenue and other resources for the ensuing fiscal year under laws existing at the time the budget is submitted and 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 Puerto Rico Planning Board.

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

Governmental Activities

General governmental activities of the Commonwealth are accounted for in four governmental funds. These funds are: general, special revenue, debt service, and capital project. The general fund is the primary operating fund of the Commonwealth. The general fund is used to account for resources traditionally associated with government, which are not required legally or by sound financial management to be accounted for in another fund. Included are transactions for services such as general government, public safety, health, public housing and welfare, education, and economic development. Other major funds are the debt service fund, which accounts for the accumulation of resources predominantly for, and the payment of the Commonwealth general long-term bonds' principal, interest and related costs; the Public Buildings Authority capital project fund, which accounts for the financial resources used for the acquisition and construction of major capital facilities; and The Children's Trust special revenue fund, which accounts for the moneys received by the Commonwealth from a global settlement agreement dated November 23, 1998, between certain tobacco companies and certain states, territories, and other jurisdictions of the United States of America, including the Commonwealth. The financial resources received by this fund are used to carry out projects aimed at promoting the well-being of children and youth of Puerto Rico. Nonmajor governmental



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funds are combined in a single column in the governmental fund financial statements, and individually identified in the supplementary combining nonmajor governmental funds financial statements of this report.

Business-Type Activities

Proprietary funds are used to account for operations that are financed and operated in a manner similar to private business enterprises, where the intent of the government is that the costs of providing goods or services to the general public on a continuing basis be financed or recovered primarily through user charges or where the government has decided that periodic determination of net income is appropriate for accountability purposes.

The Commonwealth's proprietary operations comprise the following activities: the Unemployment Insurance Trust Fund, the Lottery of Puerto Rico and the Additional Lottery System (the Lotteries Fund), both major funds. The Puerto Rico Water Pollution Control Revolving Fund, the Puerto Rico Safe Drinking Water Treatment Revolving Loan Fund, the Disability Insurance Fund, and the Drivers' Insurance Fund are all nonmajor proprietary funds combined in a single column in the proprietary fund financial statements, and individually identified in the supplementary combining nonmajor proprietary funds financial statements of this report.

Fiduciary Operations

Fiduciary funds are used to account for assets held by the Commonwealth in a trustee capacity or as an agent for individuals, private organizations, and other governmental units. These include the pension trust and agency funds. Pension trust funds are established through trust agreements specifying how the fund will operate. Agency funds are custodial in nature and do not report fund balances. The pension trust funds include the Employees' Retirement System of the Government of Puerto Rico and its Instrumentalities, the Puerto Rico Judiciary Retirement System, and the Puerto Rico System of Annuities and Pensions for Teachers.

Agency funds consist of the Special Deposits Fund. This agency fund includes deposits under the custody of the Courts of Justice for alimony payments, deposits under the custody of the Commissioner of Insurance of the Commonwealth for escheated property, and for insurance companies under bankruptcy.

Cash Management Policies and Practices

The Commonwealth maintains a cash pool for its cash and cash equivalents. The balance in the pooled cash accounts is available to meet current operating requirements and any excess is invested in various interest-bearing accounts in the Government Development Bank for Puerto Rico (GDB), a discretely presented component unit. In addition, the Puerto Rico Government Investment Trust Fund (PRGITF), was created by the Commonwealth pursuant to Act No. 176 of August 11, 1995, and began operations on December 4, 1995. PRGITF is a no-load diversified collective investment trust that was created for the purpose of providing eligible investors with a convenient and economical way to invest in a professionally managed money market



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portfolio. The deposits on hand and the investments purchased are not collateralized, secured, or guaranteed by the Commonwealth or any of its agencies, instrumentalities, or political subdivisions.

The Commonwealth's investment policy is to minimize credit and market risk while maintaining a competitive yield on its portfolio. The cash temporarily idle during this year was invested mainly in U.S. government securities, stocks, corporate bonds, repurchase agreements, Commonwealth securities, trading securities, and short-term investments. These are primary government investments that are restricted and unrestricted.

Capital Assets

These basic financial statements include the capital assets of the Commonwealth. A discussion of capital assets accounting is included in the MD&A that is part of the basic financial statements. More detailed information about capital assets can be found in the notes to the basic financial statements.

Debt Administration

As of June 30, 2006, the Commonwealth had a number of debt issues outstanding. The Commonwealth has a BBB- credit rating from Standard & Poor's Corporation and a Baa3 from Moody's Investor Service on general obligation bond issues, these classifications may vary in future years.

Section 2 of Article VI of the Constitution of Puerto Rico provides that direct obligations of the Commonwealth evidenced by full faith and credit bonds or notes shall not be issued if the amount of the principal of and interest on such bonds and notes and on all such bonds and notes theretofore issued, which is payable in any fiscal year, together with any amount paid by the Commonwealth in the preceding fiscal year on accounts of bonds or notes guaranteed by the Commonwealth, exceeds 15% of the average annual revenue raised under the provisions of the Commonwealth Legislation and covered into Treasury of Puerto Rico in the two fiscal year preceding the current fiscal year. Section 2 of Article VI does not limit the amount of debt that the Commonwealth may guarantee so long as the 15% limitation is not exceeded. See the computation of the Legal Debt Margin on page 6 in the Statistical Section. More detailed information about long-term debt can be found in the notes to the basic financial statements.

Risk Financing

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



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Financial Advisor and Fiscal Agent

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, and to make loans to private enterprises to aid the economic development of Puerto Rico. GDB was the first governmental entity in Puerto Rico to obtain a Certificate of Achievement for Excellence in Financial Reporting for its CAFR. It has received the award for the years ended June 30, 1994 through 2005. GDB is presented as a major discretely presented component unit.

ECONOMIC CONDITIONS AND OUTLOOK

Puerto Rico enjoyed almost two decades of economic expansion through fiscal year 2001. Almost every sector of the economy participated, and record levels of employment were achieved. Factors behind this expansion included government-sponsored economic development programs, periodic declines in the value of the U.S. dollar, which is the currency used in the Commonwealth, increases in the level of federal transfers, a significant expansion in construction investment driven by infrastructure projects and private investment, primarily in housing, and the relatively low cost of borrowing.

The economy of Puerto Rico is closely linked to the United States economy. The following exogenous variables are affected by the United States economy: exports, direct investment, transfer payments, interest rates, inflation, and tourist expenditures.

Puerto Rico has a diversified economy with manufacturing and services comprising its principal sectors. Manufacturing is the largest sector in terms of gross domestic product. Manufacturing in Puerto Rico is now more diversified than during the earlier phases of its industrial development and includes several industries less prone to business cycles. In the last three decades, industrial development has tended to be more capital intensive and more dependent on skilled labor.

The services sector, which includes finance, insurance, real estate, wholesale and retail trade, tourism, and other services has shown a strong interaction with manufacturing, tourism, construction, and agriculture.

Tourism makes a significant contribution to economic activity. An estimated \$3.4 billion were spent by visitors in Puerto Rico during fiscal year 2006. San Juan has become the largest home port for cruise ships in the Caribbean and the fourth largest home port for cruise ships in the world. During the year 2006, the numbers of persons registered in tourist hotels maintain the same occupancy rate of the fiscal year 2005. The construction sector is an integral part of the economic activity from fiscal year 1999 through fiscal year 2006. Puerto Rico is heavily dependent on oil imports for the production of electricity; however, as a result of the construction of two cogeneration plants, one of which is fueled by liquefied natural gas and the other by coal, Puerto Rico's dependence on oil imports for the production of electricity has been reduced from 99% to 72%.

The Puerto Rico Planning Board's preliminary reports of the performance of the Puerto Rico economy during fiscal year 2006 indicate that the economy registered an increase of 0.7% in total real gross product. Gross



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product in fiscal year 2000 was \$41.4 billion and gross product in fiscal year 2006 was \$56.7 billion. This represents an increase in gross product of 36.9% from fiscal year 2000 to fiscal year 2006.

In terms of personal income, in fiscal year 2006, personal income per capita was \$12,997 compared to 12,365 in 2005 and \$10,204 in 2000.

According to the Department of Labor and Human Resources, during fiscal year 2006 the labor force was 1.42 million compared to 1.39 million in fiscal year 2005. Unemployment, although at relative low historical levels, remains above the United States average. The average unemployment rate increased from 10.6% during fiscal year 2005 to 11.7% in fiscal year 2006.

Major Initiatives

Individual Income Taxes

Resident individuals are subject to tax on their taxable income from all sources. As a result of legislation enacted in 1999 and 2000, there are several changes in income tax brackets applicable to future taxable years. However, due to significant limitation of available resources, the Commonwealth has deferred further reduction in income tax rates through fiscal year 2006, in an effort to maintain revenue levels, and avoid budgetary shortfalls. The Commonwealth worked on a fiscal and tax reform based on sales and uses tax and implemented it during fiscal year 2007.

Proposed New U.S. Tax Regime for Companies Doing Business in Puerto Rico

In order to enhance the attractiveness for U.S. companies of establishing operations in Puerto Rico, the Commonwealth has been seeking to provide for a new and permanent tax regime applicable to U.S.-based businesses that have operations in the Commonwealth or other U.S. possessions. During the past three years, the Commonwealth has been pursuing an amendment to Section 956 of the U.S. Internal Revenue Code of 1986, as amended (the Code), that would establish a regime based on the tax rules generally applied to U.S. companies with international operations, but with certain modifications intended to promote employment both in the Commonwealth and the United States. The U.S. Congress, however, has not acted upon the proposed amendment to Section 956 of the Code. Also, due to the phase-out of Sections 30A and 936 of the Code, the U.S. Senate designated a special commission through the General Accounting Office to study the economic impact of said phase-out and to present recommendations on alternative tax incentives for U.S.-based companies operating in Puerto Rico. In the meantime, most U.S.-based companies operating under Sections 30A and 936 of the Code have converted from U.S. corporations to Puerto Rico or foreign corporations, which has lessened the impact of the phase-out of those sections.



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Public Sector Debt

Historically, the Commonwealth has maintained, as a matter of fiscal policy, a prudent relationship between the growth of public sector debt and the growth of the economic base required to service that debt. During certain fiscal years, however, public sector debt increased at a greater rate than the rate of gross product primarily due to an increase in the amount of debt incurred to finance certain key infrastructure projects, which are important to the development of the economy and are expected to produce long-term economic benefits, and debt incurred to refinance outstanding debt to enable Puerto Rico to benefit from the historically low levels of interest rates and realize debt service savings. During fiscal year 2006, public sector debt increased 15%.

Prospects for the Future

The Commonwealth is committed to research and pursue solutions to improve the Commonwealth's competitive economic performance and the quality of life for its citizens. The Governor of Puerto Rico has established three long-range priorities which he expressed in his March 2005 state of the Commonwealth message. Those priorities, named "El Triangulo del Exito," are: (1) to provide a new economy that generates new employments providing its citizens with the best quality of life, (2) to provide a safe society (3) to establish an excellent educational system for the benefit of the children.

The Commonwealth's economic development program is based on the fundamental, interrelated changes in technology, demographics, and institutions, which are transforming the global economy. These changes provide the challenges and opportunities that encompass the economic development strategy.

The economic program is based on: (1) refocus the economy on biotechnology, telecommunications, technology information, and related sectors, (2) "Apoyo al de aquí" to create new Puerto Rican enterprises, and (3) infrastructure economic planning.

Initiatives to achieve the economic development program objectives have begun in the following five areas: (1) legislation towards economic development through tax and fiscal reform; (2) consolidation and reductions of governmental entities; (3) refocused strategic projects towards excise taxes; (4) reduction of subsidies provided to governmental entities; and (5) refocused strategic projects related to the citizen's health.

The tax reform which is in force since November 15, 2006 replaced the Commonwealth's current excise tax with the sales and use tax, included compensatory income tax credits in order to address any regressive effect the proposed consumption tax may have, eliminate the marriage penalty, establish an earned income tax credit, increase the deduction for charitable contributions, restructure the estate tax system, provide incentives for investments in technological infrastructure and research and development activities, and adopt additional measures to foster individual savings. The Department of the Treasury expects that the tax reform will provide a net increase in the General Fund's annual revenues, after taking into consideration projected



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reductions in income taxes, in an amount sufficient to reduce and eventually eliminate the structural imbalance.

The proposed fiscal reform includes a long-term plan to reduce and improve the management of the Commonwealth's public debt. Upon the elimination of the structural budget imbalance, which elimination must be certified to the Legislative Assembly and the Governor by the Secretary of the Treasury, the Director of OMB, and the President of GDB, the Commonwealth's operating budget will include an annual contribution to the public improvement fund equal to two percent (2%) of the total amount of the public improvement bonds authorized for that fiscal year. The annual contribution to the public improvement fund will increase by an additional two percent (2%) of the then-current authorization for each fiscal year thereafter, up to a maximum of twenty percent (20%) of the current year's authorized public improvement bond issuance. This contribution is intended to reduce proportionally each year the amount of the Commonwealth's public improvement bond issues.

The Commonwealth faces other fiscal challenges besides its current budgetary issues. The principal one involves resolving the increasing unfunded pension liability of the Employees Retirement System of the government of Puerto Rico and its instrumentalities (Employees Retirement System) and the Puerto Rico System of Annuities and Pensions for Teachers (the Teachers Retirement System). The Commonwealth expects to reduce the unfunded liability of the Employees Retirement System based on proposed legislation which provides for increased employer and employee contributions and the issuance of up to \$2 billion of pension obligation bonds, which would be payable from the Commonwealth's general fund. Besides the Employees Retirement System is considering an issue of bonds to improve unfunded pension liability of the fund. The Employees Retirement System and the Teachers Retirement System are also seeking reimbursement from the Commonwealth for certain special retirement benefits paid by them in prior fiscal years under legislation providing such retirement benefits.

Financial Condition

The MD&A, which can be found immediately following the independent auditors' report, provides an overview of the Commonwealth's financial activities addressing both governmental and business-type activities reported in the government-wide financial statements. In addition, the MD&A focuses on the Commonwealth's major funds. Component units and fiduciary activities are excluded from the MD&A.

Preliminary Fiscal Year 2007 Compared to Actual Fiscal Year 2006

Preliminary general fund total revenue for fiscal year 2007 was \$8,890 million, representing an increase of \$349 million, or 4.1%, from fiscal year 2006 revenue. The 2006 proposed budget package included several new revenue-raising measures sufficient to cover budgeted expenditures, most of which required legislative approval. However, the Legislative Assembly did not approve the budget proposed by the Governor.



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Other Information

Certificate of Achievement

The Government Finance Officers Association of the United States and Canada (GFOA) awarded a *Certificate of Achievement for Excellence in Financial Reporting* to the Commonwealth for its CAFR for the fiscal years ended from June 1996 through 2002 and 2004 to 2005. The Certificate of Achievement is a prestigious national award recognizing conformance with the highest standards for the preparation of state and local government financial reports.

In order to be awarded a Certificate of Achievement, a government unit must publish an easily readable and efficiently organized CAFR, whose contents conform to program standards. The CAFR must satisfy both accounting principles generally accepted in the United States of America and applicable legal requirements. A Certificate of Achievement is valid for a period of only one year.

We believe the Comprehensive Annual Financial Report of the Commonwealth of Puerto Rico as of and for the fiscal year ended June 30, 2006 continues to conform to GFOA standards and we are submitting it to the GFOA to determine its eligibility for a Certificate of Achievement for Excellence in Financial Reporting.

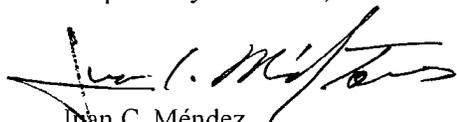
Acknowledgements

The preparation of this report requires the collective efforts of numerous finance personnel throughout the Commonwealth and is made possible only with the cooperation and support of the Executive, Legislative, and Judicial branch agencies, and component units of the Commonwealth. We sincerely appreciate the dedicated efforts of all these individuals.

The report could not have been accomplished without the professionalism and dedication of Juan Torr  Mart nez, CPA, from our accounting team as well as the rest of the personnel of the Central Government Accounting area. Also, we would like to give special thanks to our independent auditors, KPMG LLP, for their advice and commitment.

This report continues our commitment to the citizens of the Commonwealth of Puerto Rico, the Governor, the Legislature, and the financial community to maintain our general purpose financial statements in conformance with the highest standards of financial accountability.

Respectfully submitted,


Juan C. M ndez
Secretary of the Treasury



SECRETARY OF THE TREASURY

COMMONWEALTH OF PUERTO RICO

PRINCIPAL OFFICIALS

As of June 30, 2007

Aníbal Acevedo Vilá
Governor

Members of Cabinet

Jorge Silva Puras
Chief of Staff

Fernando Bonilla Ortiz
Secretary of State

Roberto Sánchez Ramos
Secretary of Justice

Juan C. Méndez Torres
Secretary of the Treasury

Rafael Aragunde Torres
Secretary of Education

Román Velasco González
Secretary of Labor and
Human Resources

Rosa Pérez Perdomo
Secretary of Health

José Orlando Fabre Laboy
Secretary of Agriculture

Carlos González Miranda
Secretary of Transportation and
Public Works

Ricardo Rivera Cardona
Secretary of Economic
Development and Commerce

Felix Matos Rodríguez
Secretary of Family Affairs

Jorge Rivera Jiménez
Secretary of Housing

Javier Vélez Arocho
Secretary of Natural and
Environmental Resources

Alejandro García Padilla
Secretary of Consumer Affairs

David E. Bernier Rivera
Secretary of Sports and
Recreation

Miguel A. Pereira Castillo
Secretary of Corrections and
Rehabilitation

LEGISLATIVES OFFICERS

As of June 30, 2006

Kenneth McClintock Hernández
President, Senate

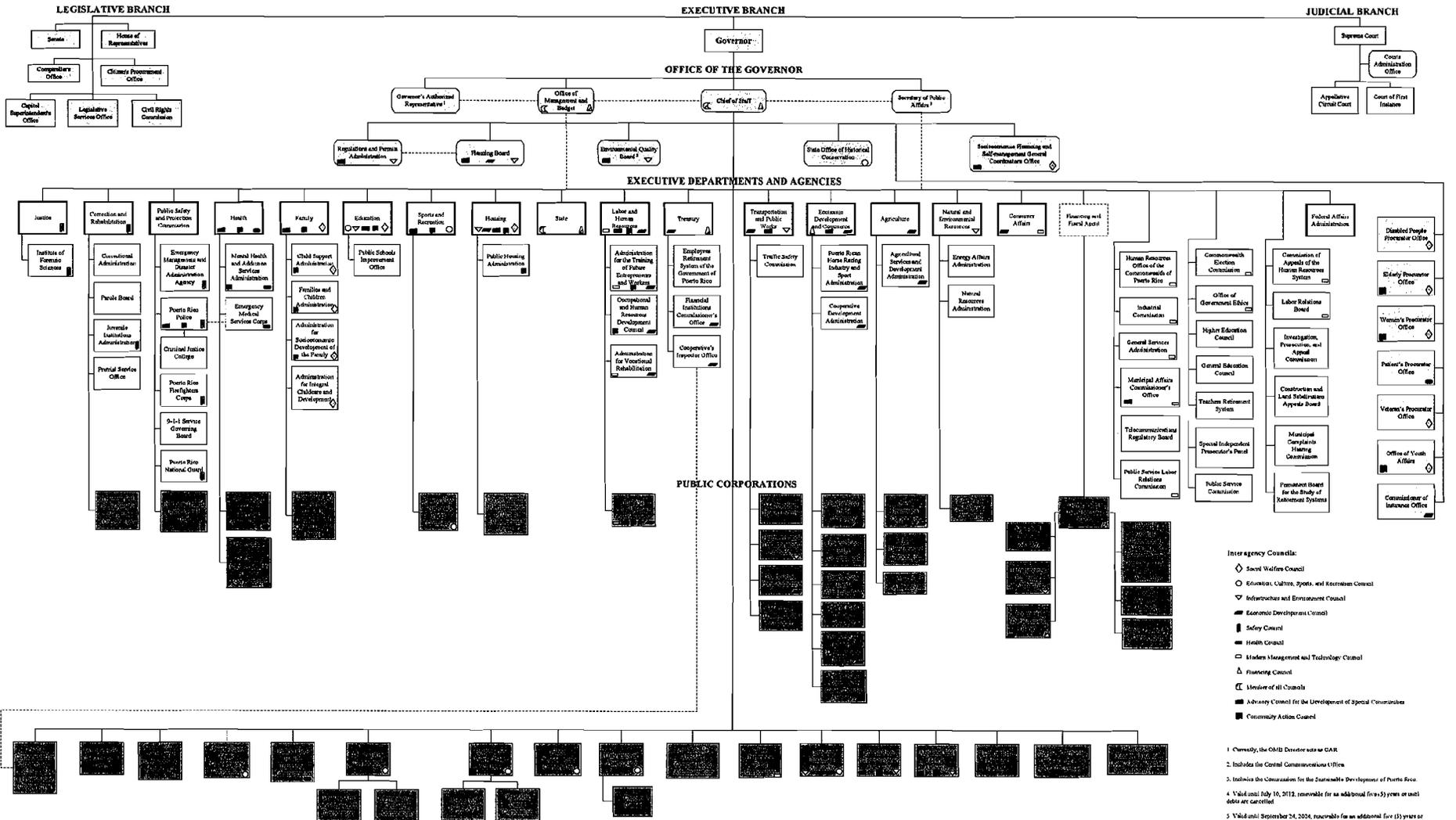
José Aponte Hernández
Speaker, House of
Representatives

FISCAL OFFICERS

As of September 1, 2006

José G. Dávila Matos
Director, Office of Management
and Budget

Alfredo Salazar Conde
President, Government
Development Bank for
Puerto Rico



- Interagency Councils:**
- ◆ Social Welfare Council
 - Education, Culture, Sports, and Recreation Council
 - ▽ Information and Environment Council
 - Economic Development Council
 - Safety Council
 - Health Council
 - Modern Management and Technology Council
 - △ Financing Council
 - Member of All Councils
 - Advisory Council for the Development of Special Commissions
 - Community Action Council

1. Currently, the OMB Director acts as GAR.
 2. Includes the Control Commissions Offices.
 3. Includes the Commission for the Sustainable Development of Puerto Rico.
 4. Valid until July 10, 2012, renewable for an additional five (5) years or until debt are cancelled.
 5. Valid until September 24, 2004, renewable for an additional five (5) years or until debt are cancelled.

Revised May/2006

Certificate of Achievement for Excellence in Financial Reporting

Presented to

Commonwealth of Puerto Rico

For its Comprehensive Annual
Financial Report
for the Fiscal Year Ended
June 30, 2005

A Certificate of Achievement for Excellence in Financial Reporting is presented by the Government Finance Officers Association of the United States and Canada to government units and public employee retirement systems whose comprehensive annual financial reports (CAFRs) achieve the highest standards in government accounting and financial reporting.



President

Executive Director

FINANCIAL SECTION



KPMG LLP
American International Plaza
Suite 1100
250 Muñoz Rivera Avenue
San Juan, PR 00918-1819

Independent Auditors' Report

The Honorable Governor and Legislature
Commonwealth of Puerto Rico
San Juan, Puerto Rico

We have audited the accompanying financial statements of the governmental activities, the business-type activities, the aggregate discretely presented component units, each major fund, and the aggregate remaining fund information of the Commonwealth of Puerto Rico (the Commonwealth) as of and for the year ended June 30, 2006, which collectively comprise the Commonwealth's basic financial statements as listed in the table of contents. These financial statements are the responsibility of the Commonwealth's management. Our responsibility is to express opinions on these financial statements based on our audit. We did not audit the financial statements of the Public Buildings Authority capital project fund or The Children's Trust special revenue fund (major funds), which represents 2% and 0%, respectively, of the assets and revenue of the governmental activities. We also did not audit the financial statements of the following activities, funds, and component units:

- Puerto Rico Public Housing Administration, Human Resources and Occupational Development Council, and the Office for the Administration of the Assets of the Urban Renovation and Housing Corporation of the Commonwealth of Puerto Rico, which collectively represent 16% and 3%, respectively, of the assets and revenue of the general fund and 6% and 3%, respectively, of the assets and revenue of the governmental activities,
- Public Buildings Authority special revenue and The Children Trust, Public Building Authority, and Puerto Rico Maritime Shipping Authority debt service funds, which collectively represent 7% and 4%, respectively, of the assets and revenue of the aggregate remaining fund information and 4% and 1%, respectively, of the assets and revenue of the governmental activities;
- The Additional Lottery System, which represents 66% and 39%, respectively, of the assets and revenue of the lotteries fund and 12% and 33%, respectively, of the assets and revenue of the business-type activities;
- Puerto Rico Water Pollution Control Revolving Fund and the Puerto Rico Safe Drinking Water Treatment Revolving Loan Fund which collectively represent 3% and 2% respectively, of the assets and revenue of the aggregate remaining fund information and 21% and 3% of the assets and revenue of the business-type activities;
- The pension trust funds, which represents 71% and 91%, respectively, of the assets and revenue of the aggregate remaining fund information; and
- Entities identified in note 2 that are presented as discretely presented component units, which collectively represent 88% and 91%, respectively, of the assets and revenue of the aggregate discretely presented component units.

These financial statements were audited by other auditors whose reports thereon have been furnished to us, and our opinions, insofar as they relate to the amounts included for the activities, funds, and component units indicated above, are based on the reports of the other auditors.



We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Commonwealth's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinions.

In our opinion, based on our audit and the reports of the other auditors, the financial statements referred to above present fairly, in all material respects, the respective financial position of the governmental activities, the business-type activities, the aggregate discretely presented component units, each major fund, and the aggregate remaining fund information of the Commonwealth of Puerto Rico as of June 30, 2006, and the respective changes in financial position, and, where applicable, cash flows thereof and the respective budgetary comparison for the general fund for the year then ended in conformity with U.S. generally accepted accounting principles.

As described in note 12, the Commonwealth adopted GASB Statement No. 42, *Accounting and Financial Reporting for Impairment of Capital Assets and for Insurance Recoveries* as of June 30, 2006.

The management's discussion and analysis on pages 3 through 20 and the schedule of funding progress on pages 149 and 150 are not a required part of the basic financial statements but are supplementary information required by U.S. generally accepted accounting principles. We and the other auditors have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the required supplementary information. However, we did not audit the information and express no opinion on it.

Our audit was conducted for the purpose of forming opinions on the financial statements that collectively comprise the Commonwealth's basic financial statements. The combining and individual fund financial statements and schedules listed in the table of contents are presented for purposes of additional analysis and are not a required part of the basic financial statements. These combining and individual fund financial statements have been subjected to the auditing procedures applied by us and the other auditors in the audit of the basic financial statements and, in our opinion, are fairly stated in all material respects in relation to the basic financial statements taken as a whole. The introductory and statistical sections listed in the table of content have not been subjected to the auditing procedures applied in the audit of the basic financial statements and, accordingly, we express no opinion on them.

KPMG LLP

August 1, 2007

Stamp No. 2221579 of the Puerto Rico
Society of Certified Public Accountants
was affixed to the record copy of this report.

COMMONWEALTH OF PUERTO RICO

Management's Discussion and Analysis

June 30, 2006

Management of the Commonwealth of Puerto Rico (the Commonwealth) provides this Management's Discussion and Analysis for the readers of the Commonwealth's basic financial statements. This narrative overview and analysis of the financial activities of the Commonwealth is for the fiscal year ended June 30, 2006, and is intended to provide an easily readable explanation of the information provided in the attached basic financial statements. We encourage readers to consider this information with the Commonwealth's basic financial statements that follow.

Financial Highlights – Primary Government

Government-wide Highlights

- The Commonwealth reported a deficit of \$16.4 billion as of June 30, 2006, a deterioration in the financial position of \$1.2 billion from last year's balances. The accumulated deficit is principally the result of the Commonwealth's practice of issuing debt and transferring such funds to its discretely presented component units in order for them to carry out the corresponding construction programs.
- The Commonwealth's total deficit increased by \$1.2 billion (an 7% increase) as a result of this year's operations. The governmental activities' deficit increased by \$1.3 billion (an 8% increase), while net assets of the business-type activities showed an increase of \$97 million (a 16% increase).
- The Commonwealth's governmental activities had total revenue of \$14.3 billion, which were exceeded by total expenses of \$15.8 billion, excluding transfers received from business-type activities amounting to \$243 million.
- The Commonwealth's business-type activities had total revenue of \$1.2 billion, which exceeded total expenses of \$903 million, excluding transfers made to the governmental activities amounting to \$243 million.

Fund Highlights

- As of June 30, 2006, the Commonwealth's governmental funds reported a combined ending fund balance of \$411 million, an increase of \$18 million in comparison with the prior year, while the business-type activities increased by \$97 million to reach \$778 million.
- The general fund reported a deficit of \$384 million as of June 30, 2006, a decrease of \$120 million in comparison with the prior year.
- The unemployment insurance trust fund reported net assets of \$543 million while the lotteries fund reported a deficit of \$170 million. The deficit in the lottery funds was a result of the transfers of investments made to the general fund a few years ago.

Long-Term Debt

- Total long-term obligations as of June 30, 2006 were \$27 billion, from which \$2 billion are due within one year. The long-term obligation of the governmental activities increased by \$2 billion (8%) to \$27 billion when compared to the prior year, while the business-type activities decreased by \$26 million (6%) to \$382 million. The increase in governmental activities' long-term obligations was mainly due to notes payables of the Department of the Treasury to cover operations needs.

COMMONWEALTH OF PUERTO RICO

Management's Discussion and Analysis

June 30, 2006

Overview of the Financial Statements

This discussion and analysis is intended to serve as an introduction to the Commonwealth's basic financial statements. The Commonwealth's basic financial statements include three components: (1) government-wide financial statements, (2) fund financial statements, and (3) notes to the financial statements. This report also contains additional required supplementary information in addition to the basic financial statements themselves. These components are described below:

Basic Financial Statements

The basic financial statements include two kinds of financial statements that present different views of the Commonwealth—the government-wide financial statements and the fund financial statements and combining major component units financial statements. These financial statements also include the notes to the basic financial statements that explain some of the information in the financial statements and provide more detail.

Government-wide Financial Statements

The government-wide financial statements provide a broad view of the Commonwealth's operations in a manner similar to a private sector business. The statements provide both short- and long-term information about the Commonwealth's financial position, which assists in assessing the Commonwealth's economic condition at the end of the fiscal year. These are prepared using the flow of economic resources measurement focus and the accrual basis of accounting. This basically means they follow methods that are similar to those used by most businesses. They take into account all revenue and expenses connected with the fiscal year even if cash involved has not been received or paid. The government-wide financial statements include two statements:

- ***Statement of Net Assets*** – This presents all of the government's assets and liabilities with the difference between the two reported as net assets (deficit). Over time, increases or decreases in the Commonwealth's net assets (deficit) may serve as a useful indicator of whether the financial position of the Commonwealth is improving or deteriorating.
- ***Statement of Activities*** – This presents information showing how the government's net assets changed during the most recent fiscal year. All changes in net assets are reported as soon as the underlying event giving rise to the change occurs, regardless of the timing of related cash flows. Thus, revenue and expenses are reported in this statement for some items that will not result in cash flows until future fiscal periods (such as uncollected taxes and earned but unused vacation leave). This statement also presents a comparison between direct expenses and program revenue for each function of the Commonwealth.

Both of the above financial statements have separate sections for three different types of Commonwealth programs or activities. These three types of activities are as follows:

- ***Governmental Activities*** – The activities in this section are mostly supported by taxes and intergovernmental revenue (federal grants). Most services normally associated with Commonwealth government fall into this category, including general government, public safety, health, public housing and welfare, education, and economic development.
- ***Business-Type Activities*** – These functions normally are intended to recover all or a significant portion of their costs through user fees and charges to external users of goods and services. These business-type activities of the Commonwealth include the operations of the following major funds: unemployment insurance trust fund (administered by the Commonwealth Employment Security Bureau) and the lotteries.

COMMONWEALTH OF PUERTO RICO

Management's Discussion and Analysis

June 30, 2006

- **Component Units** – These are organizations that are legally separate from the Commonwealth, but the Commonwealth is either financially accountable for them, or the nature and significance of their relationship with the Commonwealth are such that their exclusion would cause the Commonwealth's financial statements to be misleading or incomplete. The Commonwealth has both blended and discretely presented component units.
- **Blended Component Units** – Although legally separate entities, these are in substance part of the primary government's operations. Therefore, data from blended component units are integrated into the appropriate funds for reporting purposes.

The Commonwealth's three blended component units are:

- Public Buildings Authority
 - Puerto Rico Maritime Shipping Authority
 - The Children's Trust
- **Discretely Presented Component Units** – These are operations for which the Commonwealth has financial accountability but they have certain independent qualities as well. For the most part, these entities operate similar to private sector businesses and the business-type activities described above. The Commonwealth's discretely presented component units are presented in two categories, major and nonmajor. This separation is determined by the relative size of the entities' assets, liabilities, revenue, and expenses in relation to the total of all component units.

The Commonwealth's 34 discretely presented nonmajor component units are combined into a single column for reporting in the fund financial statements. Complete financial statements of the individual component units can be obtained from their respective administrative offices. Addresses and other additional information about the Commonwealth's component units are presented in note 1 to the basic financial statements.

The Commonwealth's seven discretely presented major component units are:

- Government Development Bank for Puerto Rico
- Puerto Rico Highways and Transportation Authority
- Puerto Rico Electric Power Authority
- Puerto Rico Aqueduct and Sewer Authority
- Puerto Rico Infrastructure Financing Authority
- Puerto Rico Health Insurance Administration
- University of Puerto Rico

The government-wide financial statements can be found immediately following this discussion and analysis.

COMMONWEALTH OF PUERTO RICO

Management's Discussion and Analysis

June 30, 2006

Fund Financial Statements

A fund is a grouping of related accounts that is used to maintain control over resources that have been segregated for specific activities or objectives. The Commonwealth, like other states and local governments, uses fund accounting to help ensure and demonstrate compliance with finance-related legal requirements. The fund financial statements focus on individual parts of the Commonwealth government, reporting the Commonwealth's operations in more detail than the government-wide financial statements. All of the funds of the Commonwealth can be divided into three categories. It is important to note that these fund categories use different accounting approaches and should be interpreted differently. The three categories of funds are the following:

- ***Governmental Funds Financial Statements*** – Most of the basic services provided by the Commonwealth are financed through governmental funds. Governmental funds are used to account for essentially the same functions reported as governmental activities in the government-wide financial statements. However, unlike the government-wide financial statements, the governmental fund financial statements focus on near-term inflows and outflows of expendable resources. They also focus on the balances of expendable resources available at the end of the fiscal year. Such information may be useful in evaluating the government's near-term financing requirements. This approach is known as using the flow of current financial resources measurement focus and the modified-accrual basis of accounting. These statements provide a detailed short-term view of the Commonwealth's finances that assists in determining whether there will be adequate financial resources available to meet the current needs of the Commonwealth. Because the focus of governmental funds is narrower than that of the government-wide financial statements, it is useful to compare the information presented for governmental funds with similar information presented for governmental activities in the government-wide financial statements. By doing so, readers may better understand the long-term impact of the government's near-term financing decisions. Both the governmental fund balance sheet and the governmental fund statement of revenue, expenditures, and changes in fund balances provide a reconciliation to facilitate this comparison between governmental funds and the governmental activities. These reconciliations are presented on the page immediately following each governmental fund financial statement.

The Commonwealth has four major governmental funds. That is, each major fund is presented in a separate column in the governmental funds balance sheet and in the governmental funds statement of revenue, expenditures, and changes in fund balances. The Commonwealth's four major governmental funds are the general fund, The Children's Trust special revenue fund, the debt service fund, and the Public Buildings Authority capital projects fund. The remaining nonmajor governmental funds are grouped and presented in a single column in the governmental funds financial statements. The basic governmental funds financial statements can be found immediately following the government-wide financial statements.

- ***Proprietary Funds Financial Statements*** – These funds are used to show activities that operate more like those of commercial enterprises. Because these funds charge fees for services provided to outside customers including local governments, they are known as enterprise funds. Proprietary funds provide the same type of information as the government-wide financial statements, only in more detail. Like the government-wide financial statements, proprietary fund financial statements use the accrual basis of accounting. There is no reconciliation needed between the government-wide

COMMONWEALTH OF PUERTO RICO

Management's Discussion and Analysis

June 30, 2006

financial statements for business-type activities and the proprietary fund financial statements. The Commonwealth has two major enterprise funds. As previously mentioned, they are the operations of the unemployment insurance trust fund (administered by the Commonwealth's Employment Security Bureau) and the lotteries. Other nonmajor proprietary funds are grouped and presented in a separate column in the proprietary funds financial statements. The basic proprietary funds financial statements can be found immediately following the governmental fund financial statements.

- ***Fiduciary Funds and Similar Component Units Financial Statements*** – These funds are used to account for resources held for the benefit of parties outside the Commonwealth government. Fiduciary funds are not reflected in the government-wide financial statements because the resources of these funds are not available to support the Commonwealth's own programs. The accounting used for fiduciary funds is much like that used for proprietary funds. They use the accrual basis of accounting. The Commonwealth's fiduciary funds are the pension trust funds (three separate retirement systems for employees, which are fiduciary component units of the Commonwealth), and the agency funds (which account for the assets held for distribution by the Commonwealth as an agent for other governmental units, other organizations, or individuals). The basic fiduciary funds and similar component units' financial statements can be found immediately following the proprietary funds financial statements.

Component Units Financial Statements

As mentioned above, these are operations for which the Commonwealth has financial accountability, but they have certain independent qualities as well, and they operate similar to private-sector businesses. The government-wide financial statements present information for the component units in a single column on the statement of net assets. Also, some information on the statement of changes in net assets is aggregated for component units. The combining statements of net assets and the combining statement of activities provide detail for each major component unit and the nonmajor component units in aggregate. The basic combining financial statements for major component units can be found immediately following the fiduciary funds financial statements.

Notes to Basic Financial Statements

The notes provide additional information that is essential to a full understanding of the data provided in the government-wide and the fund financial statements. The notes to the basic financial statements can be found immediately following the component units' financial statements.

Required Supplementary Information

The basic financial statements include within its notes a section of required supplementary information. This section includes information of funding progress for the Commonwealth's three separate retirement systems.

Government-Wide Financial Analysis

Net Assets

As noted earlier, net assets may serve over time as a useful indicator of a government's financial position. Total assets and total liabilities of the Commonwealth's primary government at June 30, 2006 amounted to

COMMONWEALTH OF PUERTO RICO

Management's Discussion and Analysis

June 30, 2006

\$14.9 billion and \$31.3 billion, respectively, for a net deficit of \$16.4 billion, compared to a \$15.2 billion net deficit at the beginning of the current year, as restated.

A portion of the Commonwealth's net assets (deficit) reflects its investment in capital assets such as land, buildings, and equipment, less any related debt used to acquire those assets that are still outstanding. The Commonwealth uses these capital assets to provide services to its residents; consequentially, these assets are not available for future spending. Although the Commonwealth's investment in its capital assets is reported net of related debt, it should be noted that the resources needed to repay this debt must be provided from other sources, since the capital assets themselves cannot be used to liquidate these liabilities.

An additional portion of the Commonwealth's net assets (deficit) represents resources that are subject to external restrictions on how they may be used. An otherwise positive remaining balance would be used to meet the Commonwealth's ongoing obligations to its residents and creditors. Internally imposed designations of resources are not presented as restricted net assets. At the end of the current fiscal year, the Commonwealth is able to report positive balances in two categories of net assets, and a deficit, both for the government as a whole, as well as for its separate governmental and business-type activities.

As explained earlier, the net deficit of the primary government primarily results from the Commonwealth's practice of issuing debt and transferring such funds to the component units so that they can carry out the construction projects. The primary government retains the debt while the component units report the corresponding asset financed by such debt.

Total assets increased by \$1.5 billion during fiscal year 2006 when compared to the prior fiscal year. The key elements for this increase are as follows:

- Restricted cash increased by \$647 million when compared to the prior year. The increase was due to approximately \$250 million in cash restricted for tax revenue anticipation notes, and an overall increase in cash restricted for the payment of other long-term debt.
- Taxes receivable increased \$120 million when compared to the prior year.
- Additions of capital assets and depreciation expense amounted to \$816 million and \$223 million, respectively.

COMMONWEALTH OF PUERTO RICO

Management's Discussion and Analysis

June 30, 2006

Total liabilities increased \$3 billion during the current fiscal year when compared to the prior fiscal year. The key elements for this increase are mostly due to the net increase in debt issued of \$1.64 billion, which consisted of issuances during fiscal year 2006 of Commonwealth bonds and notes payable amounting to \$141 million and \$3.2 billion, respectively, offset by repayments of such debt in the amount of \$209 million and \$140 million, respectively. Increases were also experienced in the net pension obligation of \$261 million and accounts payable and tax revenue anticipation notes of \$298 million and \$250 million, respectively.

Commonwealth's Net Assets – Primary Government

June 30, 2006

(expressed in thousands)

	<u>Governmental activities</u>	<u>Business-type activities</u>	<u>Total</u>
Current assets	\$ 3,665,245	939,895	4,605,140
Capital assets	7,183,178	1,008	7,184,186
Other assets	<u>2,817,053</u>	<u>255,993</u>	<u>3,073,046</u>
Total assets	\$ 13,665,476	1,196,896	14,862,372
Current liabilities	\$ 6,378,707	149,673	6,528,380
Noncurrent liabilities	<u>24,496,332</u>	<u>269,723</u>	<u>24,766,055</u>
Total liabilities	\$ 30,875,039	419,396	31,294,435
Invested in capital assets, net of related debt	\$ 3,485,882	1,008	3,486,890
Restricted	280,078	947,507	1,227,585
Unrestricted	<u>(20,975,523)</u>	<u>(171,015)</u>	<u>(21,146,538)</u>
Total net assets (deficit)	\$ (17,209,563)	777,500	(16,432,063)

COMMONWEALTH OF PUERTO RICO

Management's Discussion and Analysis

June 30, 2006

Commonwealth's Net Assets – Primary Government
June 30, 2005
(expressed in thousands)

	<u>Governmental activities</u>	<u>Business-type activities</u>	<u>Total</u>
Current assets	\$ 2,897,994	886,219	3,784,213
Capital assets	7,119,033	1,367	7,120,400
Other assets	<u>2,187,383</u>	<u>222,748</u>	<u>2,410,131</u>
Total assets	\$ 12,204,410	1,110,334	13,314,744
Current liabilities	\$ 5,268,743	142,818	5,411,561
Noncurrent liabilities	<u>22,852,456</u>	<u>296,666</u>	<u>23,149,122</u>
Total liabilities	\$ 28,121,199	439,484	28,560,683
Invested in capital assets, net of related debt	\$ 3,623,158	847	3,624,005
Restricted	296,692	872,215	1,168,907
Unrestricted	<u>(19,836,639)</u>	<u>(202,212)</u>	<u>(20,038,851)</u>
Total net assets (deficit)	\$ (15,916,789)	670,850	(15,245,939)

Changes in Net Assets

The Commonwealth's net deficit increased by \$1.2 billion or 8% from last year's total net deficit. Approximately 52% of the Commonwealth's total revenue came from taxes, while 29% resulted from grants and contributions (primarily federal financial assistance). Charges for various goods and services provided represented 13% of the total revenue. The Commonwealth's expenses cover a range of services. The largest expenses were for education, public housing and welfare, general government, and public safety. In 2006, governmental activities' expenses exceeded program revenue by \$10.5 billion, resulting in the use of \$9.2 billion in general revenue (mostly taxes) and transfers. On the other hand, program revenue from business-type activities in 2006 exceeded expenses by approximately \$306 million. In addition, the business-type activities had unrestricted investments earnings of \$33 million and transfer to the governmental activities amounting to \$243 million.

Governmental activities decreased the Commonwealth's net assets by \$1.2 billion, which is \$1.7 billion less than \$2.9 billion experienced in the prior year. The Commonwealth made efforts to decrease overall expenses; these efforts resulted in a decrease \$1.2 billion, but revenues were still lower than total expenses. The Commonwealth implemented the 5.5% sales and use tax during fiscal year 2007. This sales and use tax results in higher tax revenues. The Commonwealth expects that the effort to decrease expenses and the increase in tax revenue with the sales and use tax will eliminate or significantly lower the deficit in future years.

Business-type activities increased the Commonwealth's net assets by \$97 million. The two main factors that contributed to the increase in net assets were the reduction of \$30 million in the operating expenses in lottery funds and the increase in nonoperating revenue of \$37.3 million of contributions from federal government on unemployment fund, water pollution control and treatment revolving loan funds.

COMMONWEALTH OF PUERTO RICO

Management's Discussion and Analysis

June 30, 2006

Commonwealth of Puerto Rico's Changes in Net Assets – Primary Government
Year ended June 30, 2006
(expressed in thousands)

	<u>Governmental activities</u>	<u>Business-type activities</u>	<u>Total</u>
Revenue:			
Program revenue:			
Charges for services	\$ 828,993	1,149,426	1,978,419
Operating grants and contributions	4,365,711	59,613	4,425,324
Capital grants and contributions	100,990	—	100,990
	<u>5,295,694</u>	<u>1,209,039</u>	<u>6,504,733</u>
General revenue:			
Income taxes	6,255,391	—	6,255,391
Excise taxes	2,013,998	—	2,013,998
Other taxes	15,145	—	15,145
Revenue from component units	68,745	—	68,745
Other	601,225	33,165	634,390
	<u>8,954,504</u>	<u>33,165</u>	<u>8,987,669</u>
Total revenue	<u>14,250,198</u>	<u>1,242,204</u>	<u>15,492,402</u>
Expenses:			
General government	2,844,494	—	2,844,494
Public safety	2,217,294	—	2,217,294
Health	1,422,813	—	1,422,813
Public housing and welfare	3,287,559	—	3,287,559
Education	4,110,669	—	4,110,669
Economic development	564,447	—	564,447
Intergovernmental	440,390	—	440,390
Interest and other	882,163	25,043	907,206
Lotteries	—	670,425	670,425
Unemployment	—	207,483	207,483
Total expenses	<u>15,769,829</u>	<u>902,951</u>	<u>16,672,780</u>
(Decrease) increase in net assets before transfers	(1,519,631)	339,253	(1,180,378)
Transfers	242,642	(242,642)	—
(Decrease) increase in net assets	(1,276,989)	96,611	(1,180,378)
Net assets (deficit), beginning of year (as restated)	<u>(15,932,574)</u>	<u>680,889</u>	<u>(15,251,685)</u>
Net assets (deficit), end of year	\$ <u><u>(17,209,563)</u></u>	<u><u>777,500</u></u>	<u><u>(16,432,063)</u></u>

COMMONWEALTH OF PUERTO RICO

Management's Discussion and Analysis

June 30, 2006

Commonwealth of Puerto Rico's Changes in Net Assets – Primary Government
Year ended June 30, 2005
(expressed in thousands)

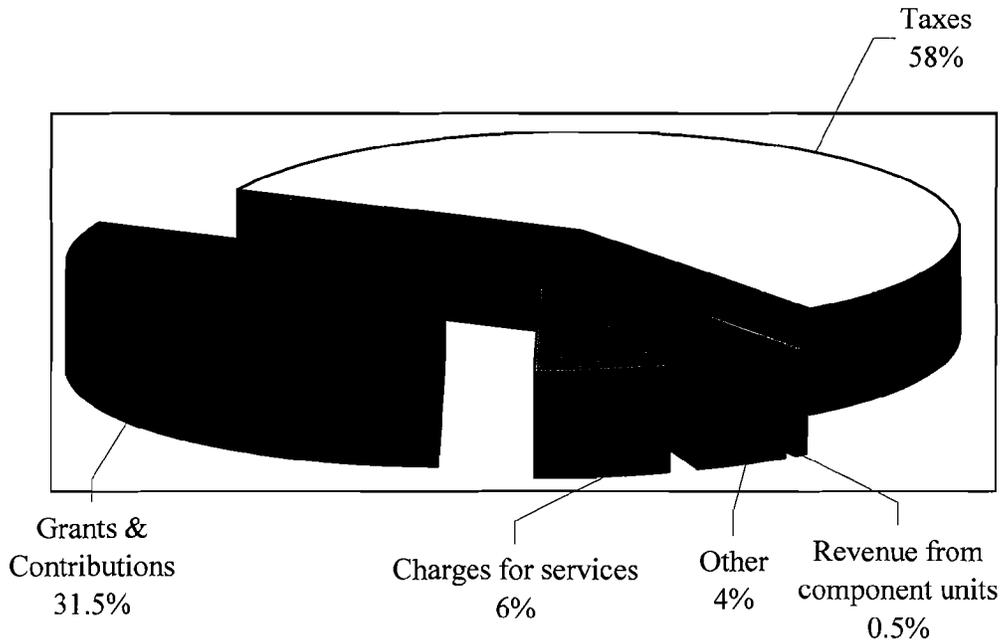
	<u>Governmental activities</u>	<u>Business-type activities</u>	<u>Total</u>
Revenue:			
Program revenue:			
Charges for services	\$ 702,691	1,187,009	1,889,700
Operating grants and contributions	4,096,204	22,315	4,118,519
Capital grants and contributions	121,083	—	121,083
	<u>4,919,978</u>	<u>1,209,324</u>	<u>6,129,302</u>
General revenue:			
Income taxes	5,526,006	—	5,526,006
Excise taxes	2,101,216	—	2,101,216
Other taxes	7,128	—	7,128
Revenue from component units	474,069	—	474,069
Other	648,083	32,284	680,367
	<u>8,756,502</u>	<u>32,284</u>	<u>8,788,786</u>
Total revenue	<u>13,676,480</u>	<u>1,241,608</u>	<u>14,918,088</u>
Expenses:			
General government	1,827,816	—	1,827,816
Public safety	2,580,951	—	2,580,951
Health	2,364,110	—	2,364,110
Public housing and welfare	3,443,886	—	3,443,886
Education	5,000,686	—	5,000,686
Economic development	1,006,945	—	1,006,945
Interest and other	845,556	32,437	877,993
Lotteries	—	699,407	699,407
Unemployment	—	197,967	197,967
	<u>17,069,950</u>	<u>929,811</u>	<u>17,999,761</u>
Total expenses	<u>17,069,950</u>	<u>929,811</u>	<u>17,999,761</u>
(Decrease) increase in net assets before transfers	(3,393,470)	311,797	(3,081,673)
Transfers	492,776	(492,776)	—
Decrease in net assets	(2,900,694)	(180,979)	(3,081,673)
Net assets (deficit), beginning of year (as restated)	<u>(13,016,095)</u>	<u>851,829</u>	<u>(12,164,266)</u>
Net assets (deficit), end of year as presented in 2005	\$ <u>(15,916,789)</u>	<u>670,850</u>	<u>(15,245,939)</u>

COMMONWEALTH OF PUERTO RICO

Management's Discussion and Analysis

June 30, 2006

**Revenue – Governmental Activities
Year ended June 30, 2006**



**Expenses – Governmental Activities
Year ended June 30, 2006
(expressed in thousands)**

Functions	Expenses
Primary government:	
Governmental activities:	
General government	\$ 2,844,494
Public safety	2,217,294
Health	1,422,813
Public housing and welfare	3,287,559
Education	4,110,669
Economic development	564,447
Intergovernmental	440,390
Interest and other	882,163
Total governmental activities	<u>\$ 15,769,829</u>

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Governmental Activities

Governmental activities increased the Commonwealth's net deficit to \$17.2 billion. The decrease in net assets by the business-type activities is explained below. A comparison of the cost of services by function for the Commonwealth's governmental activities is shown below, along with the revenue used to cover the net expenses of the governmental activities (expressed in thousands).

Governmental Activities – Expenses Net of Program Revenue
Year ended June 30, 2006
(expressed in thousands)

Net (expense) revenue:	
General government	\$ (2,025,403)
Public safety	(2,061,914)
Health	(662,913)
Public housing and welfare	(804,088)
Education	(3,111,106)
Economic development	(486,887)
Intergovernmental	(439,661)
Interest and other	<u>(882,163)</u>
Total governmental activities expenses, net program revenue	(10,474,135)
General revenue:	
Taxes	8,284,534
Revenue from component units	68,745
Transfers from business-type activities	242,642
Other revenue	<u>601,225</u>
Increase in governmental activities net deficit	\$ <u><u>(1,276,989)</u></u>

COMMONWEALTH OF PUERTO RICO

Management's Discussion and Analysis

June 30, 2006

Expenses and Program Revenue – Governmental Activities
Year ended June 30, 2006
 (expressed in thousands)

Functions	Expenses	Charges for services
Primary government:		
Governmental activities:		
General government	\$ 2,844,494	576,791
Public safety	2,217,294	58,284
Health	1,422,813	105,264
Public housing and welfare	3,287,559	29,534
Education	4,110,669	2,423
Economic development	564,447	55,968
Intergovernmental	440,390	729
Interest and other	882,163	—
Total governmental activities	\$ <u>15,769,829</u>	<u>828,993</u>

Business-Type Activities

The business-type activities increased the Commonwealth's net assets by \$97 million. This resulted from a reduction of lottery awards of \$30 million and contributions of federal government of \$37.3 million explained previously.

Financial Analysis of the Commonwealth's Individual Funds

As noted earlier, the Commonwealth uses fund accounting to help ensure and demonstrate compliance with finance-related legal requirements.

Governmental Funds

The focus of the Commonwealth's governmental funds is to provide information on near-term inflows, outflows, and balances of expendable resources. Such information is useful in assessing the Commonwealth's financing requirements. In particular, unreserved fund balance may serve as a useful measure of a government's net resources available for spending at the end of the fiscal year. As of the end of fiscal year 2006, the Commonwealth's governmental funds reported combined ending fund balance of \$411 million, an increase of \$18 million in comparison with the prior year. Although the expenditures exceeded the revenues by \$1.8 billion, the result of the other financing sources amounting to \$1.8 billion led to a break-even situation in the fund balance of the governmental funds. This year the excess of expenditures over revenue decreased by \$1.1 billion compared with the prior year. There is \$844 million of fund balance reserved to indicate that it is not available for new spending because it has already been committed (1) to liquidate contracts and purchase orders of the prior fiscal year, or (2) for a variety of other restricted purposes.

The general fund is the chief operating fund of the Commonwealth. At the end of the current fiscal year, unreserved fund deficit of the general fund was \$1.1 billion, while the total fund balance has a total deficit of

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\$384 million. The fund balance of the Commonwealth's general fund increased by \$120 million as a result of the current fiscal year's change in financial position. This is a 24% increase when compared to total fund balance reported in fiscal year 2005. Also, see additional related comments in the following section titled General Fund Budgetary Highlights.

The debt service fund is the fund in which the Commonwealth accumulates the resources for the payment of the long-term debt. At end of the year the fund balance increased by \$41 million due to the transfers received from the general fund. Cash and cash equivalents increased by \$20 million or 2% compared with the prior year mainly due to investments of the transfers received from the general fund for the payment of debt.

The PBA capital project fund received resources only from transfers from other funds and had expenditures of \$176 million, which resulted in a deficit of \$32 million for the fund. The fund total assets decreased \$153 million or 73% compared with the prior year because of a decrease in restricted cash in commercial banks, which was used to acquire capital assets.

The fund balance of The Children's Trust special revenue fund had an increase of \$17 million. The increase was mainly due to \$54 million transferred from GDB from investments related to QZAB bonds.

Although the revenue of other governmental funds (nonmajor) increased by \$18 million or 18% during the year compared with the prior year, the expenditures decreased by \$387 million or 41%, the most significant reduction in expenditures was noted in general government, education, capital outlays, and public safety of \$188 million, \$128 million, \$48 million, and \$43 million, respectively. Nevertheless the fund had \$408 million in other financing sources that led to a net decrease of \$23 million in the fund balance. Total assets of nonmajor funds increased by \$386 million or 45% compared with the prior year. The most significant contributions to this increase arose from the cash and cash equivalents, due from other funds and restricted cash and cash equivalents by \$318 million or 56%, \$39 million or 34%, and \$25 million or 22%, respectively.

Proprietary Funds

The Commonwealth's proprietary funds provide the same type of information found in the government-wide financial statements, but in more detail. As discussed in the business-type activities above, the Commonwealth's net assets increased by \$97 million as a result of operations in the proprietary funds. This resulted from a \$21 million increase in net assets by the lotteries fund, an increase in net assets of \$41 million by the unemployment insurance trust fund, and an increase of net assets of \$35 million by the Commonwealth's other nonmajor enterprise funds.

General Fund Budgetary Highlights

Actual revenues were less than final budgeted revenue by \$365 million. The net decrease was primarily attributed to unachieved income and excise taxes of \$208 million and \$117 million, respectively, in comparison with the budgeted amounts. The reduction is attributable to the current economic slowdown, caused primarily by the current price of oil and its derivatives being at a historically high level, the government's fiscal crisis, which resulted in a two-week shutdown of nonessential government services, and the uncertainty surrounding the enactment of the tax and fiscal reform to address the government's fiscal crisis.

The actual expenditures reflected an increase of \$388 million when compared to the final budgeted amounts. The excess in expenditures was predominantly caused by the Department of Education with \$137 million, the Office

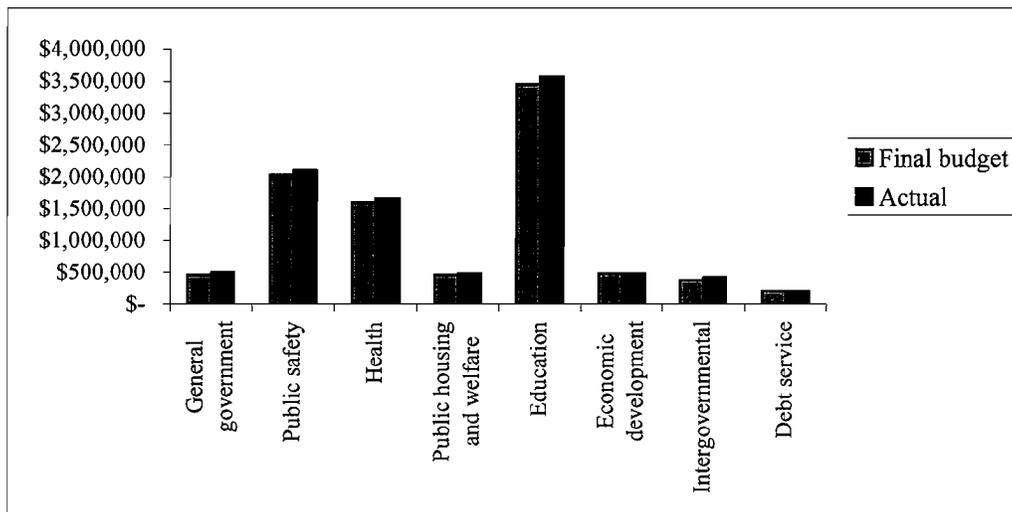
COMMONWEALTH OF PUERTO RICO

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of Management and Budget with \$45 million, the Municipal Service Administration with \$32.5 million, the Correction Administration with \$27 million, the Department of Health with \$26 million, the Puerto Rico Health Insurance Administration with \$21 million, and the Puerto Rico General Court of Justice with \$19 million. Most of these variances were financed through the use of borrowings which provided resources of \$1,345 million. These financing resources came primarily from Government Development Bank for Puerto Rico loans of \$1,109 million and proceeds generated by the issuance of the Commonwealth's Public Improvement Refunding of \$100 million.

Expenditures – General Fund Budget vs. Actual Year ended June 30, 2006 (expressed in thousands)



As of June 30, 2006, there was an excess of expenditures and other financing uses over revenue and other financing sources of \$461 million.

Capital Assets and Debt Administration

Capital Assets

The Commonwealth's investment in capital assets for its governmental and business-type activities as of June 30, 2006 amounts to \$9.7 billion, less accumulated depreciation of \$2.5 billion, leaving a book value of \$7.2 billion. This investment in capital assets includes land, buildings, building improvements, equipment, and construction in progress as infrastructure.

The net book value of capital assets at June 30, 2006 is distributed by function/activity in the following proportions: general government, 42%; public safety, 5%; health, 1%; public housing and welfare, 33%; education, 7%; and economic development 12%. Actual expenditures to purchase or construct capital assets were approximately \$816 million for the year. Depreciation charges for the year totaled \$223 million.

COMMONWEALTH OF PUERTO RICO

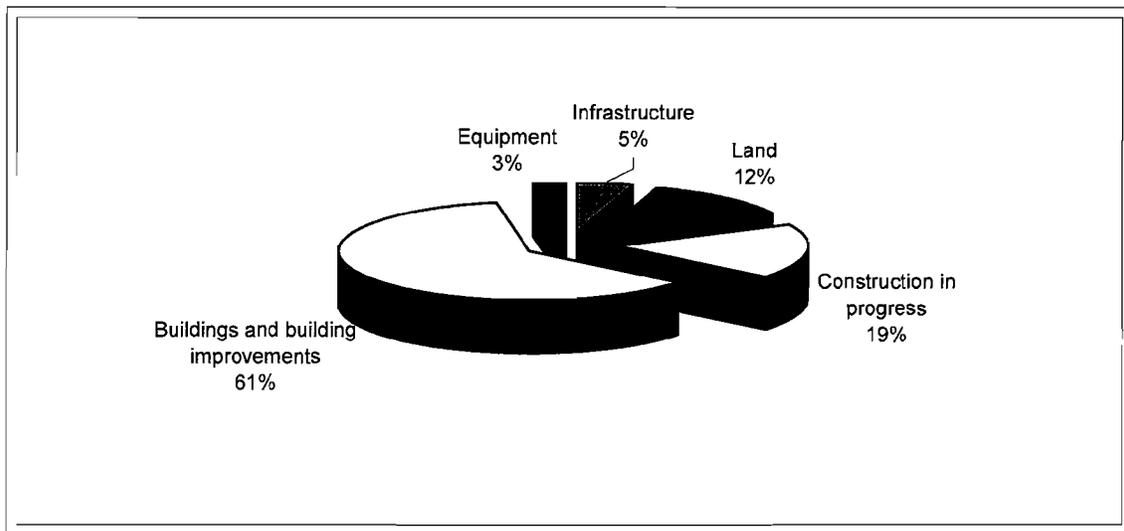
Management's Discussion and Analysis

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The infrastructure assets representing items that are normally immovable and of value only to the Commonwealth as roads, highways, bridges, toll facilities, water and sewer systems, lighting production, transmission and distribution systems, and similar items are principally owned by the component units of the Commonwealth. Therefore, the infrastructure assets are reported within depreciable capital assets under the discretely presented component units column. Additional information on the Commonwealth's capital assets can be found in note 12 to the basic financial statements that accompany this report.

Commonwealth's Capital Assets – Primary Government
Year ended June 30, 2006
 (expressed in thousands)

	<u>Governmental activities</u>	<u>Business-type activities</u>
Land	\$ 848,443	—
Construction in progress	1,381,823	—
Buildings and building improvements, net	4,395,150	—
Equipment, net	200,213	1,008
Infrastructure, net	<u>357,549</u>	<u>—</u>
Total capital assets	<u>\$ 7,183,178</u>	<u>1,008</u>



Debt Administration

General obligation bonds are backed by the full faith and credit of the Commonwealth, including the Commonwealth's power to levy additional taxes to help ensure repayment of the debt.

The Constitution of the Commonwealth provides that direct obligations of the Commonwealth evidenced by bonds or notes and backed by the full faith, credit, and taxing power of the Commonwealth are not to be issued if

COMMONWEALTH OF PUERTO RICO

Management's Discussion and Analysis

June 30, 2006

the amount of the principal of, and interest on, such bonds and notes and on all such bonds and notes issued thereafter which are payable in any fiscal year, together with any amount paid by the Commonwealth in the preceding fiscal year on account of bonds or notes guaranteed by the Commonwealth, exceed 15% of the average annual revenue raised under the provisions of Commonwealth legislation and conveyed into the Treasury in the two fiscal years preceding the then current fiscal year. Section 2, Article VI of the Constitution of the Commonwealth does not limit the amount of debt that the Commonwealth may guarantee as long as the 15% limitation is not exceeded. At June 30, 2006, the Commonwealth is in compliance with the debt limitation requirement.

Moody's lowered the rating on the Commonwealth's outstanding general obligation bonds from "Baa1" to "Baa2" earlier in the year. Standard & Poor's Rating Services (S&P) had also lowered its rating on the Commonwealth's general obligation bonds earlier in the year.

On May 22, 2007, S&P lowered its long-term rating on the Commonwealth's general obligation debt to 'BBB-' from 'BBB', reflecting a long history of structural imbalance and the ongoing difficulties anticipated with further efforts to reduce the accrued deficit. The outlook was defined as stable.

The rating on the appropriation debt, typically rated one notch below the general obligation debt, has not been lowered, reflecting the improvements that have been made. S&P does not believe that Puerto Rico's appropriation credit is speculative grade.

S&P noted that Puerto Rico's debt, which is already high, is likely to increase. Although a major new revenue source of a 5.5% sales and use tax was added in the current fiscal year, balances remain difficult to achieve, requiring expense cuts and use of one-time revenue sources. Gap forecast suggest that balance will not be achieved until 2010 and that forecast is based on the expectation of flat expense growth.

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.

The Commonwealth's total long-term obligations increased by \$2 billion during the current fiscal year, representing an 8% increase. Additional information on the Commonwealth's long-term obligations can be found in note 14 to the basic financial statements of this report.

Economic Factors and Next Year's Budgets and Rates

The unemployment rate for the Commonwealth of Puerto Rico is currently 11.7%, which is an increase from a rate of 10.6% a year ago.

Based on the projections of the Puerto Rico Planning Board, the Puerto Rico economy is expected to reflect a real growth of 1.2% for the fiscal year 2006.

In an effort to address the Commonwealth's structural budget imbalance and its other fiscal difficulties, the Executive Branch and the Legislative Assembly enacted and the Governor signed legislation providing for tax reform and fiscal reforms. The tax reform legislation is aimed at increasing revenues by expanding the tax base through the implementation of a broad-based sales tax. The fiscal reform legislation is aimed at limiting expenditures in relation to past spending rates and stabilizing expenditure growth at a level below that of recurring revenues.

COMMONWEALTH OF PUERTO RICO

Management's Discussion and Analysis

June 30, 2006

On July 4, 2006 was approved Act No. 117 (Act 117) which amends the Puerto Rico Internal Revenue Code of 1994 (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 Central Government Sales Tax). Act 117 also authorizes each municipal government to impose a municipal sales and use tax of 1.5% (the Municipal Sales Tax and, together with the Central Government Sales Tax, the Sales Tax). In general, the Municipal Sales Tax has the same tax base, exemptions (except for unprocessed foods) and limitations as those provided for the Central Government Sales Tax. Act 117 also provides certain income tax reductions to address the regressive effect of the Sales Tax on taxpayers in lower income tax brackets. Act 117 repeals the 5% general excise tax imposed on imported goods and on goods manufactured in Puerto Rico. Certain items, such as fuel, crude oil and petroleum products, and vehicles, however, remain subject to the excise tax previously applicable to such items and will not be subject to the Sales Tax. The effective date of the repeal of the 5% general excise tax was October 17, 2006 pursuant to Act 229.

The Sales Tax will be effective on November 15, 2006. Municipalities, however, were authorized to implement the Municipal Sales Tax starting on July 1, 2006, and some have already done so. The revenues derived from the Sales Tax will be distributed as follows: (i) municipal governments will retain 1.3% of the Sales Tax, (ii) the Financial Assistance Fund, created by Act No. 91 on May 13, 2006, will receive 1% of the Sales Tax, and (iii) the General Fund will receive 4.7% of the Sales Tax. The revenues to be generated by the Sales Tax will be partly offset by the partial elimination of the 5% general excise tax and the effect of the income tax reduction measures included in Act 117.

Act 117 also provides for special income tax rates with respect to certain transactions occurring on and between July 1, 2006 and December 31, 2006. These special tax rates will apply to eligible dividends declared by domestic corporations or partnerships and "built-in" gains associated with capital assets held for periods in excess of six months, as well as certain withdrawals from retirement accounts. These special tax rates are only available for transactions in connection with capital assets consisting of stock or participations of domestic and foreign corporations and partnerships, and real property located in Puerto Rico. In the case of resident corporations and partnerships, these special tax rates apply only to real property located in Puerto Rico.

The consolidated budget for the fiscal year 2005-06 amounts to \$21.8 billion. From this amount, \$15.9 billion is assigned to operating expenses, \$3.3 billion to a permanent capital improvements program, and \$2.7 billion for the debt service.

Requests for Information

This financial report is designed to provide a general overview of the Commonwealth's finances for all of the Commonwealth's residents, taxpayers, customers, investors, and creditors. This financial report seeks to demonstrate the Commonwealth's accountability for the money it receives. Questions concerning any of the information provided in this report or requests for additional information should be addressed to: Department of the Treasury of the Commonwealth of Puerto Rico, Área de Contabilidad Central, P.O. Box 9024140, San Juan, Puerto Rico 00902-4140.

COMMONWEALTH OF PUERTO RICO

Statement of Net Assets (Deficit)

June 30, 2006

(In thousands)

	Primary Government			Component units
	Governmental activities	Business-type activities	Totals primary government	
Assets:				
Cash and cash equivalents in commercial banks and U.S. Treasury	\$ 522,056	87,191	609,247	2,788,852
Cash and cash equivalents in governmental banks	1,035,991	747,049	1,783,040	635,650
Investments	188,169	—	188,169	2,474,477
Receivables, net of allowance for uncollectibles:				
Taxes	1,209,961	—	1,209,961	—
Unemployment and other insurance premiums	—	64,800	64,800	109,780
Intergovernmental	300,104	—	300,104	41,001
Accounts	94,459	—	94,459	787,415
Loans	6,790	—	6,790	5,009,012
Accrued interest	12,421	2,853	15,274	332,243
Other	108,200	13,866	122,066	116,292
Due from:				
Primary government	—	—	—	280,148
Component units	125,395	7,605	133,000	2,378,592
Other governmental entities	13,866	—	13,866	201,089
Internal balances	(16,531)	16,531	—	—
Inventories	23,490	—	23,490	338,127
Prepaid expenses	7,269	—	7,269	56,101
Other assets	33,605	—	33,605	—
Restricted assets:				
Cash and cash equivalents in commercial banks and U.S. Treasury	692,637	—	692,637	828,368
Cash and cash equivalents in governmental banks	1,896,060	—	1,896,060	797,044
Investments and other restricted assets	—	33,473	33,473	6,787,159
Long-term investments	—	—	—	1,470,098
Long-term receivables from:				
Loans	—	—	—	123,683
Interest-bearing deposits with other banks	—	—	—	6,659
Long-term amounts due from:				
Primary government	—	—	—	92,754
Component units	—	180,450	180,450	17,303
Other governmental entities	—	—	—	32,663
Other	—	—	—	531
Real estate held for sale	48,705	—	48,705	212,097
Deferred expenses and other assets	179,651	42,070	221,721	453,430
Capital assets (net of accumulated depreciation):				
Land and other nondepreciable assets	2,230,266	—	2,230,266	8,774,212
Depreciable assets	4,952,912	1,008	4,953,920	17,836,723
Total assets	\$ 13,665,476	1,196,896	14,862,372	52,981,503

See accompanying notes to basic financial statements.

COMMONWEALTH OF PUERTO RICO

Statement of Net Assets (Deficit)

June 30, 2006

(In thousands)

	Primary Government			Component units
	Governmental activities	Business-type activities	Totals primary government	
Liabilities:				
Accounts payable and accrued liabilities	\$ 2,051,175	6,569	2,057,744	2,315,969
Deposits and escrow liabilities	—	—	—	6,645,956
Tax refunds payable	264,289	—	264,289	—
Due to:				
Primary government	—	—	—	126,402
Component units	258,251	—	258,251	656,136
Other governmental entities	19,103	—	19,103	37,610
Securities lending transactions and reverse repurchase agreements	—	—	—	792,844
Interest payable	535,336	—	535,336	542,251
Deferred revenue	124,633	30,786	155,419	126,555
Tax revenue anticipation notes payable	1,050,037	—	1,050,037	—
Due to primary government – long-term portion	—	—	—	187,048
Due to component units – long-term portion	—	—	—	1,731,685
Deferred revenue – long-term portion	—	—	—	23,385
Insurance benefits payable	—	70,973	70,973	—
Liability for automobile accident insurance and workers' compensation claims	—	—	—	811,310
Liabilities payable within one year:				
Commonwealth appropriation bonds	84,190	—	84,190	4,031
Bonds	253,559	—	253,559	777,337
Notes	625,373	—	625,373	1,557,936
Capital leases	4,476	—	4,476	—
Compensated absences	962,323	3,857	966,180	232,701
Lottery prizes	—	37,488	37,488	—
Other long-term liabilities	145,962	—	145,962	152,254
Liabilities payable after one year:				
Commonwealth appropriation bonds	2,558,004	—	2,558,004	1,021,097
Bonds	12,125,648	—	12,125,648	18,733,632
Notes	3,194,405	—	3,194,405	2,764,437
Capital leases	140,025	—	140,025	—
Net pension obligation	4,740,806	—	4,740,806	—
Compensated absences	721,630	3,508	725,138	324,783
Lottery prizes	—	266,215	266,215	—
Other long-term liabilities	1,015,814	—	1,015,814	331,520
Total liabilities	\$ 30,875,039	419,396	31,294,435	39,896,879
Net assets (deficit):				
Invested in capital assets, net of related debt	\$ 3,485,882	1,008	3,486,890	10,815,299
Restricted for:				
Trust – nonexpendable	—	—	—	1,387,419
Capital projects	—	247,741	247,741	653,115
Debt service	192,490	—	192,490	909,008
Payment of unemployment and related benefits	—	699,766	699,766	—
Affordable housing and related loan insurance programs	87,588	—	87,588	781,131
Student loans and other educational purposes	—	—	—	17,321
Other	—	—	—	150,790
Unrestricted (deficit)	(20,975,523)	(171,015)	(21,146,538)	(1,629,459)
Total net assets (deficit)	\$ (17,209,563)	777,500	(16,432,063)	13,084,624

See accompanying notes to basic financial statements.

COMMONWEALTH OF PUERTO RICO

Statement of Activities
Year ended June 30, 2006
(In thousands)

Functions	Expenses	Program revenue			Net (Expense) Revenue and Changes in Net Assets			Component units
		Charges for services	Operating grants and contributions	Capital grants and contributions	Governmental activities	Primary Government Business-type activities	Total	
Primary government:								
Governmental activities:								
Current:								
General government	\$ 2,844,494	576,791	242,300	—	(2,025,403)	—	(2,025,403)	—
Public safety	2,217,294	58,284	92,550	4,546	(2,061,914)	—	(2,061,914)	—
Health	1,422,813	105,264	654,586	50	(662,913)	—	(662,913)	—
Public housing and welfare	3,287,559	29,534	2,357,917	96,020	(804,088)	—	(804,088)	—
Education	4,110,669	2,423	996,766	374	(3,111,106)	—	(3,111,106)	—
Economic development	564,447	55,968	21,592	—	(486,887)	—	(486,887)	—
Intergovernmental	440,390	729	—	—	(439,661)	—	(439,661)	—
Interest and other	882,163	—	—	—	(882,163)	—	(882,163)	—
Total governmental activities	15,769,829	828,993	4,365,711	100,990	(10,474,135)	—	(10,474,135)	—
Business-type activities:								
Lotteries	670,425	868,347	—	—	—	197,922	197,922	—
Unemployment	207,483	251,254	35,418	—	—	43,771	43,771	—
Other	25,043	29,825	24,195	—	—	64,395	64,395	—
Total business-type activities	902,951	1,149,426	59,613	—	—	306,088	306,088	—
Total primary government	\$ 16,672,780	1,978,419	4,425,324	100,990	(10,474,135)	306,088	(10,168,047)	—
Component units:								
Government Development Bank for Puerto Rico	\$ 688,830	593,004	—	156,365	—	—	—	60,539
Puerto Rico Highway and Transportation Authority	904,973	245,109	—	83,768	—	—	—	(576,096)
Puerto Rico Electric Power Authority	3,780,539	3,716,082	—	—	—	—	—	(64,457)
Puerto Rico Aqueduct and Sewer Authority	841,300	469,939	8,789	—	—	—	—	(362,572)
Puerto Rico Infrastructure Financing Authority	126,469	—	—	—	—	—	—	(126,469)
Puerto Rico Health Insurance Administration	1,561,451	452,965	—	—	—	—	—	(1,108,486)
University of Puerto Rico	1,237,194	166,023	238,149	—	—	—	—	(833,022)
Other component units	2,485,772	1,829,229	37,742	24,254	—	—	—	(594,547)
Total component units	\$ 11,626,528	7,472,351	284,680	264,387	—	—	—	(3,605,110)
General revenue:								
Taxes:								
Income taxes					\$ 6,255,391	—	6,255,391	—
Excise taxes					2,013,998	—	2,013,998	363,091
Other taxes					15,145	—	15,145	—
Revenue from global tobacco settlement agreement					66,796	—	66,796	—
Revenue from Tourism Company of Puerto Rico					23,200	—	23,200	—
Revenue from Governing Board of 9-1-1 Services					8,828	—	8,828	—
Revenue from State Insurance Fund Corporation					36,717	—	36,717	—
Grants and contributions not restricted to specific programs					196,721	—	196,721	77,912
Special Item-Defeased QZAB bonds					(2,485)	—	(2,485)	—
Payments from primary government					—	—	—	2,427,161
Unrestricted investment earnings					117,080	33,165	150,245	79,773
Gain on sale of assets					19,588	—	19,588	8,737
Other					203,525	—	203,525	20,346
Transfers					242,642	(242,642)	—	—
Total general revenue and transfers					9,197,146	(209,477)	8,987,669	2,977,020
Change in net assets					(1,276,989)	96,611	(1,180,378)	(628,090)
Net assets – beginning of year (as restated)					(15,932,574)	680,889	(15,251,685)	13,712,714
Net assets – end of year					\$ (17,209,563)	777,500	(16,432,063)	13,084,624

See accompanying notes to basic financial statements.

COMMONWEALTH OF PUERTO RICO

Balance Sheet – Governmental Funds

June 30, 2006

(In thousands)

Assets	General	Debt service	PBA capital projects	The Children's Trust special revenue	Other governmental	Totals governmental
Cash and cash equivalents in commercial banks	\$ 36,017	—	48,742	—	437,297	522,056
Cash and cash equivalents in governmental banks	67,943	421,172	7,922	96,336	442,618	1,035,991
Investments	—	—	—	73,716	114,453	188,169
Receivables, net of allowance for uncollectibles:						
Taxes	1,193,211	16,750	—	—	—	1,209,961
Intergovernmental	300,104	—	—	—	—	300,104
Accounts	81,424	—	—	—	13,035	94,459
Loans	6,754	—	—	—	36	6,790
Accrued interest	10,114	1,676	—	162	469	12,421
Other	8,330	—	—	—	—	8,330
Due from:						
Other funds	433,039	—	—	—	156,142	589,181
Component units	83,209	—	—	—	42,186	125,395
Other governmental entities	—	—	—	—	13,866	13,866
Restricted assets:						
Cash and cash equivalents in commercial banks	692,621	—	—	—	16	692,637
Cash and cash equivalents in governmental banks	1,896,060	—	—	—	—	1,896,060
Other assets	33,605	—	—	—	—	33,605
Real estate held for future development	32,466	—	—	—	16,239	48,705
Total assets	\$ 4,874,897	439,598	56,664	170,214	1,236,357	6,777,730

See accompanying notes to basic financial statements.

COMMONWEALTH OF PUERTO RICO

Balance Sheet – Governmental Funds

June 30, 2006

(In thousands)

Liabilities and Fund Balances	General	Debt service	PBA capital projects	The Children's Trust special revenue	Other governmental	Totals governmental
Liabilities:						
Accounts payable and accrued liabilities	\$ 1,916,682	10,236	88,690	4,102	63,788	2,083,498
Tax refunds payable	264,289	—	—	—	—	264,289
Due to:						
Other funds	232,325	—	—	—	373,385	605,710
Other governmental entities	19,103	—	—	—	—	19,103
Component units	244,570	—	—	—	13,681	258,251
Notes payable	495,446	—	—	—	30,598	526,044
Bonds payable	—	199,186	—	—	69,935	269,121
Interest payable	47,818	181,417	—	—	73,122	302,357
Deferred revenues	988,382	—	—	—	—	988,382
Tax revenue anticipation notes	1,050,037	—	—	—	—	1,050,037
Total liabilities	5,258,652	390,839	88,690	4,102	624,509	6,366,792
Fund balances (deficit):						
Reserved for:						
Encumbrances	611,419	—	—	—	24,587	636,006
Debt service	—	48,759	—	—	—	48,759
Assets in liquidation	71,621	—	—	—	—	71,621
Inventories	—	—	—	—	—	—
Long-term receivables	—	—	—	—	—	—
Low income housing assistance	87,588	—	—	—	—	87,588
Other specified purposes	—	—	—	—	—	—
Unreserved (deficit):						
General fund	(1,154,383)	—	—	—	—	(1,154,383)
Debt service funds	—	—	—	—	143,732	143,732
Special revenue funds	—	—	—	166,112	192,340	358,452
Capital projects funds	—	—	(32,026)	—	251,189	219,163
Total fund balances (deficit)	(383,755)	48,759	(32,026)	166,112	611,848	410,938
Total liabilities and fund balances (deficit) \$	4,874,897	439,598	56,664	170,214	1,236,357	6,777,730

See accompanying notes to basic financial statements.

COMMONWEALTH OF PUERTO RICO

Reconciliation of the Balance Sheet to the Statement of Net Assets
Governmental Funds

Year ended June 30, 2006

(In thousands)

Amounts reported for governmental activities in the statement of net assets are different because:

Total fund balances of governmental funds	\$ 410,938
Inventories and prepaid expenses that are not available to pay for current period expenditures and therefore are not recognized in the funds	30,759
Capital assets used in governmental activities are not financial resources and therefore are not reported in the funds	7,183,178
Long-term account receivable from Global tobacco settlement agreement and PBA	99,870
Deferred revenue in governmental funds that are recognized as revenue in the governmental activities	863,747
Debt issued by the Commonwealth have associated costs that are paid from current available resources in the funds. However, these costs are deferred on the statement of net assets	172,366
Net pension asset of the Puerto Rico Judiciary Retirement System recognized in governmental activities is not a financial resource and therefore is not reported in the funds	7,285
Liabilities, including Commonwealth accounts payable \$32,323, appropriation bonds (\$2,642,194), bonds payable (\$12,110,086), notes payable (\$3,293,734), capital leases payable (\$144,501), compensated absences (\$1,683,953), net pension obligation (\$4,740,806), and other long-term liabilities (\$1,161,776) are not due and payable in the current period and therefore are not reported in the funds	(25,744,727)
Interest liabilities are not due and payable in the current period and therefore are not reported in the funds	(232,979)
Deficit of governmental activities	\$ <u><u>(17,209,563)</u></u>

See accompanying notes to basic financial statements.

COMMONWEALTH OF PUERTO RICO
Statement of Revenue, Expenditures, and Changes in Fund Balances -
Governmental Funds
Year ended June 30, 2006
(In thousands)

	<u>General</u>	<u>Debt service</u>	<u>PBA capital projects</u>	<u>The Children's Trust special revenue</u>	<u>Other governmental</u>	<u>Totals governmental</u>
Revenue:						
Taxes:						
Income taxes	\$ 6,181,995	—	—	—	—	6,181,995
Excise taxes	2,013,998	—	—	—	—	2,013,998
Other taxes	15,145	—	—	—	—	15,145
Charges for services	828,993	—	—	—	—	828,993
Revenue from global tobacco settlement agreement	—	—	—	—	65,602	65,602
Revenues from component units:						
Governing Board of 9-1-1 Services	8,828	—	—	—	—	8,828
Tourism Company of Puerto Rico	23,200	—	—	—	—	23,200
State Insurance Fund Corporation	36,717	—	—	—	—	36,717
Intergovernmental	4,522,786	118,326	—	—	22,310	4,663,422
Proceeds from sale of capital assets	15,943	—	—	—	—	15,943
Interest and investment earnings	97,929	2,046	—	4,590	12,515	117,080
Other	167,526	—	—	—	16,775	184,301
Total revenue	13,913,060	120,372	—	4,590	117,202	14,155,224
Expenditures:						
Current:						
General government	2,334,326	—	—	—	154,767	2,489,093
Public safety	2,107,355	—	—	—	797	2,108,152
Health	1,421,328	—	—	2,572	5,988	1,429,888
Public housing and welfare	3,119,011	—	—	—	11,362	3,130,373
Education	4,091,772	—	—	10,208	—	4,101,980
Economic development	463,875	—	—	1,959	48,610	516,444
Intergovernmental	408,039	—	—	—	1,688	409,727
Capital outlays	261,992	—	175,536	—	64,820	502,348
Debt service:						
Principal	168,360	199,186	—	—	78,735	446,281
Interest and other	274,827	364,579	—	383	181,073	820,862
Debt issuance costs	—	1,372	—	—	—	1,372
Total expenditures	14,652,885	565,137	175,536	15,122	547,840	15,956,520
Excess of expenditures over revenue	(739,825)	(444,765)	(175,536)	(10,532)	(430,638)	(1,801,296)
Other financing sources (uses):						
Transfers in	607,039	484,368	38,002	391	293,440	1,423,240
Transfers out	(1,046,651)	(100,000)	—	(26,688)	(7,259)	(1,180,598)
Long-term debt issued	1,295,239	101,695	—	—	121,421	1,518,355
Bond issue discount	—	(323)	—	—	—	(323)
Special item	—	—	—	54,135	—	54,135
Capital leases	4,580	—	—	—	—	4,580
Total other financing sources	860,207	485,740	38,002	27,838	407,602	1,819,389
Net change in fund balances	120,382	40,975	(137,534)	17,306	(23,036)	18,093
Fund balances (deficit) at beginning of year (as restated)	(504,137)	7,784	105,508	148,806	634,884	392,845
Fund balances (deficit) at end of year	\$ (383,755)	48,759	(32,026)	166,112	611,848	410,938

See accompanying notes to basic financial statements.

COMMONWEALTH OF PUERTO RICO

Reconciliation of the Statement of Revenue, Expenditures, and Changes in Fund Balances
to the Statement of Activities – Governmental Funds

Year ended June 30, 2006

(In thousands)

Amounts reported for governmental activities in the statement of activities
are different because:

Net change in fund balances – total governmental funds	\$ 18,093
Governmental funds report capital outlays as expenditures. However, in the statement of activities, the cost of those assets is allocated over their estimated useful lives as depreciation expense. This is the amount by which capital outlays (\$502,348) exceeded depreciation (\$222,794) in the current period.	279,554
Impairment of capital assets are expensed in the statement of activities, but not reported in the governmental funds as such impairment does not requires the use of current financial resources.	(62,895)
In the statement of activities, only the gain on the sale of capital assets are reported, whereas in the governmental funds, the proceeds from the sale increase financial resources. Therefore, the change in the net assets differs from the change in fund balance by the cost of the asset sold.	(20,643)
Revenue in the statement of activities that do not provide current financial resources are not reported as revenue in the governmental funds.	7,404
Debt proceeds provide current financial resources to governmental funds, but issuing debt increases long-term liabilities in the statement of net assets. Repayment of debt principal is an expenditure in the governmental funds, but the repayment reduces long-term liabilities in the statement of net assets. This is the amount by which net proceeds (\$1,522,612) exceeded repayments (\$446,281).	(1,076,331)
Repayments of advances from a component unit provided current financial resources to governmental funds, but reduced the liability to component units in the statement of net assets.	13,050
Income tax revenue that are not currently available are deferred in the governmental funds, but are accruable as revenue in the statement of activities. This is the amount by which deferred revenue increased during the year.	3,396
Governmental funds do not report transfers of long-term assets or liabilities because such transfers do not represent financial resources; however, they are recorded in the statement of activities. This amount represents the transfer of property by the Commonwealth to certain municipalities (see note 12).	(78,958)
Generally, inventory and prepayments are recorded as expenditures in the governmental funds when purchased rather than capitalized as an asset. However, these assets are capitalized in the statement of net assets. This is the sum of the decrease in inventory (\$0) and net pension asset (\$2,826) for the year.	(2,826)
Debt issuance costs are expenditures to governmental funds, but are deferred assets in the statement of net assets. This is the amount of debt issue costs for the year.	1,372
Certain interest and other costs reported in the statement of activities do not require the use of current financial resources and therefore are not reported as expenditures in the governmental funds. This is the amount equivalent to the increase in interest payable (\$7,060), combined with the amortization of debt issue costs (\$18,107), and the net accretion and amortization of debt issue discount and deferred losses (\$61,910).	(87,078)
Some expenses reported in the statement of activities do not require the use of current financial resources and therefore are not reported as expenditures in the governmental funds. This is the amount by which the net increases in net pension obligation (\$261,011), accrued compensated absences (\$214,607), and other liabilities (\$54,060) exceeded the net decreases in Christmas bonus liability (\$64,971), liability in federal cost disallowances (\$70,321), and liability for legal claims and judgments (\$125,819).	(214,507)
Effect of reversal of QZAB defeasance is reported as an expense in the statement of activities but not reported in the governmental funds.	<u>(56,620)</u>
Change in deficit of governmental activities	<u>\$ (1,276,989)</u>

See accompanying notes to basic financial statements.

COMMONWEALTH OF PUERTO RICO
Statement of Revenue and Expenditures – Budget and Actual –
Budget Basis – General Fund

Year ended June 30, 2006

(In thousands)

	<u>Original budget</u>	<u>Amended budget</u>	<u>Actual</u>	<u>Variance</u>
Revenue:				
Income taxes	\$ 5,969,000	6,198,000	5,989,906	(208,094)
Excise taxes	2,210,000	2,084,000	1,966,986	(117,014)
Other taxes	112,000	106,000	101,882	(4,118)
Charge for services	231,000	253,000	228,663	(24,337)
Intergovernmental	26,000	20,000	9,553	(10,447)
Revenue from component units	20,000	20,000	23,167	3,167
Other	131,000	107,000	103,140	(3,860)
Total revenue	<u>8,699,000</u>	<u>8,788,000</u>	<u>8,423,297</u>	<u>(364,703)</u>
Expenditures:				
Current:				
General government	454,364	458,607	507,050	(48,443)
Public safety	1,927,738	2,036,528	2,109,969	(73,441)
Health	1,399,675	1,600,416	1,662,309	(61,893)
Public housing and welfare	458,402	458,052	481,600	(23,548)
Education	3,109,607	3,443,028	3,580,049	(137,021)
Economic development	475,204	481,930	492,779	(10,849)
Intergovernmental	384,321	384,376	416,949	(32,573)
Debt service:				
Principal	78,365	78,365	78,365	—
Interest and other	131,689	131,689	131,689	—
Total expenditures	<u>8,419,365</u>	<u>9,072,991</u>	<u>9,460,759</u>	<u>(387,768)</u>
Excess (deficiency) of revenue over (under) expenditures	<u>279,635</u>	<u>(284,991)</u>	<u>(1,037,462)</u>	<u>(752,471)</u>
Other financing sources (uses):				
Notes payable issued	100,000	1,064,726	1,344,897	280,171
Transfer in	146,000	157,000	167,941	10,941
Transfer out	(525,635)	(936,735)	(936,617)	118
Total other financing sources (uses)	<u>(279,635)</u>	<u>284,991</u>	<u>576,221</u>	<u>291,230</u>
Excess (deficiency) of revenue and other sources over (under) expenditures and other uses	<u>\$ —</u>	<u>—</u>	<u>(461,241)</u>	<u>(461,241)</u>

See accompanying notes to basic financial statements.

COMMONWEALTH OF PUERTO RICO

Statement of Net Assets – Proprietary Funds

June 30, 2006

(In thousands)

Assets	<u>Unemployment insurance</u>	<u>Lotteries</u>	<u>Other proprietary</u>	<u>Totals</u>
Current assets:				
Cash and cash equivalents in commercial banks and U.S. Treasury	\$ —	49,434	37,757	87,191
Cash and cash equivalents in governmental banks	535,651	71,775	139,623	747,049
Receivables, net:				
Insurance premiums, net	56,766	—	8,034	64,800
Component units	—	—	7,605	7,605
Due from other funds	23,010	53,175	—	76,185
Accrued interest	566	—	2,287	2,853
Other	8,769	4,555	542	13,866
Investments:				
Restricted investments	—	—	33,473	33,473
Total current assets	<u>624,762</u>	<u>178,939</u>	<u>229,321</u>	<u>1,033,022</u>
Noncurrent assets:				
Loans receivable, excluding current portion, net:				
Component units	—	—	180,450	180,450
Intergovernmental	—	—	1,819	1,819
Capital assets, net	—	1,008	—	1,008
Other	—	40,251	—	40,251
Total assets	<u>\$ 624,762</u>	<u>220,198</u>	<u>411,590</u>	<u>1,256,550</u>
Liabilities and Net Assets (Deficit)				
Current liabilities:				
Accounts payable and accrued liabilities	\$ —	3,585	2,984	6,569
Due to other funds	—	59,654	—	59,654
Deferred revenue	11,745	19,015	26	30,786
Compensated absences	—	2,338	1,519	3,857
Lottery awards	—	37,488	—	37,488
Insurance benefits payable	69,833	—	1,140	70,973
Total current liabilities	<u>81,578</u>	<u>122,080</u>	<u>5,669</u>	<u>209,327</u>
Noncurrent liabilities:				
Compensated absences	—	1,910	1,598	3,508
Lottery awards	—	266,215	—	266,215
Total liabilities	<u>\$ 81,578</u>	<u>390,205</u>	<u>7,267</u>	<u>479,050</u>
Net assets:				
Invested in capital assets	\$ —	1,008	—	1,008
Restricted for:				
Payment of insurance benefits	543,184	—	156,582	699,766
Capital projects	—	—	247,741	247,741
Unrestricted	—	(171,015)	—	(171,015)
Total net assets (deficit)	<u>\$ 543,184</u>	<u>(170,007)</u>	<u>404,323</u>	<u>777,500</u>

See accompanying notes to basic financial statements.

COMMONWEALTH OF PUERTO RICO
Statement of Revenue, Expenses, and Changes in Net Assets -
Proprietary Funds
Year ended June 30, 2006
(In thousands)

	<u>Unemployment insurance</u>	<u>Lotteries</u>	<u>Other proprietary</u>	<u>Totals</u>
Operating revenues:				
Lottery ticket sales	\$ —	868,295	—	868,295
Insurance premiums	251,254	—	24,099	275,353
Interest	—	—	5,726	5,726
Other	—	52	—	52
Total operating revenues	<u>251,254</u>	<u>868,347</u>	<u>29,825</u>	<u>1,149,426</u>
Operating expenses:				
Lottery awards	—	532,793	—	532,793
Insurance benefits	207,483	—	4,277	211,760
General, administrative, and other operating expenses	—	137,244	20,766	158,010
Depreciation and amortization	—	388	—	388
Total operating expenses	<u>207,483</u>	<u>670,425</u>	<u>25,043</u>	<u>902,951</u>
Operating income	<u>43,771</u>	<u>197,922</u>	<u>4,782</u>	<u>246,475</u>
Nonoperating revenue:				
Contributions from federal government	35,418	—	24,195	59,613
Interest and investment earnings	25,892	6,380	893	33,165
Total nonoperating revenue	<u>61,310</u>	<u>6,380</u>	<u>25,088</u>	<u>92,778</u>
Income before transfers	105,081	204,302	29,870	339,253
Transfers from general fund	204,330	21,318	4,802	230,450
Transfers to general fund	(268,790)	(204,302)	—	(473,092)
Net change in net assets	40,621	21,318	34,672	96,611
Net assets (deficit) at beginning of year as restated	502,563	(191,325)	369,651	680,889
Net assets (deficit) at end of year	<u>\$ 543,184</u>	<u>(170,007)</u>	<u>404,323</u>	<u>777,500</u>

See accompanying notes to basic financial statements.

COMMONWEALTH OF PUERTO RICO

Statement of Cash Flows
Proprietary Funds

Year ended June 30, 2006

(In thousands)

	<u>Unemployment insurance</u>	<u>Lotteries</u>	<u>Other proprietary</u>	<u>Totals</u>
Cash flows from operating activities:				
Receipts from customers and users	\$ 250,923	865,952	21,025	1,137,900
Other receipts	—	52	15,248	15,300
Payments to suppliers and employees	3,242	(146,000)	(20,601)	(163,359)
Payment of lottery prizes	—	(558,199)	—	(558,199)
Payments of insurance benefits	(207,483)	—	(4,332)	(211,815)
Other payments	—	—	(43,759)	(43,759)
Net cash provided by (used in) operating activities	<u>46,682</u>	<u>161,805</u>	<u>(32,419)</u>	<u>176,068</u>
Cash flows from noncapital financing activities:				
Intergovernmental grants and contributions	35,418	—	24,107	59,525
Principal payments of notes payable	—	(520)	—	(520)
Transfers from other funds	175,531	—	4,802	180,333
Transfers to other funds	(268,790)	(159,791)	—	(428,581)
Net cash provided by (used in) noncapital financing activities	<u>(57,841)</u>	<u>(160,311)</u>	<u>28,909</u>	<u>(189,243)</u>
Cash flows from capital and related financing activities:				
Capital expenditures	—	(29)	—	(29)
Net cash used in capital and related financing activities	<u>—</u>	<u>(29)</u>	<u>—</u>	<u>(29)</u>
Cash flows from investing activities:				
Interest received on deposits and investments	25,905	6,380	1,391	33,676
Net cash provided by investing activities	<u>25,905</u>	<u>6,380</u>	<u>1,391</u>	<u>33,676</u>
Net increase (decrease) in cash and cash equivalents	14,746	7,845	(2,119)	20,472
Cash and equivalents at beginning of year	520,905	113,364	179,499	813,768
Cash and cash equivalents at end of year	\$ <u>535,651</u>	<u>121,209</u>	<u>177,380</u>	<u>834,240</u>
Reconciliation of operating income to net cash provided by (used in) operating activities:				
Operating income	\$ 43,771	197,922	4,782	246,475
Adjustments to reconcile operating income to net cash provided by (used in) operating activities:				
Depreciation and amortization	—	388	—	388
Interests earned on deposits loans and investments	—	—	(371)	(371)
Changes in operating assets and liabilities:				
Increase in accounts and loans receivable	(331)	(2,343)	(35,564)	(38,238)
Decrease in obligation for unpaid lottery awards	—	(25,405)	—	(25,405)
Decrease in due to other funds	—	(9,514)	—	(9,514)
Increase (decrease) in deferred revenues	3,242	1,911	(3)	5,150
Increase (decrease) in compensated absences	—	(589)	1,451	862
Decrease in liability for insurance benefits payable	—	—	(407)	(407)
Decrease in accounts payable and accrued liabilities	—	(243)	(2,307)	(2,550)
Decrease in other assets	—	(322)	—	(322)
Total adjustments	<u>2,911</u>	<u>(36,117)</u>	<u>(37,201)</u>	<u>(70,407)</u>
Net cash provided by (used in) operating activities	\$ <u>46,682</u>	<u>161,805</u>	<u>(32,419)</u>	<u>176,068</u>

See accompanying notes to basic financial statements.

COMMONWEALTH OF PUERTO RICO

Statement of Fiduciary Net Assets

June 30, 2006

(In thousands)

Assets	Pension trust	Special deposits – agency
Cash and cash equivalents in commercial banks and U.S. Treasury:		
Unrestricted	\$ 82,963	583,196
Restricted	1,717	—
Cash and cash equivalents in governmental banks:		
Unrestricted	28,951	46,984
Restricted	2,156	—
Investments:		
Debt and equity securities, at fair value	3,957,755	27,013
Investment in PRTA Holdings, at appraised value	495,318	—
Other	87,824	—
Receivables, net:		
Accounts	44,622	—
Loans and advances	881,159	—
Accrued interest and dividends	32,726	—
Due from general fund	10,401	—
Other	51,280	—
Capital assets, net	33,359	—
Other assets	8,283	—
Total assets	5,718,514	657,193
Liabilities		
Accounts payable and accrued liabilities	77,938	657,193
Repurchase agreements	139,074	—
Due to component unit	4	—
Other liabilities	60,000	—
Bonds payable	20,430	—
Total liabilities	297,446	657,193
Net Assets		
Net assets held in trust for pension and other benefits	\$ 5,421,068	—

See accompanying notes to basic financial statements.

COMMONWEALTH OF PUERTO RICO
Statement of Changes in Fiduciary Net Assets – Pension Trust Funds
Year ended June 30, 2006
(In thousands)

Additions:	
Contributions:	
Sponsor	\$ 524,298
Participants	475,130
Special	77,750
Total contributions	<u>1,077,178</u>
Interest and investment income:	
Interest	122,605
Dividends	64,827
Net change in fair value of investments	453,515
Investment expenses	(16,194)
Net interest and investment income	<u>624,753</u>
Other income	<u>36,355</u>
Total additions	<u>1,738,286</u>
Deductions:	
Pension and other benefits	1,191,980
Refunds of contributions	26,508
General and administrative	57,537
Total deductions	<u>1,276,025</u>
Net change in net assets held in trust for pension and other benefits	462,261
Net assets held in trust for pension and other benefits:	
Beginning of year	<u>4,958,807</u>
End of year	<u>\$ 5,421,068</u>

See accompanying notes to basic financial statements.

COMMONWEALTH OF PUERTO RICO

Combining Statement of Net Assets –
Major Component Units

June 30, 2006

(In thousands)

Assets	Government Development Bank for Puerto Rico	Puerto Rico Highway and Transportation Authority	Puerto Rico Electric Power Authority	Puerto Rico Aqueduct and Sewer Authority	Puerto Rico Infrastructure Financing Authority	Puerto Rico Health Insurance Administration	University of Puerto Rico	Total nonmajor component units	Total component units
Assets:									
Current assets:									
Cash and cash equivalents	\$ 2,479,515	73,093	18,614	7,764	—	44,095	45,916	119,855	2,788,852
Cash and cash equivalents in governmental banks	—	—	—	65,374	49,892	34,676	46,923	438,785	635,650
Investments, including collateral from securities lending transactions	821,945	—	—	—	—	—	—	1,652,532	2,474,477
Receivables, net:									
Insurance premiums	—	—	—	—	—	—	—	109,780	109,780
Intergovernmental	—	—	—	10,661	—	—	28,415	1,925	41,001
Accounts	—	3,791	549,048	44,111	—	—	14,182	176,283	787,415
Loans and advances	4,955,136	—	—	—	—	—	—	53,876	5,009,012
Accrued interest	292,392	—	3,449	—	934	136	—	35,332	332,243
Other governmental entities	—	—	88,656	40,756	5,436	7,150	17,099	41,992	201,089
Other	—	—	—	3,594	34,226	3,629	1,821	73,022	116,292
Due from:									
Primary government Component units	2,313,577	—	133,608	—	—	23,857	50,134	72,549	280,148
Inventories	—	—	25,844	—	—	—	18,030	21,141	2,378,592
Prepays	—	5,294	277,802	13,745	—	—	7,115	39,465	338,127
Prepays	—	—	5,406	1,905	591	18	32,284	10,603	56,101
Total current assets	10,862,565	82,178	1,102,427	187,910	91,079	113,561	261,919	2,847,140	15,548,779
Noncurrent assets:									
Restricted assets:									
Cash and cash equivalents	52,675	4,099	337,744	150	90,958	—	15,766	326,976	828,368
Cash and cash equivalents in governmental banks	—	30,438	—	32,596	17,988	—	—	716,022	797,044
Investments	1,673,479	820,143	374,676	—	1,555,704	—	148,462	2,214,695	6,787,159
Investments	—	—	—	—	—	—	—	1,470,098	1,470,098
Receivables:									
Loans, interest, and other	—	—	—	—	—	—	2,469	121,214	123,683
Interest-bearing deposits with other	—	—	—	—	—	—	—	6,659	6,659
Other governmental entities	—	—	—	—	—	—	—	32,663	32,663
Other	—	—	—	—	—	—	—	531	531
Due from:									
Primary government Component units	—	—	36,754	—	—	—	56,000	—	92,754
Component units	—	—	—	—	—	—	—	17,303	17,303
Property held for sale and future development	70,898	—	—	—	—	—	—	141,199	212,097
Capital assets, not being depreciated	13,546	3,203,805	2,103,257	845,345	1,052,993	—	266,407	1,288,859	8,774,212
Capital assets, depreciable, net	14,313	7,953,943	3,334,404	4,081,278	85	828	491,170	1,960,702	17,836,723
Deferred expenses and other assets	59,336	133,180	128,849	28,738	58,829	—	—	44,498	453,430
Total noncurrent assets	1,884,247	12,145,608	6,315,684	4,988,107	2,776,557	828	980,274	8,341,419	37,432,724
Total assets	\$ 12,746,812	12,227,786	7,418,111	5,176,017	2,867,636	114,389	1,242,193	11,188,559	52,981,503

COMMONWEALTH OF PUERTO RICO

Combining Statement of Net Assets –
Major Component Units

June 30, 2006

(In thousands)

Liabilities and Net Assets	Government Development Bank for Puerto Rico	Puerto Rico Highway and Transportation Authority	Puerto Rico Electric Power Authority	Puerto Rico Aqueduct and Sewer Authority	Puerto Rico Infrastructure Financing Authority	Puerto Rico Health Insurance Administration	University of Puerto Rico	Total nonmajor component units	Total component units
Liabilities:									
Current liabilities:									
Accounts payable and accrued liabilities	\$ 111,017	144,452	570,097	368,600	77,140	84,648	112,978	847,037	2,315,969
Deposits and escrow liabilities	5,838,162	—	155,366	5,271	—	—	—	647,157	6,645,956
Due to:									
Primary government	—	—	—	8,115	—	25,800	—	92,487	126,402
Component units	—	29,996	113,467	39,449	925	—	86,781	385,518	656,136
Other governmental entities	—	—	—	—	—	—	125	37,485	37,610
Securities lending transactions and reverse repurchase agreements	515,000	—	—	—	—	—	—	277,844	792,844
Interest payable	51,144	163,073	136,696	11,263	67,842	—	4,765	107,468	542,251
Deferred revenue	—	—	—	—	2,199	—	25,598	98,758	126,555
Notes payable, current portion	1,048,867	—	379,835	—	—	—	—	129,234	1,557,936
Commonwealth appropriation bonds, current portion	45	—	—	2,733	46	—	—	1,207	4,031
Bonds payable, current portion	94,111	98,520	377,532	26,641	30,695	—	20,625	129,213	777,337
Accrued compensated absences	3,547	15,739	75,428	16,962	129	442	22,506	97,948	232,701
Worker's compensation claims	—	—	—	—	—	—	—	696,922	696,922
Reserves for automobile accident benefit payments	—	—	—	—	—	—	—	114,388	114,388
Current portion of other long-term liabilities	—	4,149	90,002	—	—	—	1,779	56,324	152,254
Total current liabilities	7,661,893	455,929	1,898,423	479,034	178,976	110,890	275,157	3,718,990	14,779,292
Noncurrent liabilities:									
Due to:									
Primary government	—	—	—	179,940	—	—	—	7,108	187,048
Component units	—	—	59,200	685,701	44,089	—	9,864	932,831	1,731,685
Interest payable	4,499	—	—	—	—	—	—	—	4,499
Deferred revenue	—	—	—	—	—	—	—	23,385	23,385
Notes payable	1,686,090	—	32,000	—	—	—	—	1,046,347	2,764,437
Commonwealth appropriation bonds	10,199	—	—	704,035	10,507	—	—	296,356	1,021,097
Bonds payable	1,285,986	6,542,692	4,778,998	802,717	2,551,562	—	445,561	2,326,116	18,733,632
Accrued compensated absences	1,709	12,380	138,306	35,342	143	294	112,569	24,040	324,783
Other long-term liabilities	—	31,940	—	65,432	5,998	—	68,827	154,824	327,021
Total noncurrent liabilities	2,988,483	6,587,012	5,008,504	2,473,167	2,612,299	294	636,821	4,811,007	25,117,587
Total liabilities	10,650,376	7,042,941	6,906,927	2,952,201	2,791,275	111,184	911,978	8,529,997	39,896,879
Net assets:									
Invested in capital assets, net of related debt	27,859	4,478,815	269,241	3,201,573	1,053,079	828	207,168	1,576,736	10,815,299
Restricted for:									
Trust – nonexpendable	—	—	—	—	1,335,171	—	52,248	—	1,387,419
Capital projects	—	72,417	206,748	32,746	225,353	—	35,235	80,616	653,115
Debt service	55,682	605,864	—	—	307	—	37,558	209,597	909,008
Affordable housing and related loan insurance programs	254,219	—	—	—	—	—	—	526,912	781,131
Student loans and other educational purposes	—	—	—	—	—	—	7,867	9,454	17,321
Other specified purposes	—	—	—	—	17,989	—	32,520	100,281	150,790
Unrestricted	1,758,676	27,749	35,195	(1,010,503)	(2,555,538)	2,377	(42,381)	154,966	(1,629,459)
Total net assets	2,096,436	5,184,845	511,184	2,223,816	76,361	3,205	330,215	2,658,562	13,084,624
Total liabilities and net assets	\$ 12,746,812	12,227,786	7,418,111	5,176,017	2,867,636	114,389	1,242,193	11,188,559	52,981,503

See accompanying notes to basic financial statements.

COMMONWEALTH OF PUERTO RICO

Combining Statement of Activities –
Major Component Units

Year ended June 30, 2006

(In thousands)

	Expenses	Program revenues			Net revenues (expenses) and changes in net assets	Payments from primary government	Payments from (to) other component units	Contributions not restricted to specific programs	Taxes	Interest and investment earnings	Gain in sale of assets	Miscellaneous	Change in net assets	Net assets, beginning of year, as restated	Net assets, end of year
		Charges for services	Operating grants and contributions	Capital grants and contributions											
Major component units:															
Government Development Bank for Puerto Rico	\$ 688,830	593,004	—	156,365	60,539	65,316	(252)	—	—	—	—	8,670	134,273	1,962,163	2,096,436
Puerto Rico Highway and Transportation Authority	904,973	245,109	—	83,768	(576,096)	—	—	—	296,814	31,438	—	—	(247,844)	5,432,689	5,184,845
Puerto Rico Electric Power Authority	3,780,539	3,716,082	—	—	(64,457)	—	—	56,378	—	24,475	—	—	16,396	494,788	511,184
Puerto Rico Aqueduct and Sewer Authority	841,300	469,939	8,789	—	(362,572)	19,096	53,396	12,380	—	3,180	—	5,670	(268,850)	2,492,666	2,223,816
Puerto Rico Infrastructure Finance Authority	126,469	—	—	—	(126,469)	72,450	(53,396)	—	—	(175,665)	—	—	(283,080)	359,441	76,361
Puerto Rico Health Insurance Administration	1,561,451	452,965	—	—	(1,108,486)	1,134,152	—	—	—	2,232	—	—	27,898	(24,693)	3,205
University of Puerto Rico	1,237,194	166,023	238,149	—	(833,022)	812,594	69,035	5,439	—	5,802	—	14,237	74,085	256,130	330,215
Nonmajor component units	2,485,772	1,829,229	37,742	24,254	(594,547)	323,553	(68,783)	3,715	66,277	188,311	8,737	(8,231)	(80,968)	2,739,530	2,638,362
Total component units	\$ 11,626,528	7,472,351	284,680	264,387	(3,605,110)	2,427,161	—	77,912	363,091	79,773	8,737	20,346	(628,090)	13,712,714	13,084,624

See accompanying notes to basic financial statements.

COMMONWEALTH OF PUERTO RICO

Notes to Basic Financial Statements

June 30, 2006

(1) Summary of Significant Accounting Policies

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

The accompanying basic financial statements of the Commonwealth have been prepared in conformity with U.S. generally accepted accounting principles (GAAP) as prescribed by the Governmental Accounting Standards Board (GASB).

The accompanying basic financial statements present the financial position of the Commonwealth and its various funds, the results of operations of the Commonwealth and its various funds and fund types, and the cash flows of the proprietary funds. The basic financial statements are presented as of June 30, 2006, and for the year then ended. The basic financial statements include the various departments, agencies, boards, commissions, public trusts and public corporations, and any other organizational units governed by the Puerto Rico Legislature and/or officers of the Commonwealth.

(a) *The Financial Reporting Entity*

The accompanying basic financial statements include all departments, agencies, and governmental entities whose funds are under the custody and control of the Secretary of the Treasury of the Commonwealth and the Commonwealth's component units pursuant to Act No. 230 of July 23, 1974, as amended, known as Commonwealth of Puerto Rico Accounting Law. The Commonwealth has considered all potential component units for which it is financially accountable and other organizations for which the nature and significance of their relationship with the Commonwealth are such that exclusion would cause the Commonwealth's basic financial statements to be misleading or incomplete. The GASB has set forth criteria to be considered in determining financial accountability. These criteria include appointing a voting majority of an organization's governing body and (1) the ability of the Commonwealth to impose its will on that organization or (2) the potential for the organization to provide specific financial benefits to, or impose specific financial burdens on, the Commonwealth.

As required by U.S. GAAP, these basic financial statements present the Commonwealth and its component units.

(b) *Component Units*

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

COMMONWEALTH OF PUERTO RICO

Notes to Basic Financial Statements

June 30, 2006

because it appoints the members of the governing authorities of each of the component units and because it is able to impose its will on these organizations or because the organizations provide financial benefits or impose financial burdens on the Commonwealth. The financial statements of the component units discussed below have been included in the financial reporting entity either as blended component units or as discretely presented component units in accordance with GASB Statement No. 14, *The Financial Reporting Entity*, as amended by GASB 39 *Determining Whether Certain Organization are Component Units*.

Blended Component Units

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

Public Buildings Authority (PBA) – PBA is governed by a six-member board comprised by the Secretary of the Department of Transportation and the Public Works (DTPW), the Secretary of the Department of Education of the Commonwealth, the Interim President of the Government Development Bank for Puerto Rico (GDB), and three members appointed by the Governor of Puerto Rico with the advice and consent of the Senate. It is a legally separate entity, whose activities are blended within the primary government because it exists to construct, purchase, or lease office, school, health, correctional, social welfare, and other facilities for lease to the Commonwealth's departments, component units, and instrumentalities. Bonds issued by PBA to finance such facilities are payable from lease collections, which are largely derived from Commonwealth appropriations and are further secured by the Commonwealth's guaranty.

Puerto Rico Maritime Shipping Authority (PRMSA) – PRMSA is governed by the President of GDB. The operations of PRMSA consist of servicing the long-term liability to third parties that resulted from the sale of certain maritime operations formerly owned and operated by PRMSA. The Commonwealth is required to annually appropriate funds in its general operating budget to provide for the payment of principal and interest on such debt [see note 14 (d)].

The Children's Trust (the Trust) – The Trust is governed by a seven-member board comprised by the Governor, who designated the president of the board, the President of GDB, the Director of the Office of Management and Budget (OMB) of the Commonwealth, the Secretary of Justice of the Commonwealth, and three private citizens appointed by the Governor with the consent of the Senate. The Trust's sole operation consists of providing financial assistance principally to the Commonwealth's departments to carry out projects aimed at promoting the well-being of children and youth of Puerto Rico, especially in the areas of education, recreation, and health. The operation of the Trust is financed with the moneys being received by the Commonwealth from a global settlement agreement dated November 23, 1998, between certain tobacco companies and certain states, territories, and other jurisdictions of the United States of America, including the Commonwealth. The agreement calls for annual payments through the year 2025, which will vary due to inflationary and volume adjustments. After 2025, the tobacco companies shall continue making contributions in perpetuity.

The blended component units are composed of various funds. The PBA capital projects and the Children's Trust special revenue fund are presented as major governmental funds. All other funds are

COMMONWEALTH OF PUERTO RICO

Notes to Basic Financial Statements

June 30, 2006

reported in the other governmental column. Complete financial statements of the blended component units can be obtained directly by contacting their respective administrative offices at:

Public Buildings Authority
P.O. Box 41029 Minillas Station
San Juan, PR 00940-1029

Puerto Rico Maritime
Shipping Authority
P.O. Box 42001
San Juan, PR 00940-2001

The Children's Trust
P.O. Box 42001
San Juan, PR 00940-2001

Discretely Presented Component Units

The following component units, consistent with GASB No. 14, are discretely presented in the basic financial statements because of the nature of the services they provide, the Commonwealth's ability to impose its will, principally through the appointment of their governing authorities, and because the component units provide specific financial benefits to, or impose financial burdens on, the Commonwealth. These have been classified by management between major and nonmajor component units.

Major Component Units

Government Development Bank for Puerto Rico (GDB) – is governed by a seven-member board appointed by the Governor. GDB acts as fiscal agent, depository of funds, disbursing agent, and financial advisor for the Commonwealth, its public corporations, and municipalities in connection with the issuance of bonds and notes; and it also makes loans and advances funds predominantly to the Commonwealth's departments, component units, and municipalities. GDB's board of directors members are executives on a trustworthy position, named and supervised by the Governor. The Commonwealth provides financial support to GDB through legislative appropriations.

Puerto Rico Aqueduct and Sewer Authority (PRASA) – PRASA is governed by a nine-member board comprised of five members appointed by the Governor, the Secretary of DTPW, the President of GDB, and two members elected in a referendum carried out by the Puerto Rico Consumer Affairs Department. PRASA owns and operates the system of public water supply and sanitary sewer facilities. PRASA is authorized, among other things, to borrow money and issue revenue bonds for any of its corporate purposes. Through the approval of Act No. 328 of 1998, as discussed in note 15 (a), the Commonwealth guarantees the principal and interest payments of certain outstanding bonds and of all future bonds issued to refinance those outstanding bonds, and other loans under the State Revolving Fund Program. The Commonwealth provides financial support to PRASA through legislative appropriations.

Puerto Rico Electric Power Authority (PREPA) – PREPA is governed by a nine-member board comprised of the Secretary of DTPW, six members appointed by the Governor with the consent of the Senate, and two members representing the consumers' interest elected in a referendum carried out by the Puerto Rico Consumer Affairs Department. Board members are appointed or elected for a period of four years. PREPA is responsible for conserving, developing, and utilizing the power

COMMONWEALTH OF PUERTO RICO

Notes to Basic Financial Statements

June 30, 2006

resources of Puerto Rico and owns and operates the Commonwealth's electrical power generation, transmission, and distribution system. The Commonwealth provides financial support to PREPA through legislative appropriation.

Puerto Rico Health Insurance Administration (PRHIA) – PRHIA is governed by a nine-member board comprised by the Secretary of Health of the Commonwealth, the Secretary of the Treasury of the Commonwealth, and the Insurance Commissioner of Puerto Rico, being these members inherent by law, and six additional members appointed by the Governor, with the consent of the Senate. PRHIA was created for implementing, administering, and negotiating a health insurance system through contracts with insurance underwriters to provide quality medical and hospital care to low income individuals, employees of the Commonwealth, and policeman who voluntarily subscribe to the Puerto Rico health insurance medical plan. The board of directors' president is elected by the Governor and all board of directors' members are executives on a trustworthy position. The Commonwealth provides financial support to PRHIA through legislative appropriations.

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

Puerto Rico Infrastructure Financing Authority (PRIFA) – PRIFA is governed by the board of directors of GDB and the Secretary of the Treasury of the Commonwealth. Its responsibilities are to provide financial, administrative, consulting, technical, advisory, and other types of assistance to other component units and governmental instrumentalities of the Commonwealth, which are authorized to develop infrastructure facilities and to establish alternate means for financing them. PRIFA's board of directors' members are executives on a trustworthy position, named and supervised by the Governor. The Commonwealth provides financial support to PRIFA through legislative appropriations.

University of Puerto Rico (UPR) – UPR is governed by a thirteen-member board of trustees comprised of one full-time student, two permanent professors, and ten community citizens of the private sector, of which at least one must be graduated from the institution. Community citizens are designated by the Governor with the advice and consent of the Senate. Members designated by the Governor are appointed for a period of four to eight years. The terms for the student and professors are one year. The Commonwealth provides financial support to UPR through legislative appropriations.

COMMONWEALTH OF PUERTO RICO

Notes to Basic Financial Statements

June 30, 2006

Nonmajor Component Units

Agricultural Services and Development Administration (ASDA) – ASDA is governed by the Secretary of Agriculture of the Commonwealth. The purpose of ASDA is to provide a wide variety of services and incentives to the agricultural sector. Therefore, the government has the ability to impose its will. The Commonwealth provides financial support to ASDA through legislative appropriations.

Automobile Accidents Compensations Administration (AACA) – AACA is governed by a four-member board appointed by the Governor with the advice and consent of the Senate. AACA operates a system of compulsory insurance coverage for all registered motor vehicles and compensates citizens for injuries arising from motor vehicle accidents. The Commonwealth has the ability to significantly influence rates charged by AACA.

Cardiovascular Center Corporation of Puerto Rico and the Caribbean (CCCPRC) – CCCPRC is governed by a five-member board comprised of the Secretary of Health of the Commonwealth, the Director of the Medical Sciences Campus of the UPR, the Executive Director of the Puerto Rico Medical Services Administration, and two additional members appointed by the Governor with the consent of the Senate, one of which should be from the Cardiology Society of Puerto Rico and another a member of a cardiology foundation properly registered in the Department of State of the Commonwealth. The purpose of the CCCPRC is to provide special treatment to patients suffering from cardiovascular diseases. The Commonwealth provides financial support to CCCPRC through legislative appropriations.

Caribbean Basin Projects Financing Authority (CBPFA) – CBPFA is governed by a seven-member board comprised of the Secretary of State of the Commonwealth, the Executive Director of the Puerto Rico Industrial Development Company (PRIDCO), the President of GDB, the President of the Economic Development Bank for Puerto Rico, and three citizens, including at least two from the private sector, appointed by the Governor with the advice and consent of the Senate. CBPFA is authorized to issue revenue bonds and to lend the proceeds thereof to finance projects for the development of the Caribbean Basin countries that were authorized to receive investments of funds under the provisions of Section 936 of the U.S. Internal Revenue Code. The Commonwealth has access to CBPFA's resources.

Culebra Conservation and Development Authority (CCDA) – CCDA is a component unit of the Commonwealth of Puerto Rico created by Law No. 66 of June 22, 1975, as amended, to formulate, adopt, and administer the program and plan for the conservation, use, and development of natural resources of the Municipality of Culebra. CCDA is administered through a board of directors composed of seven members, including the Mayor of Culebra. The administration and operations of the Authority are conducted by an Executive Director elected by the board of directors. Law No. 66 of June 22, 1975 was amended by Law No. 76 of June 6, 2002 to ascribe CCDA to the Municipality of Culebra.

COMMONWEALTH OF PUERTO RICO

Notes to Basic Financial Statements

June 30, 2006

Economic Development Bank for Puerto Rico (EDB) – EDB is governed by a eleven-member board comprised of the President of GDB, who is the Chairman, the Secretary of Agriculture of the Commonwealth, the Secretary of the Department of Economic Development and Commerce of the Commonwealth, the Executive Director of the Puerto Rico Industrial Development Company, the Executive Director of the Tourism Company of Puerto Rico, and six other members representing the private sector and appointed by the Governor with the consent of the Senate. Private sector members are appointed for a period of three years. EDB is responsible for the promotion and development of the private sector economy of the Commonwealth. This purpose is to be met by granting direct loans, loan guarantees, and/or direct investments to any person or business organization devoted to manufacturing, agriculture, trade, tourism, or other service enterprises with preference to but not limited to economic activities that may have the effect of substituting imports. The Commonwealth has the ability to impose its will on this component unit.

Employment and Training Enterprises Corporation (ETEC) – ETEC is governed by a consultant board, which includes two private citizens appointed by the Governor with the consent of the Senate. The purpose of ETEC is to provide training, management, development, and employment for inmates of the correctional institutions of the Commonwealth. The Commonwealth provides financial support to ETEC through legislative appropriations.

Farm Insurance Corporation of Puerto Rico (FICPR) – FICPR is governed by a four-member board consisting of the Secretary of Agriculture of the Commonwealth, the Dean of the Agricultural Sciences Faculty of the UPR Mayaguez Campus, a representative of GDB, and one bona fide farmer appointed by the Governor with the consent of the Senate. The purpose of the FICPR is to provide insurance to farmers against losses on their farms caused by natural disasters.

Fine Arts Center Corporation (FACC) – FACC is governed by a nine-member board comprised of the President of the Musical Arts Corporation and eight members named by the Governor. FACC was created with the purpose of administering the Fine Arts Center. The Commonwealth provides financial support to FACC through legislative appropriations.

Governing Board of the 9-1-1 Service (911 Service) – The Governing Board of 911 Service (the Board) is governed by a five-member board comprised of the Chief of Police, the Executive Director of the Medical Emergency Services, the Director of the State Emergency Management Agency, the Chief of the Puerto Rico Firefighters Corps, and one member appointed by consensus of the four ex-officio members to represent the public interest. The 911 Service is responsible for providing an efficient service of fast response to emergency calls through the 911 number and transferring these to the appropriate response agencies using technological and human resources to safeguard lives and properties. The Commonwealth has access to 911 Service's resources.

Institutional Trust of the National Guard of Puerto Rico (ITNGPR) – ITNGPR is governed by a six-member board comprised of the National Guard Special Assistant, the President of GDB, the Secretary of Justice of the Commonwealth, two militaries from the Puerto Rico National Guard, and one representative from the community recommended by the National Guard Special Assistant and appointed by the Governor. ITNGPR's purpose is to provide life insurance, retirement benefits, and economic assistance to the active members of the Puerto Rico National Guard and their families. The Commonwealth provides financial support to ITNGPR through legislative appropriations.

COMMONWEALTH OF PUERTO RICO

Notes to Basic Financial Statements

June 30, 2006

Land Authority of Puerto Rico (LAPR) – LAPR is governed by a six-member board consisting of the Secretary of Agriculture of the Commonwealth and five members appointed by the Governor. LAPR was created to carry out the provisions of the Land Law of Puerto Rico. LAPR maintains debt that is paid with Commonwealth appropriations.

Musical Arts Corporation (MAC) – MAC is governed by a seven-member board appointed by the Governor with the consent of the Senate. MAC was created to promote the development of the arts and cultural programs of the Commonwealth. The Commonwealth provides financial support to MAC through legislative appropriations.

National Parks Company of Puerto Rico (NPCPR) – NPCPR is governed by a nine-member board comprised of the Secretary of Recreation and Sports of the Commonwealth (the Secretary), who is the chairman, the Secretary of Education of the Commonwealth, the Executive Director of the Puerto Rico Tourism Company (PRTC), the Secretary of Natural and Environmental Resources of the Commonwealth, and five members appointed by the Governor with the recommendation from the Secretary and with known interest in the development and preservation of parks in the private sector. NPCPR is responsible for the operation of all national parks and the protection, conservation, and use of parks, beaches, forests, and natural and historical monuments for the optimum enjoyment of present and future generations. The Commonwealth provides financial support to NPCPR through legislative appropriations.

Public Corporation for the Supervision and Deposit Insurance of Puerto Rico Cooperatives (PCSDIPRC) – PCSDIPRC is governed by a nine-member board consisting of the Administrator of the Cooperative Development Administration, the Commissioner of Financial Institutions of Puerto Rico (the Commissioner of Financial Institutions), the Commissioner of Insurance of Puerto Rico, the Secretary of the Treasury of the Commonwealth, the Inspector of Cooperatives, four citizens representing the cooperative movement, and one private citizen representing the public interest. PCSDIPRC has the responsibility of providing to all the cooperatives and the Federation of Cooperatives of Puerto Rico insurance coverage over the stocks and deposits, for monitoring the financial condition of the insured cooperatives, and of uninsured cooperatives when requested by the Commissioner of Financial Institutions.

Puerto Rico Conservatory of Music Corporation (PRCMC) – PRCMC is governed by a six-member board appointed by the Governor, with the consent of the Senate. PRCMC is responsible for providing the Puerto Rican community and especially its youths with the required facilities to educate and perfect their musical skills, including secondary education programs for developing musical arts. It prepares the artistic element that nourishes the Puerto Rico Symphony Orchestra and other musical organizations, and coordinates the governmental efforts to interested industries, private enterprises, and particular citizens. The Commonwealth provides financial support to PRCMC through legislative appropriations.

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Puerto Rico Convention Center District Authority (PRCCDA) – PRCCDA is governed by a board comprised of nine members, four of which shall be from the public sector and five from the private sector. The public sector members are comprised of the Secretary of Economic Development and Commerce of the Commonwealth, who is the Chairman, the Executive Director of the Puerto Rico Tourism Company, the president of GDB, and one member from the public sector. The private sector members are individuals having experience in the areas of hospitality, tourism, real estate, or convention centers who are appointed by the Governor with the advice and consent of the Senate. PRCCDA was created to develop, own, finance, plan, design, construct, operate, manage, and promote the new Puerto Rico Convention Center. The Commonwealth provides financial support to PRCCDA through legislative appropriations.

Puerto Rico Council on Higher Education (PRCHE) – PRCHE is governed by a board comprised of eight members appointed by the Governor with the consent of the Senate and the Secretary of Education of the Commonwealth as an ex-officio member. Its purpose is to develop higher education, to administer the licensing and certification of institutions of higher education, and to administer scholarship funds. The Commonwealth provides financial support to PRCHE through legislative appropriations.

Puerto Rico Government Investment Trust Fund (PRGITF) – PRGITF is governed by the Secretary of the Treasury of the Commonwealth. GDB is its trustee, custodian, and administrator. PRGITF's main objective is to provide investment opportunities in a professionally managed money market portfolio by investing in high-quality securities with minimal credit risk. Qualified investors include the Commonwealth's central government, its public corporations, instrumentalities and agencies, and the municipalities of Puerto Rico. In conformity with GASB Statement No. 31, *Accounting and Financial Reporting for Certain Investments and for External Investments Pools*, the financial statements of the PRGITF are not included in the accompanying basic financial statements because the primary government and each component unit investor is already presenting as cash or investment their corresponding share of the assets of the PRGITF (see note 5).

Puerto Rico Industrial Development Company (PRIDCO) – PRIDCO is governed by a seven-member board comprised of the Secretary of Economic Development and Commerce of the Commonwealth, who is the Chairman, the Secretary of the Treasury of the Commonwealth, the President of GDB, the President of the Planning Board of Puerto Rico, and three members from the private sector appointed by the Governor with the advice and consent of the Senate. The private sector members are appointed for a period of four years. PRIDCO administers the Commonwealth-sponsored economic development program by providing facilities, general assistance, and special incentive grants to manufacturing companies operating in Puerto Rico. PRIDCO has issued interim notes and revenue bonds to finance manufacturing plants and other facilities. Rentals derived from the leasing of specified facilities of PRIDCO are pledged for the payment of PRIDCO's revenue bonds. PRIDCO maintains debt that is paid with Commonwealth appropriations.

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Puerto Rico Industrial, Tourist, Educational, Medical, and Environmental Control Facilities Financing Authority (known as AFICA by its Spanish acronym) – AFICA is governed by a seven-member board consisting of the Secretary of Economic Development and Commerce, the President of GDB, the Executive Director of PRIFA, the Executive Director of the Tourism Company of Puerto Rico, the President of the Environmental Quality Board, and two private citizens appointed by the Governor. AFICA is authorized to issue revenue bonds to finance industrial, tourist, environmental control, medical, and educational facilities in Puerto Rico and the United States for use by private companies, nonprofit entities, or governmental agencies. The bonds are payable solely from collections from such private companies, nonprofit entities, or governmental agencies, and do not constitute debt of the Commonwealth or any of its other component units. The Commonwealth has access to AFICA's resources. AFICA maintains debt that is paid with Commonwealth appropriations.

Puerto Rico Land Administration (PRLA) – PRLA is governed by an eight-member board comprised of the Secretary of Economic Development and Commerce of the Commonwealth, who serves as president, the Secretary of the Treasury of the Commonwealth, the Secretary of Agriculture of the Commonwealth, the Secretary of DTPW of the Commonwealth, the Secretary of Housing of the Commonwealth, the President of the Planning Board of Puerto Rico, and two other members appointed by the Governor with the consent of the Senate. PRLA acquires parcels of land on behalf of government instrumentalities through negotiation or expropriation. The Commonwealth provides financial support to the PRLA through legislative appropriations.

Puerto Rico Medical Services Administration (PRMSA) – PRMSA is governed by a ten-member board comprised of the Secretary of Health of the Commonwealth, who is the Chairman, the Dean of the Medical Sciences Faculty of the UPR, the President of the Board of the Puerto Rican Cancer Society, the Mayor of the Municipality of San Juan, the Administrator of the State Insurance Fund Corporation (SIFC), the Executive Director of PRMSA, the Administrator of the Administration of Mental Health and Anti-Addiction Services, the President of the Medical Policy and Administration Committee, and two consumers appointed by the Secretary of Health of the Commonwealth. Its purpose is to plan, organize, operate, and administer the centralized health services, provided in support of the hospital and other functions, offered by the member institutions and users of the medical complex known as the Puerto Rico Medical Center. The Commonwealth provides financial support to PRMSA through legislative appropriations.

Puerto Rico Metropolitan Bus Authority (PRMBA) – PRMBA is governed by the Secretary of DTPW of the Commonwealth. PRMBA provides bus transportation to passengers within the San Juan Metropolitan Area. The Commonwealth provides financial support to PRMBA through legislative appropriations.

Puerto Rico Municipal Finance Agency (PRMFA) – PRMFA is governed by a five-member board comprised of the President of GDB, who is the Chairman, the Commissioner of Municipal Affairs, and three additional members appointed by the Governor, one of whom shall be either the mayor or chief financial officer of a municipality. PRMFA was organized to create a capital market to assist the municipalities of Puerto Rico in financing their public improvement programs.

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Puerto Rico Ports Authority (PRPA) – PRPA is governed by a five-member board consisting of the Secretary of DTPW of the Commonwealth, who is the Chairman, the Secretary of Economic Development and Commerce of the Commonwealth, the Executive Director of PRIDCO, the Executive Director of the Puerto Rico Tourism Company, and one private citizen appointed by the Governor with the consent of the Senate. The purpose of PRPA is to administer all ports and aviation transportation facilities of the Commonwealth and to render other related services. The Commonwealth provides financial support to PRPA through legislative appropriations.

Puerto Rico Public Broadcasting Corporation (PRPBC) – PRPBC is governed by an eleven-member board of directors comprised of the Secretary of Education of the Commonwealth, the President of the UPR, the Executive Director of IPRC, and eight private citizens, appointed by the Governor with the advice and consent of the Senate. At least three of these private citizens must have proven interest, knowledge, and experience in education, culture, art, science, or radio and television. PRPBC was created for the purpose of integrating, developing, and operating the radio, television, and electronic communication facilities that belong to the Commonwealth. The Commonwealth provides financial support to PRPBC through legislative appropriations.

Puerto Rico School of Plastic Arts (PRSPA) – PRSPA is governed by a seven-member board. Four members are appointed by the board of directors of IPRC, representing the public educational and cultural interests. Board members may not be employees of the PRSPA. The remaining three members are elected from among the members of the board of directors of IPRC, one of whom will serve as president. PRSPA was created to develop, promote, plan, and coordinate programs of study in higher education oriented to the plastic arts, teaching, artistic techniques, and to help students to develop humanistic values. The Commonwealth provides financial support to PRSPA through legislative appropriations.

Puerto Rico Solid Waste Authority (PRSWA) – PRSWA is governed by a government board appointed by the Secretary of the Department of Natural Resources, whereby, the Secretary and the Executive Director of PRSMA periodically meet. PRSWA provides alternatives for processing of solid waste and encourages recycling, reuse, and recovery of resources from waste. The Commonwealth provides financial support to PRSWA through legislative appropriations.

Puerto Rico Telephone Authority (PRTA) – PRTA is governed by a five-member board comprised of the President of GDB and four members that are appointed by the board of directors of GDB. PRTA is the legal entity responsible to account for the equity interest in Telecomunicaciones de Puerto Rico, Inc. for the benefit of the Employees' Retirement System of the Government of Puerto Rico and its Instrumentalities. The Commonwealth provides financial support to PRTA through legislative appropriations.

Puerto Rico Tourism Company (PRTC) – PRTC is governed by a seven-member board comprised of representatives of different tourist-related sectors appointed by the Governor with the consent of the Senate. At least one member must represent internal tourism and two must not be residents of the metropolitan area. Its purpose is to promote the tourism industry of Puerto Rico. The Commonwealth provides financial support to PRTC through legislative appropriations.

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Puerto Rico Trade and Export Company (PRTEC) – PRTEC is governed by an eight-member board comprised of the Secretary of Department of Economic Development and Commerce, who is the Chairman, the Executive Director of the Ports Authority, the Secretary of the Department of Agriculture, the President of EDB, the Executive Director of PRIDCO, the Legal Division Director of PRTEC, and two private citizens. PRTEC has the responsibility to promote the highest efficiency in the services provided to the commercial sector, with emphasis on small and medium-sized enterprises while promoting the export of products and services from Puerto Rico to other countries. The Commonwealth provides financial support to PRTEC through legislative appropriations.

Right to Employment Administration (REA) – REA is governed by an administrator appointed by the Governor with the consent of the Senate. In addition, a consultative board comprised of the Secretary of Labor and Human Resources of the Commonwealth, the Secretary of Agriculture of the Commonwealth, the Secretary of the DTPW of the Commonwealth, the Secretary of Education of the Commonwealth, and five additional members appointed by the Governor, with the Consent of the Senate, will advise the administrator on the implementation of the Right to Employment Act. The Commonwealth provides financial support to REA through legislative appropriations.

Special Communities Perpetual Trust (SCPT) – SCPT is governed by a board of directors composed of eleven members: the Secretary of Housing of the Commonwealth, the Secretary of the DTPW of the Commonwealth, the Coordinator for the Social and Economic Financing of the Special Communities, one mayor of the municipality of Puerto Rico, one community leader resident in one special community, four private citizens representing the public interest, and two public employees. All members of the Board of directors are appointed by the Governor. SCPT's principal purpose is to fund development projects that address the infrastructure and housing needs of the underprivileged communities. The Commonwealth of Puerto Rico provides financial support to SCPT through legislative appropriations.

State Insurance Fund Corporation (SIFC) – SIFC is governed by a six-member board appointed by the Governor with the advice and consent of the Senate. The board is comprised of the Commissioner of Insurance of Puerto Rico, an officer from the Department of Labor and Human Resources of the Commonwealth, an officer from the Department of Health of the Commonwealth, a representative of the employer's interest, a representative of the employees' interest, and two members without any of these interests. One of these members is appointed by the Governor as president of the board for a period of six years. The three public officials are appointed for a period of five years, and the rest of the members for four, three, two, and one year, respectively. SIFC provides workers' compensation and disability insurance to public and private employees. The Commonwealth has access to SIFC's resources. Payments made by SIFC to the Commonwealth during the year ended June 30, 2006 amounted to approximately \$37.3 million.

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

Government Development Bank for Puerto Rico P.O. Box 42001 San Juan, PR 00940 – 2001	Puerto Rico Aqueduct and Sewer Authority P.O. Box 7066 San Juan, PR 00916-7066
Puerto Rico Electric Power Authority P.O. Box 364267 San Juan, PR 00936-4267	Puerto Rico Health Insurance Administration P.O. Box 195661 San Juan PR 00919-5661
Puerto Rico Highways and Transportation Authority P.O. Box 42007 San Juan, PR 00940-2007	Puerto Rico Infrastructure Financing Authority Capital Center 235 Ave. Arterial Hostos, Suite 1600 San Juan, PR 00918-1433
University of Puerto Rico Jardin Botanico Sur 1187 Calle Flamboyán San Juan, PR 00926-1117	Agricultural Services and Development Administration P.O. Box 9200 San Juan, PR 00908-0202
Automobile Accidents Compensations Administration P.O. Box 364847 San Juan, PR 00936-4847	Cardiovascular Center Corporation of Puerto Rico and the Caribbean P.O. Box 366528 San Juan, PR 00936-6528
Caribbean Basin Projects Financing Authority P.O. Box 42001 San Juan, PR 00940-2001	Culebra Conservation and Development Authority P.O. Box 217 Culebra, PR 00775-0217
Economic Development Bank for Puerto Rico P.O. Box 2134 San Juan, PR 00922-2134	Employment and Training Enterprises Corporation P.O. Box 366505 San Juan, PR 00936-6505
Farm Insurance Corporation of Puerto Rico P.O. Box 9200 Santurce, PR 00908	Fine Arts Center Corporation P.O. Box 41287 – Minillas Station San Juan, PR 00940-1287
Governing Board of the 9-1-1 Service P.O. Box 270200 San Juan, PR 00927-0200	Institutional Trust of the National Guard of Puerto Rico P.O. Box 9023786 San Juan, PR 00902-3786

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Land Authority of Puerto Rico
P.O. Box 9745
San Juan, PR 00908-9745

Musical Arts Corporation
P.O. Box 41227 – Minillas Station
San Juan, PR 00940-1227

National Parks Company of Puerto Rico
P.O. Box 902098
San Juan, PR 00902-2089

Public Corporation for the Supervision and
Deposit Insurance of Puerto Rico Cooperatives
P.O. Box 195449
San Juan, PR 00919-5449

Puerto Rico Conservatory of Music Corporation
350 Lamar Street and Roosevelt Avenue
San Juan, PR 00918-2199

Puerto Rico Convention Center District Authority
P.O. Box 19269
San Juan, PR 00910-1269

Puerto Rico Council on Higher Education
P.O. Box 19900
San Juan, PR 00910-1900

Puerto Rico Government Investment Trust Fund
P.O. Box 42001 – Minillas Station
San Juan, PR 00940-2001

Puerto Rico Industrial Development Company
P.O. Box 362350
San Juan, PR 00936-2350

Puerto Rico Industrial, Tourist, Educational,
Medical, and Environmental Control
Facilities Financing Authority
P.O. Box 42001
San Juan, PR 00940-2001

Puerto Rico Land Administration
P.O. Box 363767
San Juan, PR 00936-3767

Puerto Rico Medical Services Administration
P.O. Box 2129
San Juan, PR 00922-2129

Puerto Rico Metropolitan Bus Authority
P.O. Box 195349
San Juan, PR 00919-5349

Puerto Rico Municipal Finance Agency
P.O. Box 42001
San Juan, PR 00940

Puerto Rico Ports Authority
P.O. Box 362829
San Juan, PR 00936-2829

Puerto Rico Public
Broadcasting Corporation
P.O. Box 19-0909
San Juan, PR 00919-0909

Puerto Rico School of Plastic Arts
P.O. Box 9021112
San Juan, PR 00902-1112

Puerto Rico Solid Waste Authority
P.O. Box 40285 – Minillas Station
San Juan, PR 00940-0285

Puerto Rico Telephone Authority
P.O. Box 42001
San Juan, PR 00940-2001

Puerto Rico Tourism Company
P.O. Box 902-3960
Old San Juan Station
San Juan, PR 00902-3960

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Puerto Rico Trade and Export Company
P.O. Box 195009
San Juan, PR 00919-5009

Right to Employment Administration
P.O. Box 364452
San Juan, PR 00936-4452

Special Communities
Perpetual Trust
P.O. Box 42001
San Juan, PR 00940-2001

State Insurance Fund
Corporation
P.O. Box 365028
San Juan, PR 00936-5028

The financial statements of the discretely presented component units have a year-end of June 30, 2006, except for the Puerto Rico Telephone Authority, which has a year-end of December 31, 2005.

Fiduciary Component Units

The three employee retirement systems administer pension funds for the Commonwealth and its political subdivisions. The three systems are subject to legislative and executive controls, and the administrative expenses are subject to legislative budget controls. These component units, while meeting the definition of a component unit and are legally separate, are presented in the fund financial statements along with other fiduciary funds of the Commonwealth. They have been omitted from the government-wide financial statements.

Employees' Retirement System of the Government of Puerto Rico and its Instrumentalities (ERS) – ERS is governed by a board of trustees, which is composed of the Secretary of the Treasury of the Commonwealth, who is the President, the President of GDB, the Commissioner for Municipal Affairs, the Director of the Puerto Rico Central Office of Personnel Administration, two participating employees, and one retiree, who are appointed by the Governor. The Commonwealth reports ERS as a single-employer pension plan. ERS is the administrator of a defined-benefit pension plan, which covers all regular employees of the Commonwealth and its instrumentalities and of certain municipalities and component units not covered by their own retirement systems. On September 24, 1999, an amendment to the law that created ERS was enacted with the purpose of establishing a new defined-contribution plan (System 2000) for employees hired by the government on or after January 1, 2000.

Puerto Rico Judiciary Retirement System (JRS) – JRS is governed by the same board of trustees as ERS. JRS is a single-employer defined-benefit plan, administered by ERS, which covers all individuals holding a position as Justice of the Supreme Court, Judge of the Superior Court or the District Court, or Municipal Judges of the Commonwealth.

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Puerto Rico System of Annuities and Pensions for Teachers (TRS) – TRS is governed by a nine member board comprised of the Secretary of Education of the Commonwealth, the Secretary of the Treasury of the Commonwealth, the President of GDB, two active teachers (one of them is a representative of the teachers' organization according to Act No. 45 of February 1998), two retired teachers, one representative of the teachers' organization and one representative of the public interest appointed by the Governor with the advice and consent of the Senate for four years. The Commonwealth reports TRS as a single-employer pension plan. TRS provides retirement benefits to all teachers of the Department of Education of the Commonwealth, all pensioned teachers, all teachers transferred to an administrative position in the Department of Education of the Commonwealth, teachers who work in the Teachers' Association of Puerto Rico, and those who practice in private institutions accredited by the Department of Education of the Commonwealth. TRS provides retirement, death, and disability benefits.

Complete financial statements of these component units can be obtained directly by contacting their respective administrative offices at:

Employees' Retirement System of the
Government of Puerto Rico and its
Instrumentalities
P.O. Box 42003 – Minillas Station
Santurce, PR 00940

Puerto Rico Judiciary
Retirement System
P.O. Box 42003 – Minillas Station
Santurce, PR 00940

Puerto Rico System of Annuities and Pensions for
Teachers
P.O. Box 191879
San Juan, PR 00919-1879

(c) ***Government-wide Financial Statements***

The government-wide financial statements (the statement of net assets and the statement of activities) report information of all of the nonfiduciary activities of the Commonwealth and its component units. For the most part, the effect of interfund activity has been removed from these government-wide financial statements. Governmental activities, which normally are supported by taxes and intergovernmental revenue, are reported separately from business-type activities, which rely to a significant extent on fees and charges for support. Likewise, the primary government is reported separately from the legally separate component units for which the primary government is financially accountable. The statement of net assets presents the reporting entities' nonfiduciary assets and liabilities, with the difference reported as net assets. Net assets are reported in three categories:

- ***Invested in Capital Assets, Net of Related Debt*** – These consist of capital assets, net of accumulated depreciation and amortization and reduced by outstanding balances for bonds, notes, and other debt that are attributed to the acquisition, construction, or improvement of those assets.

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- **Restricted Net Assets** – These result when constraints placed on net assets use on either externally imposed by creditors, grantors, contributors, and the like, or imposed by law through constitutional provisions or enabling legislation.

The government-wide statement of net assets reports \$1,195,559 of restricted net assets, none restricted by enabling legislation.

- **Unrestricted Net Assets** – These consist of net assets that do not meet the definition of the two preceding categories. Unrestricted net assets often are designated to indicate that management does not consider them to be available for general operations. Unrestricted net assets often have constraints on resources that are imposed by management, but can be removed or modified.

When both restricted and unrestricted resources are available for use, generally it is the Commonwealth's policy to use restricted resources first, then the unrestricted resources as they are needed.

The statement of activities demonstrates the degree to which the direct expenses of a given function, segment, or component unit are offset by program revenue. Direct expenses are those that are clearly identifiable with a specific function, segment, or component unit. Program revenue includes charges to customers who purchase, use, or directly benefit from goods or services provided by a given function, segment, or component unit. Program revenue also includes grants and contributions that are restricted to meeting the operational or capital requirements of a particular function, segment, or component unit. Taxes and other items not properly included among program revenue are reported instead as general revenue. Resources that are dedicated internally are reported as general revenue rather than as program revenue. The Commonwealth does not allocate general government (indirect) expenses to other functions.

(d) Measurement Focus, Basis of Accounting, and Financial Statement Presentation

Government-wide Financial Statements – The government-wide financial statements are reported using the economic resources measurement focus and the accrual basis of accounting. Revenue is recorded when earned and expenses are recorded when a liability is incurred, regardless of the timing of related cash flows. Grants and similar items are recognized as revenue as soon as all eligibility requirements have been met.

Governmental Fund Financial Statements – The governmental fund financial statements are reported using the current financial resources measurement focus and the modified-accrual basis of accounting. Revenue is recognized as soon as it is both measurable and available. Revenue is considered to be available when it is collectible within the current period or soon enough thereafter to pay liabilities of the current period. For this purpose, the Commonwealth considers revenue to be available if collected within 120 days after the end of the current fiscal year-end. Principal revenue sources considered susceptible to accrual include tax revenue, net of estimated overpayments (refunds) and amounts considered not collectible, which are recorded as taxpayers earn income (income taxes), as sales are made (consumption and use taxes), and as cash is received (miscellaneous taxes). In applying the susceptible to accrual concept to federal grants, there are essentially two types of revenue. For the majority of grants, moneys must be expended by the

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Commonwealth on the specific purpose or project before any amounts will be reimbursed. Revenue is, therefore, recognized as expenditures are incurred to the extent available. For the other revenue, moneys are virtually unrestricted and are generally revocable only for failure to comply with prescribed compliance requirements. These resources are reflected as revenue at the time of receipt or earlier if the susceptible to accrual criteria is met. Expenditures are generally recorded when a liability is incurred, as under accrual accounting. Modifications to the accrual basis of accounting include the following:

- Employees' vested annual vacation and sick leave are recorded as expenditures when utilized. The amount of accumulated annual vacation and sick leave unpaid at June 30, 2006 has been reported only in the government-wide financial statements.
- Interest and principal on general long-term obligations are recorded when due, except for interest and principal due on July 1 of the following fiscal year, if resources are available for its payment as of June 30.
- Executory purchase orders and contracts are recorded as a reservation of fund balance.
- Debt service expenditures, federal funds cost disallowances, other long-term obligations, and amounts subject to judgments under litigation are recorded only when payment is due.

Proprietary Funds, Fiduciary Funds, and Discretely Presented Component Units Financial Statements – The financial statements of the proprietary funds, fiduciary funds, and discretely presented component units are reported using the economic measurement focus and the accrual basis of accounting, similar to the government-wide financial statements described above.

Each enterprise fund has the option under GASB Statement No. 20 to elect and apply all Financial Accounting Standards Board (FASB) pronouncements issued after November 30, 1989, unless these conflict with a GASB pronouncement. The primary government's major enterprise funds have elected not to apply FASB pronouncements issued after November 30, 1989 and two nonmajor enterprise funds elected to adopt the FASB's pronouncements issued after November 30, 1989. Also, certain discretely presented component units have disclosed their election in their separately issued financial statements. The component units follow U.S. GAAP as issued by GASB and FASB as applicable to each component unit based on the nature of their operations. In addition, the Puerto Rico Government Investment Trust Fund adopted GASB Statement No. 31, *Accounting and Financial Reporting for Certain Investments and for External Investments Pools*; however, such financial statements are not included in the accompanying basic financial statements because the primary government and each component unit's investor already present their corresponding share of the assets of the PRGITF as cash or investments.

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Proprietary funds distinguish operating revenue and expenses from nonoperating items. Operating revenue and expenses generally result from providing services and producing and delivering goods in connection with a proprietary fund's principal ongoing operations. Revenue and expenses not meeting this definition are reported as nonoperating revenue and expenses. The major operating revenue of the Commonwealth enterprise funds is as follows:

- Unemployment Insurance Trust Fund – Amounts requisitioned for the Puerto Rico Unemployment Insurance Trust Fund held by the U.S. Treasury for payment of unemployment benefits and charges made to individual employers.
- Lotteries Fund – Amounts collected from the sale of traditional lottery tickets and electronic lotto games.

(e) *Fund Accounting*

The Commonwealth reports its financial position and results of operations in funds, which are considered separate accounting entities, and discrete presentations of those component units, which are not required to be blended. The operations of each fund are accounted for within a set of self-balancing accounts. Fund accounting segregates funds according to their intended purpose and is used to aid management in demonstrating compliance with legal, financial, and contractual provisions. Major funds are determined using a predefined percentage of the assets, liabilities, revenue, or expenditures/expenses of either the fund category or the governmental and enterprise funds combined. The nonmajor funds are combined in a single column in the fund financial statements. The Commonwealth reports the following major funds:

Governmental Funds

General Fund – The general fund is the primary operating fund of the Commonwealth. It is used to account for all financial transactions, except those required to be accounted for in another fund. Included are transactions for services such as general government, public safety, health, public housing and welfare, and education.

Debt Service Fund – The debt service fund accounts for the accumulation of resources predominantly for, and the payment of, general long-term bonds' principal, interest and related costs other than bonds payable from the operations of proprietary fund types, pension trust funds, and discretely presented component units. Long-term debt and interest due on July 1 of the following fiscal year are accounted for as a fund liability if resources are available as of June 30 for its payment.

Public Buildings Authority's Capital Projects Fund – The Public Buildings Authority's capital projects fund is used to account for the financial resources used for the acquisition or construction of major capital facilities not financed by proprietary fund types, pension trust funds, and discretely presented component units.

The Children's Trust Special Revenue Fund – The Children's Trust special revenue fund is used to account for the moneys received by the Commonwealth from a global settlement agreement dated November 23, 1998, between certain tobacco companies and certain states, territories, and other jurisdictions of the United States of America, including the Commonwealth. The financial resources

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received by this fund are used to carry out projects aimed at promoting the well-being of children and youth of Puerto Rico.

Proprietary Funds

These funds account for those activities for which the intent of management is to recover, primarily through user charges, the cost of providing goods or services to the general public.

Unemployment Insurance Trust Fund – This fund accounts for amounts requisitioned for the Puerto Rico Unemployment Insurance Trust Fund held by the U.S. Treasury for payment of unemployment benefits and charges made to individual employers.

Lotteries Fund – This fund accounts for the assets and operations of two lottery systems administered by the Commonwealth.

Fiduciary Funds

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

Pension Trust Funds – These are used to account for the assets, liabilities, and net assets available for pension benefits held in trust for the public employees' retirement systems.

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

Discretely Presented Component Units

Discrete presentation of component units is used to present the financial information of entities that do not qualify to be blended, in accordance with GASB No. 14, with the funds of the primary government. The component units column in the government-wide financial statements is used to report the financial activities of the Commonwealth's discretely presented component units. The financial statements of these component units are presented following the accrual basis of accounting. Under the accrual basis, revenue is recognized when earned and expenses are recorded as liabilities when incurred, without regard to receipt or payment of cash.

(f) Statutory (Budgetary) Accounting

The Commonwealth's budget is adopted in accordance with a statutory basis of accounting, which is not in accordance with GAAP. Revenue is generally recognized when cash is received, net of tax refunds claimed by taxpayers as of year-end. Short-term and long-term borrowings may be used to finance budgetary excess of expenditures over revenue. Expenditures are generally recorded when the related expenditure is incurred or encumbered. Encumbrances lapse the year following the end of the fiscal year when the encumbrance was established, as established by Act No. 123 of August 17, 2001, which amended the then existing appropriations and encumbrances lapsing provisions of Act No. 230 of July 23, 1974. Unencumbered appropriations lapse at year-end. Amounts required for settling claims and judgments against the Commonwealth and certain other liabilities are not recognized until they are encumbered or otherwise processed for payment.

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

The statement of revenue and expenditures – budget and actual – budget basis – general fund, only presents the information for the general fund for which there is a legally adopted budget, as required by GAAP. See note 3 for a reconciliation of the statement of revenue and expenditures – budget and actual – budget basis – general fund with the statement of revenue, expenditures, and changes in fund balance (deficit) for the general fund. The special revenue funds do not have a legally mandated budget.

(g) *Cash and Short-term Investments*

The Commonwealth follows the practice of pooling cash. The balance in the pooled cash accounts is available to meet current operating requirements, and any excess is invested in various interest bearing accounts with GDB and with the PRGITF. At June 30, 2006, excess of checks drawn over the pooled bank balance amounted to approximately \$1.4 billion and is reported within accounts payable and accrued liabilities of the governmental activities.

Cash and cash equivalents include investments with original maturities of 90 days or less from the date of acquisition.

The Commissioner of Financial Institutions requires that private financial institutions deposit collateral securities to secure the deposits of the Commonwealth and all other governmental entities in each of these institutions. The amount of collateral securities to be pledged for the security of public deposits shall be established by the rules and regulations promulgated by the Commissioner of Financial Institutions.

The Puerto Rico Unemployment Insurance Trust Fund is maintained to account for the collection of unemployment insurance contributions from employers and the payment of unemployment benefits to eligible claimants. As required by federal law, all resources not necessary for current benefit payments are placed on deposit with the U.S. Treasury. Interest earned over such deposit is retained in the fund.

Cash and short-term investments and cash equivalents of the component units are maintained in separate bank accounts, from those of the primary government, in their own names.

(h) *Securities Purchased Under Agreements to Resell*

Certain component units of the Commonwealth enter into purchases of securities with simultaneous agreements to resell. The securities underlying these agreements mainly consist of U.S. government obligations, mortgage-backed securities, and interest-bearing deposits with other banks.

(i) *Securities Lending Transactions*

Certain component units of the Commonwealth enter into securities lending transactions in which governmental entities (lenders) transfer their securities to broker-dealers and other entities

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(borrowers) for collateral with a simultaneous agreement to return the collateral for the same securities in the future. Securities received as collateral are generally reflected as investments with a corresponding liability resulting from the obligation to return such collateral.

(j) Investments

Investments include U.S. government and agencies obligations, mortgage-backed securities, repurchase agreements, commercial paper, local government obligations, investment contracts, and corporate debt and equity obligations. Investment securities, including investments in limited partnerships, are presented at fair value, except for money market investments and participating investment contracts with a remaining maturity at the time of purchase of one year or less and nonparticipating investment contracts, which are presented at cost. Changes in the fair value of investments are presented as investment earnings in the statement of activities, the statement of revenue, expenditures, and changes in balance – governmental funds, and the statement of revenue, expenses, and changes in fund net assets – proprietary funds. Fair value is determined based on quoted market prices. When securities are not listed on national exchanges, quotations are obtained from brokerage firms.

The PRGITF is considered a 2a7-like external investment pool and, as such, reports its investments at amortized cost.

The reverse repurchase agreements reported by certain discretely presented component units are authorized transactions under their respective enabling legislation and authorized by GDB.

(k) Receivables

Tax receivables in the general fund include predominantly amounts owed by taxpayers for individual and corporate income taxes, net of estimated uncollectible amounts. Income tax receivables are recognized as revenue when they become measurable and available based on actual collections during the 120 days following the fiscal year-end related to tax returns due before year-end. Tax receivables also include amounts owed by taxpayers on income earned in periods prior to June 30, 2006, estimated to be collectible but not currently available, and thus are reported as deferred revenue in the general fund. Unemployment, disability, and driver's insurance receivables in the enterprise funds are stated net of estimated allowances for uncollectible accounts.

Accounts receivable are stated net of estimated allowances for uncollectible accounts, which are determined based upon past collection experience and current economic conditions. Intergovernmental receivables primarily represent amounts owed to the Commonwealth for reimbursement of expenditures incurred pursuant to federally funded programs. Intergovernmental receivables also include taxes that the Municipal Revenue Collection Center (CRIM, as per its Spanish acronym), a municipal corporation, is required to remit to the Commonwealth to be used by the Commonwealth's debt service fund for payment of debt service on general obligations of the Commonwealth. The amount to be remitted is based on the special tax of 1.03% of the assessed value of all real and personal property not exonerated from taxation, which is levied by the CRIM [see note 14(c)].

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The accounts receivable from nongovernmental customers of the component units are net of estimated uncollectible amounts. These receivables arise primarily from service charges to users. Accounts receivable from the primary government and other component units that arise from service charges do not have allowances for uncollectible accounts, as these are deemed fully collectible.

Loans of the general fund represent predominantly amounts owed by public corporations and municipalities for public insurance and rent paid by the general fund on their behalf.

The loans of the pension trust funds do not have allowances for uncollectible amounts since such loans are secured by mortgage deeds, plan members' contributions, and any unrestricted amounts remaining in escrow. Loans of the component units consist predominantly of loans to the primary government, other component units and municipalities, and do not have allowances for uncollectible accounts as those are deemed fully collectible. The remaining loans of the component units are to small and medium businesses, agricultural, and low-income housing loans from nongovernmental customers, and are presented net of estimated losses on such portfolios.

(l) Inventories

Generally, inventories are valued at cost and predominantly on the first-in, first-out basis. Governmental fund inventories are recorded as expenditures when purchased rather than capitalized as an asset. Only significant amounts of inventory at the end of the year are capitalized in the governmental funds. However, inventories are always capitalized in the statement of net assets of governmental activities.

(m) Restricted Assets

Funds set aside for the payment and guarantee of notes and interest payable and for other specified purposes are classified as restricted assets since their use is limited for this purpose by applicable agreements or required by law. Restricted assets in the proprietary funds mainly include amounts set aside for the payment of insurance benefits.

(n) Real Estate Held for Sale

Real estate held for sale are carried at the lower of fair value or cost, which is established by a third party professional assessment or based upon an appraisal, minus estimated costs to sell. Subsequent declines in the value of real estate available for sale are charged to expenditure/expense.

(o) Capital Assets

Capital assets, which include land, buildings, building improvements, equipment, vehicles, construction in process, and infrastructure assets, are reported in the applicable governmental, business-type activities and component unit columns in the government-wide financial statements. The Commonwealth's primary government defines capital assets as assets that have an initial, individual cost of \$25,000 or more at the date of acquisition and have a useful life of five or more years. Capital assets are recorded at historical cost or at estimated historical cost if actual historical cost is not available.

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The method to deflate the current cost of the same or a similar asset using an approximate price index was used to estimate the historical cost of certain land, buildings, and building improvements because invoices and similar documentation was no longer available in certain instances. Donated capital assets are recorded at fair market value at the time of donation. Major outlays for capital assets and improvements are capitalized as projects are constructed. Interest costs are capitalized during the construction period only for business-type activities and most component units. The costs of normal maintenance and repairs that do not add value to the assets or materially extend asset lives are not capitalized.

GASB Statement No. 34, *Basic Financial Statements and Management's Discussion and Analysis for State and Local Governments*, provides transition standards that make available an extended period of deferral (fiscal year 2006) before the requirement to record and depreciate general infrastructure assets acquired before implementation date (July 1, 2001) becomes effective. General infrastructure assets acquired prior to July 1, 2001 were recorded during the fiscal year ended June 30, 2006.

Capital assets utilized in the governmental funds are recorded as expenditures in the governmental fund financial statements. Depreciation expense is recorded in the government-wide financial statements, as well as the proprietary funds and component units' financial statements.

Capital assets of the primary government are depreciated on the straight-line method over the assets' estimated useful life. There is no depreciation recorded for land and construction in progress. The estimated useful life of capital assets is as follows:

	<u>Years</u>
Buildings and building improvements	20 – 50
Equipment, furniture, fixtures, and vehicles	5 – 15
Infrastructure	50

The capital assets of the component units are recorded in accordance with the applicable standards of the component units and under their own individual capitalization thresholds. Depreciation has been recorded when required by these standards based on the types of assets, use and estimated useful lives of the respective assets, and on the nature of each of the component unit's operations.

The estimated useful lives of capital assets reported by the component units are as follows:

	<u>Years</u>
Buildings and building improvements	3 – 50
Equipment, furniture, fixtures, and vehicles	3 – 20
Infrastructure	10 – 50

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The Commonwealth adopted the provision of GASB Statement No. 42 *Accounting and Financial Reporting for Impairment of Capital Assets and for Insurance Recoveries*, an amendment to GASB Statement No. 34. This statement establishes guidance for accounting and reporting for the impairment of capital assets and for insurance recoveries.

(p) Tax Refunds Payable

During the calendar year, the Commonwealth collects individual income taxes through withholdings and payments from taxpayers. At June 30, the Commonwealth estimates the amount owed to taxpayers for overpayments during the first half of the calendar year. These estimated amounts and the actual tax refunds claimed for prior years but not paid at year-end are recorded as tax refunds payable and as a reduction of tax revenue.

(q) Deferred Revenue

Deferred revenue at the governmental fund level arises when potential revenue does not meet either the “measurable” or the “available” criteria for revenue recognition in the current period. Deferred revenue also arises when resources are received before the Commonwealth has a legal claim to them, as when grant moneys are received prior to incurring the qualifying expenditures. In subsequent periods, when the revenue recognition criteria is met, or when the Commonwealth has a legal claim to the resources, the liability for deferred revenue is removed from the balance sheet and the revenue is recognized. Deferred revenue at the government-wide and proprietary fund levels arises only when the Commonwealth receives resources before it has a legal claim to them.

(r) Long-term Debt

The liabilities reported in the government-wide financial statements include Commonwealth general obligation bonds and long-term notes, obligations under lease/purchase agreements, and long-term liabilities including vacation, sick leave, long-term liabilities to other governmental entities, net pension obligation, legal claims, and noncurrent federal fund cost disallowances related to expenditures of federal grants. Long-term obligations financed by proprietary fund types and component units are recorded as liabilities in those funds and in the discretely presented component units column.

Premiums, discounts, and issuance costs – in the government-wide financial statements, long-term debt and other long-term obligations are presented in the columns for governmental and business-type activities. The same is presented in the proprietary fund financial statements. Bond and note premiums and discounts, as well as issuance costs, are deferred and amortized over the life of the debt. Bonds and notes payable are reported net of the applicable bond premium or discount. Bond issuance costs are reported as deferred charges in other assets and are amortized over the term of the related debt. In the governmental fund financial statements, governmental funds recognize bond premiums and discounts, as well as bond issuance costs, during the current period. The face amount of debt issued is reported as other financing sources. Premiums received on debt issuance are reported as other financing sources while discounts are reported as other financing uses. Issuance costs, whether or not withheld from the actual debt proceeds received, are reported as expenditures.

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(s) *Reservations of Fund Balance – Governmental Funds*

The governmental fund financial statements present fund balance reserves for those portions of fund balance (1) not available for appropriation for expenditures or (2) legally segregated for a specific future use. Reserves for encumbrances, debt service, and other specific purposes are examples of the latter.

(t) *Accounting for Pension Costs*

For the purpose of applying the requirements of GASB Statement No. 27, *Accounting for Pensions by State and Local Government Employers*, the Commonwealth's financial reporting entity is considered to be a sponsor of three single-employer defined-benefit pension plans: ERS, JRS, and the TRS. This is because substantially all the participants in the three pension trust funds are part of the financial reporting entity of the Commonwealth. For the purpose of the basic financial statements, and as disclosed in note 19, the Commonwealth's annual pension cost, measured on the accrual basis of accounting, for the year ended June 30, 2006 amounted to approximately \$866 million. However, the amount recognized as pension expenditure in the governmental funds was recorded under the modified-accrual basis, and amounted to approximately \$602 million. The excess of the annual required contribution over the statutorily required contributions increased the net pension obligation at June 30, 2006 to approximately \$4.7 billion. This amount is presented in the statement of net assets of the governmental activities as of June 30, 2006.

For purposes of the stand-alone financial statements of each of the blended and discretely presented component units, the entities accounted for pension costs from the standpoint of a participant in a multiple-employer cost-sharing plan. Accordingly, pension costs recognized are equal to the statutorily or contractually required contributions, with a liability recorded for any unpaid required contributions. The basis of accounting used by the component units was either modified-accrual basis or accrual basis, depending upon individual fund structure and type of entity. Most component units did not have pension-related assets or liabilities at transition because they have contributed the statutorily required contributions.

(u) *Post-employment Benefits*

In addition to the pension benefits described in note 19, the Commonwealth provides post-employment healthcare benefits and a Christmas bonus for its retired employees in accordance with local law. Substantially all of the employees may become eligible for these benefits if they reach normal retirement age while working for the Commonwealth. Healthcare benefits are provided through insurance companies whose premiums are paid by the retiree with the Commonwealth providing a matching share of not more than \$100 per month for each retiree. During the year ended June 30, 2006, the cost of providing healthcare benefits amounted to approximately \$148 million for approximately 123,534 retirees. The Christmas bonus paid to these retired employees during the year ended June 30, 2006 was \$400 per retiree and the total amount was approximately \$49.4 million. These benefits are recorded as expenditures when paid in the general fund.

(v) *Compensated Absences*

The vacation policy of the Commonwealth generally provides for the accumulation of 2.5 days per month, except for the teachers who accrue 4 days per month. Vacation time accumulated is fully

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vested to the employees from the first day of work up to a maximum of 60 days. Employees accumulate sick leave generally at a rate of 1.5 days per month up to a maximum of 90 days. Upon retirement, an employee receives compensation for all accumulated unpaid leave at the current rate, if the employee has at least 10 years of service with the Commonwealth. Accrued compensated absences of the primary government at June 30, 2006 amounting to approximately \$1.7 billion are presented in the statement of net assets. Compensated absence accumulation policies for the blended component units and discretely presented component units vary from entity to entity based on negotiated agreements and other factors agreed upon between the management of these entities and their employees.

The Public Service Personnel Law requires certain component units and the primary government of the Commonwealth to annually pay the employees the accumulated vacation and sick leave earned in excess of the limits mentioned above.

(w) *Interfund and Intraentity Transactions*

The Commonwealth has the following types of transactions among funds:

Interfund Transfer – Legally required transfers that are reported when incurred as transfer-in by the recipient fund and as transfers-out by the disbursing fund, with receivables and payables presented as amounts due to and due from other funds. Advances between funds are also presented as amounts due to and due from other funds. However, these transfers and related amounts receivable and payable are considered internal balances and activities that have been eliminated in the government-wide financial statements.

Intraentity Transactions – There are two types of intraentity transactions. First, are resource flows between the primary government and its component units and among the component units. These resource flows and related outstanding balances are reported as if they were external transactions. However, resource flows between the primary government and blended component units are classified as interfund transactions, as described above. Second, are intraentity balances between the primary government funds and discretely presented component units that are tantamount to long-term debt financing. The primary government's liability is reported in the statement of net assets, the proceeds in the primary government's funds, and the asset in the discretely presented component units' statement of net assets.

(x) *Lottery Revenue and Prizes*

The revenue, expenses, and prizes awarded by the Lottery of Puerto Rico and the Additional Lottery System, reported within the lotteries enterprise fund, are recognized as drawings are held. Moneys collected prior to June 30 for tickets related to drawings to be conducted subsequent to June 30 are reported as deferred revenue. Unpaid prizes awarded as of June 30 are reported as a fund liability.

(y) *Risk Management*

The Commonwealth purchases commercial insurance covering casualty, theft, tort claims, and other losses for the primary government, most component units, and the municipalities. The Commonwealth is reimbursed for premium payments made on behalf of the component units and the municipalities. The current insurance policies have not been canceled or terminated. For workers'

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compensation, the Commonwealth has a discretely presented component unit, the SIFC, which provides workers' compensation to both public and private employees. In the past three years, the Commonwealth has not settled claims that exceed insurance coverage.

Certain component units combine commercial insurance with internal self-insurance funds covering specific risks related to their specialized operations.

(z) *GASB Technical Bulletin No. 2004-1*

The Children's Trust (the Trust) follows GASB Technical Bulletin No. 2004-1, Tobacco Settlement Recognition and Financial Reporting Entity Issue (the TB), which provides accounting guidance for entities created to obtain the rights to all or a portion of future tobacco settlement resources and for the governments that create such entities.

The TB indicates that the entity created to obtain the rights, which is called the Tobacco Settlement Authority (TSA), should be considered a component unit of the government that created it and the component unit should be blended. The TB also states that the government receiving the payments from the tobacco companies under the Agreement, which are called settling governments, should recognize a receivable and revenue for tobacco settlement resources (TSRs) when an event occurs. The event that results in the recognition of an asset and revenue by the settling government is the domestic shipment of cigarettes. The TB indicates that accruals should be made by the settling government and TSAs for estimates for estimated shipments from January 1 to their respective fiscal year-ends, since the annual payments are based on a calendar year. However, under the modified-accrual basis of accounting at the fund level, revenue should be recognized only to the extent that resources are available.

(aa) *Reclassifications*

Certain reclassifications have been made to the information presented in the separately issued financial statements of certain blended component units and agencies included within the special revenue, debt service, capital projects, proprietary funds, and discretely presented component units to conform to the accounting classifications used by the Commonwealth in the basic financial statements.

(bb) *Use of Estimates*

The preparation of the basic financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the basic financial statements and the reported amounts of revenue and expenses during the reporting period. Actual results could differ from those estimates.

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(cc) *Future Adoption of Accounting Pronouncements*

The GASB has issued the following accounting standards that have effective dates after June 30, 2006:

- GASB Statement No. 45, *Accounting and Financial Reporting by Employers for Post-employment Benefits Other Than Pensions*, which is effective for fiscal years beginning after December 15, 2006.
- GASB Statement No. 48, *Sales and Pledges of Receivables and Future Revenues and Intra-Entity Transfer of Assets and Future Revenues*, which is effective for periods ending after December 31, 2007.
- GASB Technical Bulletin No. 2004-2, *Recognition of Pensions and Other Post-employment Benefit Expenditures/Expense and Liability by Cost-Sharing Employers*. As it relates to pension transactions, this Technical Bulletin is effective for financial statements for periods ending after December 15, 2004. As it relates to OPEB transactions, it is effective for financial statements for periods beginning after December 15, 2006. The effect of this Technical Bulletin on the accompanying basic financial statements was not considered material as it relates to pension transactions.

The impact of these statements on the Commonwealth's basic financial statements has not yet been determined.

(2) **Component Units**

The Commonwealth follows the provisions of GASB No. 14. The basic financial statements of the Commonwealth include the financial statements of the following component units that were audited by other auditors:

Blended component units:

Public Buildings Authority
Puerto Rico Maritime Shipping Authority
The Children's Trust

Discretely presented component units:

Agricultural Services and Development Administration
Automobile Accidents Compensations Administration
Cardiovascular Center Corporation of Puerto Rico and the Caribbean
Caribbean Basin Projects Financing Authority
Culebra Conservation and Development Authority
Employment and Training Enterprises Corporation
Farm Insurance Corporation of Puerto Rico
Fine Arts Center Corporation
Governing Board of the 9-1-1 Service
Government Development Bank for Puerto Rico

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Institutional Trust of the National Guard of Puerto Rico
Land Authority of Puerto Rico
Musical Arts Corporation
National Parks Company of Puerto Rico
Public Corporation for the Supervision and Deposit Insurance of Puerto Rico Cooperatives
Puerto Rico Conservatory of Music Corporation
Puerto Rico Convention Center District Authority
Puerto Rico Council on Higher Education
Puerto Rico Electric Power Authority
Puerto Rico Government Investment Trust Fund
Puerto Rico Health Insurance Administration
Puerto Rico Highways and Transportation Authority
Puerto Rico Industrial Development Company
Puerto Rico Industrial, Tourist, Educational, Medical, Environmental
Control Facilities Financing Authority
Puerto Rico Infrastructure Financing Authority
Puerto Rico Land Administration
Puerto Rico Medical Services Administration
Puerto Rico Metropolitan Bus Authority
Puerto Rico Municipal Finance Agency
Puerto Rico Ports Authority
Puerto Rico Public Broadcasting Corporation
Puerto Rico School of Plastic Arts
Puerto Rico Solid Waste Authority
Puerto Rico Trade and Export Company
Puerto Rico Telephone Authority
Right to Employment Administration
Special Communities Perpetual Trust
State Insurance Fund Corporation
University of Puerto Rico

(3) Stewardship, Compliance, and Accountability

(a) *Budgetary Control*

The Governor is constitutionally required to submit to the Legislature an annual balanced budget of the Commonwealth for the ensuing fiscal year. The annual budget is prepared by the Commonwealth's Office of Management and Budget (OMB) and takes into consideration the advice provided by the Puerto Rico Planning Board (annual economic growth forecasts, and four-year capital improvements plan), the Department of the Treasury of the Commonwealth (revenue estimates, accounting records, and the comprehensive annual financial report), GDB (fiscal agent), and other governmental offices and agencies. Section 7 of Article VI of the Constitution of Puerto Rico provides that "The appropriations made for any fiscal year shall not exceed the total revenue, including available surplus, estimated for said fiscal year, unless the imposition of taxes sufficient to cover said appropriations is provided by law."

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The annual budget, which is developed utilizing elements of performance-based program budgeting and zero-based budgeting, includes an estimate of revenue and other resources for the ensuing fiscal year under: (1) laws existing at the time the budget is submitted; and (2) 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 capital improvements plan adopted by the Puerto Rico Planning Board.

The Legislature may amend the budget submitted by the Governor but may not increase any items so as to cause a deficit without imposing taxes or identifying other sources of revenue to cover such deficit. Upon approval by the Legislature, the budget is referred to the Governor who may decrease or eliminate any line item but may not increase or insert any new line item in the budget. The Governor may also veto the budget in its entirety and return it to the Legislature with his objections. The Legislature, by 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 approved by the Legislature and the Governor, is automatically renewed for the ensuing fiscal year until a new budget is approved by the Legislature and the Governor. This permits the Commonwealth to continue making payments for its operating and other expenses until the new budget is approved. The appropriated annual budget for fiscal year 2006 amounted to approximately \$5.5 billion. The Legislature also made several special budgetary appropriations to the general fund throughout the year, which amounted to approximately \$3.4 billion.

The OMB has authority to amend the budget within a department, agency, or government unit without legislative approval.

For budgetary purposes, encumbrance accounting is used. The encumbrances (that is, purchase orders, contracts) are considered expenditures when a commitment is made. For GAAP reporting purposes, encumbrances outstanding at year-end are reported as reservations of budgetary appropriations within GAAP fund balances and do not constitute expenditures or liabilities on a GAAP basis because the commitments will be honored during the subsequent year. The unencumbered balance of any appropriation of the general fund at the end of the fiscal year lapses immediately. Appropriations, other than in the general fund, are continuing accounts for which the Legislature has authorized that an unspent balance from the prior year be carried forward and made available for current spending.

In addition, the Legislature may direct that certain revenue be retained and made available for spending within a specific appropriation account. Generally, expenditures may not exceed the level of spending authorized for an individual department. However, the Commonwealth is statutorily required to pay debt service, regardless of whether such amounts are appropriated. Appropriations are enacted for certain departments, agencies, and government units included in the balance sheet of the general fund. For these funds, a statement of revenue and expenditures – budget and actual budget basis – general fund is included. Appropriations for capital projects are made for each bond issue and the authorization continues for the expected construction period.

The Commonwealth's Department of the Treasury and OMB have the responsibility to ensure that budgetary spending control is maintained on an individual department basis. OMB may transfer part

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or all of any unencumbered balance within a department to another department subject to legislative approval. Budgetary control is exercised through the Puerto Rico Integrated Financial Accounting System (PRIFAS). PRIFAS ensures that encumbrances or expenditures are not processed if they exceed the department's total available spending authorization, which is considered its budget. The legal level of budgetary control is at the individual department level for general fund expenditures, principal and interest due for the year for the debt service fund, and by bond authorization for capital expenditures.

(b) Budget/GAAP Reconciliation

The following schedule presents comparisons of the legally adopted budget with actual data on a budget basis. Because accounting principles applied for purposes of developing data on a budget basis differ significantly from those used to present financial statements in conformity with GAAP, a reconciliation of entity, timing, and basis differences in the excess (deficiency) of revenue and other financing sources over expenditures and other financing uses for the year ended June 30, 2006 is presented below for the general fund (expressed in thousands):

Deficiency of revenue and other financing sources over expenditures and other financing uses – budget basis	\$ (461,241)
Entity differences:	
Excess (deficiency) of revenue and other financing sources over expenditures and other financing uses for:	
Non-budgeted funds	402,864
Inclusion of agencies with independent treasuries	(66,354)
Timing differences:	
Adjustment for encumbrances	39,370
Current year expenditure against prior year encumbrances	(30,718)
Basis of accounting differences:	
Net increase in taxes receivable (net of tax refunds)	108,079
Net increase in other receivables	90,580
Net decrease in deferred revenue	37,802
Excess of revenue and other financing sources over expenditures and other financing uses (GAAP basis)	\$ 120,382

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(c) Deficit Net Assets

The following activities, funds, and discretely presented component units reflect deficit fund balance/net assets at June 30, 2006 (expressed in thousands):

Primary government:	
Governmental activities	\$ <u>17,209,563</u>
General fund	\$ <u>383,755</u>
PBA capital projects fund	\$ <u>32,026</u>
Enterprise fund – lotteries	\$ <u>170,007</u>
Component units:	
Land Authority of Puerto Rico	\$ <u>124,912</u>
Agricultural Services Development Administration	\$ <u>107,674</u>
Puerto Rico Medical Services Administration	\$ <u>48,264</u>
Cardiovascular Center Corporation of Puerto Rico and the Caribbean	\$ <u>32,889</u>
Employment and Training Enterprises Corporation	\$ <u>6,034</u>
Right to Employment Administration	\$ <u>2,527</u>
Musical Arts Corporation	\$ <u>950</u>

The Commonwealth's governmental activities show a deficit of approximately \$17.2 billion, mostly attributed to long-term obligations amounting to approximately \$26 billion, which is recognized in the statement of net assets. On the other hand, the discretely presented component units report net assets of approximately \$13.1 billion. This inverse relationship between the governmental activities and component units' net assets reveal the operational structure of the Commonwealth where the primary government issues debt, the proceeds of which are predominantly transferred to the component units and to other governments as well, to finance their capital projects and other operational needs. The Commonwealth includes within the annual budgetary appropriation process the necessary funds to cover the annual debt service requirements of the aforementioned debt, most of which are the result of Act No. 164 of December 17, 2001, described in note 14(d). Also, as part of the fiscal reform referred to below, certain component units will be subject to reductions in future legislative appropriations provided by the primary government, requiring the affected component units to increase their revenue base and fee structure currently being charged to the general public.

In an effort to address the Commonwealth's structural budget imbalance and its other fiscal difficulties, the Executive Branch and the Legislative Assembly enacted and the Governor signed legislation providing for tax reform and fiscal reforms. The tax reform legislation is aimed at increasing revenues by expanding the tax base through the implementation of a broad-based sales tax. The fiscal reform legislation is aimed at limiting expenditures in relation to past spending rates and stabilizing expenditure growth at a level below that of recurring revenues.

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On July 4, 2006 the legislative assembly approved Act No. 117 (Act 117) which amends the Puerto Rico Internal Revenue Code of 1994 (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 Central Government Sales Tax). Act 117 also authorizes each municipal government to impose a municipal sales and use tax of 1.5% (the Municipal Sales Tax and, together with the Central Government Sales Tax, the Sales Tax). In general, the Municipal Sales Tax has the same tax base, exemptions (except for unprocessed foods), and limitations as those provided for the Central Government Sales Tax. Act 117 also provides certain income tax reductions to address the regressive effect of the Sales Tax on taxpayers in lower income tax brackets. Act 117 repeals the 5% general excise tax imposed on imported goods and on goods manufactured in Puerto Rico. Certain items, such as fuel, crude oil and petroleum products, and vehicles, however, remain subject to the excise tax previously applicable to such items and will not be subject to the Sales Tax. The effective date of the repeal of the 5% general excise tax was October 17, 2006 pursuant to Act 229.

The Sales Tax will be effective on November 15, 2006. Municipalities, however, were authorized to implement the Municipal Sales Tax starting on July 1, 2006, and some have already done so. The revenues derived from the Sales Tax will be distributed as follows: (i) municipal governments will retain 1.3% of the Sales Tax, (ii) the Financial Assistance Fund, created by Act No. 91 of May 13, 2006, will receive 1% of the Sales Tax, and (iii) the General Fund will receive 4.7% of the Sales Tax. The revenues to be generated by the Sales Tax will be partly offset by the partial elimination of the 5% general excise tax and the effect of the income tax reduction measures included in Act 117.

Act 117 also provides for special income tax rates with respect to certain transactions occurring on and between July 1, 2006 and December 31, 2006. These special tax rates will apply to eligible dividends declared by domestic corporations or partnerships and “built-in” gains associated with capital assets held for periods in excess of six months, as well as certain withdrawals from retirement accounts. These special tax rates are only available for transactions in connection with capital assets consisting of stock or participations of domestic and foreign corporations and partnerships, and real property located in Puerto Rico. In the case of resident corporations and partnerships, these special tax rates apply only to real property located in Puerto Rico.

The Additional Lottery System (electronic Lotto Games) activities show a deficit of approximately \$170 million, mostly attributed to a payment amounting to \$200 million made in the prior year to the Commonwealth. This transaction was authorized pursuant to Law No. 171, dated July 29, 2004, which among other things authorizes the Secretary of the Treasury of the Commonwealth to provide funding for the payment of Lotto prize annuities upon depletion of other resources available at the Additional Lottery.

It is the opinion of the Additional Lottery Management that the deficiency is not an indication of financial difficulties for the payment of long-term Lotto prizes because funds will always be provided from either the Additional Lottery or from financial assistance from the Commonwealth.

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(4) Changes in Reporting Entity and Restatement

The following table illustrates the change to net assets at the beginning of the year as previously reported in the governmental activities' statement of net assets and to fund balances at the beginning of the year as reported in the statement of revenue, expenditures, and changes in fund balances – governmental funds. The changes resulted from the effect of a correction of housing units and land lot held for resale, cash accounts not recorded in prior years, and to correct miscellaneous accounts resulting in a net effect of \$67.8 million. In addition, capital assets were decreased by \$22.9 million. The beginning balances have been restated as follows (expressed in thousands):

	<u>Net assets – governmental activities</u>	<u>Fund balances – general fund</u>
Beginning balance, as previously reported	\$ (15,916,789)	(511,271)
Correction of errors	7,134	7,134
Over capitalization of capital assets	<u>(22,919)</u>	<u>—</u>
Beginning balance, as restated	\$ <u><u>(15,932,574)</u></u>	<u><u>(504,137)</u></u>

The following table summarizes changes to net assets at the beginning of the year as previously reported in the statement of net assets by certain discretely presented component units. The changes resulted primarily from exclusions of nonmajor component units in the current year's presentation, and restatements to correct errors in the prior year's financial statements of certain component units (expressed in thousands):

Beginning net assets, as previously reported	\$ 17,763,736
Restatement of major component units:	
Puerto Rico Highways and Transportation Authority	(4,027,913)
Puerto Rico Infrastructure Financing Authority	1,394
Restatements of non-major component units	(8,954)
Non-major component units excluded in fiscal year 2005, but included in fiscal year 2006	11,526
Non-major component units included in fiscal year 2005, but excluded in fiscal year 2006	<u>(27,075)</u>
Beginning net assets, as restated	\$ <u><u>13,712,714</u></u>

The Puerto Rico Highways and Transportation Authority has restated its financial statements principally for projects included as construction in progress that had also been included as roads, bridges, and for certain other projects for which capitalized interest has been overstated. The net effect of the restatement was to decrease capital assets and beginning balance of net assets by approximately \$4 billion.

(5) Puerto Rico Government Investment Trust Fund (PRGITF)

PRGITF was created by Act No. 176, of August 11, 1995, and began operations on December 4, 1995. PRGITF is a no-load diversified collective investment trust administered by GDB that was created for the purpose of providing eligible governmental investors of Puerto Rico with a convenient and economical

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way to invest in a professionally managed money market portfolio. PRGITF is not an investment company or a mutual fund and is not subject to regulation or registration under the investment company Act of 1940. Units issued by PRGITF are not subject to regulation or registration under the Securities and Exchange Act of 1933, as amended, because the units are issued by a government entity. The deposits on hand and the investments purchased are not collateralized, secured, or guaranteed by the Commonwealth or any of its agencies, instrumentalities, or political subdivisions.

PRGITF is considered a 2a7-like external investment pool, and as such, reports its investment at amortized cost.

The investment securities on hand at June 30, 2006, consisted of certificates of deposit, bank notes, corporate obligations, commercial paper, and U.S. government and agencies obligations, all of which may be considered highly liquid. However, the participants' investments are subject to the ability of PRGITF to receive payment from the securities' issuer when due. The liquidity of certain investments and changes in interest rates may affect PRGITF's yield and the fair value of its investments.

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The dollar amount of the deposits on hand at June 30, 2006, at \$1.00 per unit of participation, was reported in the individual financial statements of each of the participants, and combined in the basic financial statements as follows (expressed in thousands):

	<u>Balance outstanding</u>	<u>Percentage of total</u>
Primary government:		
Commonwealth	\$ 231,207	66.80%
The Children's Trust	73,648	21.28%
Public Buildings Authority	78	0.02%
Employees' Retirement System of the Government of Puerto Rico and its Instrumentalities	2	0.00%
Total for primary government	<u>304,935</u>	<u>88.10%</u>
Discretely presented component units:		
Puerto Rico Aqueduct and Sewer Authority	18,304	5.30%
Government Development Bank for Puerto Rico	16,157	4.67%
Institutional Trust of National Guard of Puerto Rico	3,510	1.01%
Puerto Rico Land Administration	611	0.18%
Puerto Rico Solid Waste Authority	560	0.16%
State Insurance Fund Corporation	413	0.12%
Public Corporation for the Supervision and Deposit Insurance of Puerto Rico Cooperatives	409	0.12%
Puerto Rico Electric Power Authority	155	0.04%
Puerto Rico Infrastructure Financing Authority	148	0.04%
Puerto Rico Highways and Transportation Authority	97	0.03%
National Parks Company of Puerto Rico	43	0.01%
Puerto Rico Convention Center District Authority	5	0.00%
	<u>40,412</u>	<u>11.68%</u>
Other governmental entities	<u>776</u>	<u>0.22%</u>
Total for all participants	<u>\$ 346,123</u>	<u>100.00%</u>

The deposits at June 30, 2006 were invested in securities with a cost which approximates fair value, plus accrued interest, for approximately \$346 million. The external portion of PRGITF was not considered significant for separate reporting in the accompanying basic financial statements.

(6) Deposits and Investments

Pursuant to the provisions of Act No. 91 of March 29, 2004 that superseded Act No. 218 of 1951, as amended, the primary government may invest in different types of securities, including domestic, international, and fixed income securities, among others.

The primary government maintains a cash and investment pool that is available for use by all funds, except for the fiduciary funds. Each fund's portion of this pool is reported on the statement of net assets as cash

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and cash equivalents. The fiduciary funds investments are held and managed separately from those of other primary government funds.

Primary Government

Cash and cash equivalents consist of demand deposits, interest-bearing accounts, certificates of deposit, and bank investment contracts.

The carrying amount of deposits of the primary government at June 30, 2006 consists of the following (expressed in thousands):

	Carrying amount			Bank balance
	Unrestricted	Restricted	Total	
Commercial banks and U.S.				
Treasury	\$ 609,247	692,637	1,301,884	870,144
Component unit banks	1,783,040	1,896,060	3,679,100	2,775,618
Total	<u>\$ 2,392,287</u>	<u>2,588,697</u>	<u>4,980,984</u>	<u>3,645,762</u>

Custodial credit risk is the risk that in the event of bank failure, the primary government's deposit might not be recovered. The Commonwealth requires that public funds deposited in commercial banks in Puerto Rico must be fully collateralized for the amount deposited in excess of federal depository insurance. All securities pledged as collateral are held by the Secretary of the Treasury of the Commonwealth. There is no formal policy for custodial credit risk for cash accounts opened with commercial banks outside of Puerto Rico.

At year-end, the Commonwealth's bank balance of deposits in commercial banks amounting to \$337 million was covered by Federal depository insurance or by collateral held by the Commonwealth's agent in the Commonwealth's name. Deposits of approximately \$533 million with the U.S. Treasury represent unemployment insurance taxes collected from employers that are transferred to the Federal Unemployment Insurance Trust Fund in the U.S. Treasury. These deposits are uninsured and uncollateralized. The bank balance of deposits in component unit banks, which as of June 30, 2006 amounted to approximately \$2.8 billion, are also uninsured and uncollateralized. These deposits in component unit banks are maintained with GDB and EDB. Deposits maintained in GDB and EDB are exempt from the collateral requirement established by the Commonwealth and thus represent a custodial credit risk because in the event of GDB's or EDB's failure, the Commonwealth may not be able to recover these deposits.

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Deposits in component unit banks represent the balance of interest and noninterest-bearing accounts in GDB and EDB. The deposit liability at GDB and EDB is substantially related to deposits from other component units and of the Commonwealth. The deposit liability does not agree with the governmental cash balances shown above because of reconciling items such as outstanding checks and deposits in transit. The bank balance of GDB's and EDB's deposits at June 30, 2006 is broken down as follows (expressed in thousands):

Primary government	\$ 2,698,709
Discretely presented components units	<u>1,901,906</u>
Total pertaining to the Commonwealth	4,600,615
Municipalities of Puerto Rico	526,905
Other nongovernmental entities	790,517
Certificates of indebtedness	54,884
Escrow accounts	<u>153,487</u>
Total deposits per GDB and EDB	\$ <u><u>6,126,408</u></u>

Unrestricted deposits include approximately \$231 million that are invested in PRGITF (see note 5). Such amount has been included as cash and cash equivalents in the primary government's statement of net assets.

Investments

Custodial Credit Risk

Custodial credit risk for investments is the risk that, in the event of the failure of the counterparty to the transaction, the primary government may not be able to recover the value of the investment or collateral securities that are in the possession of an outside party. At June 30, 2006, securities investments were registered in the name of the Commonwealth and were held in the possession of the Commonwealth's custodian bank.

Primary Government

The fair value by investment type, credit quality ratings, and maturity of the unrestricted investments reported by the governmental activities at June 30, 2006 consist of the following (expressed in thousands):

	Fair market value	Investment rating		Investment Maturity less than 1 year
		AAA to A	Not rated	
Guaranteed investment contract	\$ 83,684	83,684	—	83,684
PRGITF	73,647	73,647	—	73,647
Investment pool	30,769	30,769	—	30,769
Non participating contracts	<u>69</u>	<u>69</u>	—	<u>69</u>
Total investments	\$ <u><u>188,169</u></u>	<u><u>188,169</u></u>	—	<u><u>188,169</u></u>

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Business-type Activities

The fair value by investment type, credit quality ratings, and maturity of the restricted investments reported by the business-type activities at June 30, 2006 consist of the following (expressed in thousands):

	Fair value		Investment rating		
	Restricted	Total	AAA to A	BBB+	Not rated
Mortgage-backed securities	\$ 5,132	5,132	1,676	—	3,456
U.S. government and agency securities	8,044	8,044	8,044	—	—
U.S. equity securities	12,199	12,199	12,199	—	—
U.S. corporate debt securities	5,216	5,216	4,527	689	—
Other	2,882	2,882	2,882	—	—
Total	\$ 33,473	33,473	29,328	689	3,456

	Fair value	Maturity (in years)			
		Less than 1 year	1 to 5 years	6 to 10 years	More than 10 years
Mortgage-backed securities	\$ 5,132	—	—	—	5,132
U.S. government and agency securities	8,044	—	6,797	—	1,247
U.S. equity securities	12,199	12,199	—	—	—
U.S. corporate debt securities	5,216	—	—	5,216	—
Other	2,882	1,697	1,185	—	—
Total	\$ 33,473	13,896	7,982	5,216	6,379

Component Units

Cash, cash equivalents, and investments of the component units at June 30, 2006 consist of (expressed in thousands):

	Carrying amount			Bank balance
	Unrestricted	Restricted	Total	
Commercial banks	\$ 2,788,852	828,368	3,617,220	3,653,669
Component units banks	635,650	797,044	1,432,694	1,481,361
Total	\$ 3,424,502	1,625,412	5,049,914	5,135,030

Cash and cash equivalents consist of demand deposits, interest-bearing accounts, certificates of deposit, and bank investment contracts.

Custodial credit risk is the risk that in the event of bank failure, the component unit's deposits might not be recovered. The Commonwealth requires that public funds deposited in commercial banks in Puerto Rico must be fully collateralized for the amount deposited in excess of federal depository insurance. All securities pledged as collateral are held by the Secretary of the Treasury of the Commonwealth. There is no formal policy for custodial credit risk for cash accounts opened with commercial banks outside of Puerto Rico.

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Deposits maintained in GDB and EDB are exempt from the collateral requirement established by the Commonwealth and thus represent a custodial credit risk because in the event of GDB's or EDB's failure, the Commonwealth may not be able to recover the deposits.

The component units were exposed to the following custodial credit risk arising from the balance of deposits maintained in commercial and component unit banks at June 30, 2006 (expressed in thousands):

Uninsured and uncollateralized	\$ 4,176,000
Uninsured and collateralized, with securities held by the pledging financial institutions	957,071
Uninsured and collateralized, with securities held by the pledging financial institutions	<u>1,959</u>
Total	<u>\$ 5,135,030</u>

Investments

The component units' investment policies allow management to purchase or enter into the following investment instruments:

- U.S. government and agencies obligations
- Certificates and time deposits
- Bankers' acceptances
- Obligations of the Commonwealth of Puerto Rico and municipalities
- Federal funds sold
- Securities purchased under agreements to resell
- World Bank securities
- Corporate debt, including investment contracts
- External investment pools
- Stock of corporations created under the laws of the United States of America or the Commonwealth
- Options, futures, and interest-rates swap agreements for hedging and risk control purposes, as well as for the creation of synthetic products that qualify under any of the foregoing investment categories.
- Open-end mutual funds with acceptable underlying assets and rated AAA by Standard & Poor's or AAA by Moody's Investors Service
- A few component units, principally SIFC, are also allowed to enter into foreign currency investments, under certain limitations

The component units' investment policies establish limitations and other guidelines on amounts to be invested in the aforementioned investment categories and by issuer/counterparty and on exposure by

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country. In addition, such policies provide guidelines on the institutions with which investment transactions can be entered into.

The component unit's investment policies provide that investments transactions shall be entered into only with counterparties that are rated BBB+/A-1 or better by the Standard & Poor's or equivalent rating by Fitch or Moody's Investors Service, depending on the type and maturity of the investment and the counterparty to the transaction. Also, the investment policy specifies that no more than 5% of a manager's assets at fair value shall be invested in the securities of any single issuer.

All investments in U.S. treasury securities and mortgage-backed securities guaranteed by GNMA carry the explicit guarantee of the U.S. government and are presented as "not rated" in the table below. The credit qualifying rating for investments held by the component units at June 30, 2006 are as follows (expressed in thousands):

	Fair value			Investing rating		
	Unrestricted	Restricted	Total	Rating AAA to A	BBB+	Not rated
Mortgage-backed securities	\$ 593,693	985,805	1,579,498	1,573,483	—	6,015
U.S. government and agency securities	711,972	2,466,220	3,178,192	3,177,905	205	82
Negotiable certificates of deposit	306,075	261,148	567,223	438,825	—	128,398
U.S. corporate stocks	79,196	16,790	95,986	16,790	—	79,196
Non-U.S. corporate stocks	22,652	1,850	24,502	—	—	24,502
U.S. corporate bonds	487,681	15,950	503,631	357,340	145,992	299
Commercial paper	—	5,986	5,986	5,986	—	—
Repurchase agreement	16,185	—	16,185	16,185	—	—
Foreign and municipal bonds	9,674	1,521,251	1,530,925	6,753	1,523,473	699
Money market fund	157,804	30,726	188,530	30,726	—	157,804
Guaranteed investment contract	239,587	1,208,172	1,447,759	1,392,228	—	55,531
P.R. government investment trust fund	17,535	—	17,535	17,126	—	409
Investment pool	583,314	20,614	603,928	577,834	—	26,094
Security lending transactions	161,705	—	161,705	—	—	161,705
Investment in other equity securities	404,136	—	404,136	—	—	404,136
Non-participating contracts	79,232	44,479	123,711	—	—	123,711
Other	74,134	52,709	126,843	9,189	49,890	67,764
Total investments	\$ 3,944,575	6,631,700	10,576,275	7,620,370	1,719,560	1,236,345

Certain component units classified approximately \$23 million of investments presented in PRGITF as cash and cash equivalents.

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The following table summarizes the type and maturities of investments held by the component units at June 30, 2006 (expressed in thousands):

	Fair value	Maturity (in years)				No stated maturity date
		Less than 1 year	1-5 years	6-10 years	More than 10 years	
Mortgage-backed securities	\$ 1,579,498	36,605	59,183	24,520	1,459,190	—
U.S. government and agency securities	3,178,192	332,981	920,042	375,018	1,550,103	48
Negotiable certificates of deposit	567,223	315,378	2,428	—	249,417	—
U.S. equity securities	95,986	—	—	—	—	95,986
Non-U.S. equity securities	24,502	—	—	—	1,850	22,652
U.S. corporate debts securities	503,631	78,059	267,626	87,184	70,762	—
Commercial paper	5,986	5,986	—	—	—	—
Repurchase agreement	130,316	130,316	—	—	—	—
Foreign and municipal bonds	1,530,925	102,118	375,169	454,771	598,867	—
Money market fund	188,530	157,804	—	—	—	30,726
Guaranteed investment contract	1,447,759	261,354	301,554	—	884,851	—
PRGITF	17,535	17,122	—	—	—	413
Investment pool	603,928	577,834	—	—	—	26,094
Security lending transactions	47,574	27,569	13,205	6,800	—	—
Investment in other equity securities	404,136	352,123	—	—	800	51,213
Non-participating contracts	123,711	99,773	—	—	23,938	—
Other	126,843	3,996	63,944	—	—	58,903
Total investments	\$ 10,576,275	2,499,018	2,003,151	948,293	4,839,778	286,035

The component units were exposed to the following custodial credit risk for investments held at June 30, 2006 (expressed in thousands):

Insured or registered	\$ 2,385,461
Uninsured and registered, with securities held by the counterparty's trust department or agent in the component units' name	8,013,984
Uninsured and unregistered, with securities held by the counterparty's trust department or agent, but not in the component units' name	<u>176,830</u>
Total	\$ <u>10,576,275</u>

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Foreign Currency Risk

SIFC limits its exposure to foreign currency risk by limiting the total amount invested to 5% of the portfolio. The SIFC investments were presented as follow (in thousands):

<u>Investment type</u>	<u>Local currency</u>	<u>Fair value</u>
Money market funds	Canadian Dollar	\$ 1
	Euro	55
	Japanese Yen	57
		<u>\$ 113</u>
Common stocks	Australian Dollar	\$ 995
	British Pound	14,930
	Canadian Dollar	995
	Danish Krone	974
	Euro	16,739
	Hong Kong Dollar	1,351
	Japanese Yen	12,905
	Norwegian Krone	1,051
	Swedish Krone	823
	Swiss Franc	<u>6,379</u>
	<u>\$ 57,142</u>	

Unrestricted repurchase agreements of approximately \$16 million belongs to EDB. As of June 30, 2006, the fair value of the collateral for the repurchase agreements amounted to approximately \$16 million for EDB, which consisted primarily of investment securities held in custody by EDB's agent.

Fiduciary Funds

Cash and cash equivalents of the fiduciary funds at June 30, 2006 consist of the following (expressed in thousands):

	<u>Carrying amount</u>			<u>Bank balance</u>
	<u>Unrestricted</u>	<u>Restricted</u>	<u>Total</u>	
Commercial banks	\$ 666,159	1,717	667,876	670,331
Governmental banks	75,935	2,156	78,091	23,031
Total	<u>\$ 742,094</u>	<u>3,873</u>	<u>745,967</u>	<u>693,362</u>

Cash and cash equivalents consist of demand deposits, interest-bearing accounts, certificates of deposit, and bank investment contracts.

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Custodial Risk

Custodial credit risk is the risk that, in the event of a bank failure, the fiduciary funds' deposits might not be recovered. The Commonwealth requires that public funds deposited in commercial banks in Puerto Rico must be fully collateralized for the amount deposited in excess of federal depository insurance. All securities pledged as collateral are held by the Secretary of the Treasury of the Commonwealth. There is no formal policy for custodial credit risk for cash accounts opened with commercial banks outside of Puerto Rico.

Deposits maintained in component unit banks are exempt from the collateral requirement established by the Commonwealth and thus represent a custodial credit risk because in the event of the component unit bank's failure, the Commonwealth may not be able to recover these deposits.

As of June 30, 2006, \$47.2 million was exposed to custodial credit risk. Cash exposed to foreign currency risk as of June 30, 2006 is as follows (expressed in thousands):

<u>Investment type</u>	<u>Currency</u>	<u>Fair value at U.S. dollar currency</u>
Foreign currency	South African Rand	\$ 719
Foreign currency	Japanese Yen	312
Foreign currency	Swiss Franc	27
Foreign currency	Singapore Dollar	18
Foreign currency	Australian Dollar	2
Foreign currency	New Turkish Lira	1
		<u>\$ 1,079</u>

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The investment policies of the pension trust funds limit the investment in corporate debt securities to the top rating issued by nationally recognized credit rating organizations. The portfolio is expected to maintain a minimum weighted average credit quality of either “A” or better using either Standard and Poor’s or Moody’s credit ratings. The following table summarizes the fair value by investment type and maturities of investments held by the pension trust funds at June 30, 2006 (expressed in thousands):

<u>Investments type</u>	<u>Less than 1 year</u>	<u>1-5 years</u>	<u>6-10 years</u>	<u>More than 10 years</u>	<u>No stated maturity date</u>	<u>Total</u>
Non-U.S. securities and other investments	\$ —	—	—	—	989,438	989,438
U.S. equity securities	—	—	—	—	2,330,196	2,330,196
U.S. government and agencies securities	101,778	113,732	37,799	142,385	—	395,694
Mortgage-backed securities	—	—	—	7	—	7
Money market funds	—	—	—	—	5,961	5,961
Municipal bonds	100	—	—	—	—	100
U.S. corporate debt securities	4,016	59,154	94,160	85,099	1,435	243,864
Limited partnership/private equity	—	—	—	—	87,824	87,824
Investment in PRTA Holdings	—	—	—	—	495,318	495,318
Other	—	—	—	—	19,508	19,508
Total	\$ 105,894	172,886	131,959	227,491	3,929,680	4,567,910

Expected maturities will differ from contractual maturities, because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

The following table summarizes the credit quality ratings for investments held by the pension trust funds at June 30, 2006 (expressed in thousands):

<u>Investments type</u>	<u>Fair value</u>	<u>AAA to A</u>	<u>BBB+</u>	<u>Not rated</u>
Non-U.S. equity securities	\$ 989,438	—	—	989,438
U.S. equity securities	2,330,196	—	—	2,330,196
U.S. government and agencies securities	395,694	387,444	536	7,714
Mortgage-backed securities	7	—	—	7
Money market funds	5,961	—	—	5,961
Municipal bonds	100	—	100	—
U.S. debt securities	243,864	120,794	120,344	2,726
Limited partnership/private equity	87,824	—	—	87,824
Investment in PRTA Holdings	495,318	—	—	495,318
Other	19,508	—	—	19,508
Total	\$ 4,567,910	508,238	120,980	3,938,692

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As of June 30, 2006 the investments of the pension trust funds were exposed to custodial credit risk as follows (expressed in thousands):

Uninsured or unregistered investments not held in the name of the Commonwealth, but held by the counterparty's trust department, or the counterparty's agent, but not held in the Commonwealth's name	\$ <u>16,801</u>
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At June 30, 2006, securities investments amounting to \$4,055,793 were registered in the name of the pension trust funds and were held in the possession of the pension's trust funds custodian banks. Additionally, securities investments amounting to \$495,318 were registered in the name of the ERS and held in its possession.

The investment in non-U.S. stocks is expected to achieve long-term, aggressive capital appreciation by investing in Core EAFE (Europe Australasia and the Far East) securities. The portfolio is expected to be broadly diversified with respect to exposures to countries, economic sectors, industries, and individual stock. No single issue is expected to exceed 5% (at market) of the portfolio.

Investments exposed to foreign currency risk as of June 30, 2006 are as follows (expressed in thousands):

<u>Investment type</u>	<u>Currency</u>	<u>Fair value at U.S. dollar currency</u>
Equity securities	Euro	\$ 270,033
Equity securities	Japanese Yen	246,779
Equity securities	Pound Sterling	223,110
Equity securities	Swiss Franc	66,699
Equity securities	Australian Dollar	38,397
Equity securities	Swedish Krona	30,358
Depository receipts	Commingled	24,246
Equity securities	Hong Kong Dollar	23,910
Mutual funds	Pound Sterling	17,726
Equity securities	New Zealand Dollar	10,020
Equity securities	Russia Rubles	8,858
Equity securities	Danish Krone	5,650
Equity securities	Canadian Dollar	5,570
Equity securities	Turkey Libra	4,429
Equity securities	Brazil Real	4,429
Equity securities	Mexico Pesos	4,286
Equity securities	Poland Zlotys	2,286
Equity securities	Thailand Baht	2,143
Equity securities	Singapore	366
Equity securities	South African	143
		\$ <u>989,438</u>

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(7) **Securities Lending Transactions**

During the year, the pension trust funds, included within the fiduciary funds, and SIFC and AACA, two discretely presented component units, entered into securities lending transactions. These transactions are explained below:

Pension Trust Funds

The Retirements System participates in a security lending program whereby securities are transferred to an independent broker or dealer in exchange for collateral in the form of cash, government securities, and irrevocable bank letters of credit equal to approximately 102% of the market value of the domestic securities on loan and 105% of the market value of the international securities on loan, with a simultaneous agreement to return the collateral for the same securities in the future. Collateral is marked to market daily and the agent places a request for additional collateral from brokers if needed. The custodian bank is the agent for the securities lending program.

Securities lending obligations for which collateral was received as of June 30, 2006 consist of the following (expressed in thousands):

<u>Securities lent</u>	<u>FV of underlying securities</u>
U.S. corporate debt securities	\$ 19,672
U.S. government securities	61,925
U.S. equity securities	110,496
Non U.S. equity securities	49,819
	<u>\$ 241,912</u>

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The collateral received amounted to approximately \$247.2 million. The collateral securities cannot be pledged or sold unless the borrower defaults; therefore, these transactions are not reported as assets and liabilities in the statements of fiduciary net assets. Collateral received was invested as follows:

Collateral	Fair value
Commercial paper	\$ 72,105
Certificate of deposit	47,129
Corporate	38,023
Bank note	17,506
TD	14,329
Repo	12,107
ABCP	7,331
CP	3,115
Deposit note	42
Reverse repurchase agreement U.S. agency delivered	5,541
Reverse repurchase agreement U.S. mortgage-backed tri-party	30,000
	<u>\$ 247,228</u>

The relationship between the investment maturities and the Retirement Systems' loans cannot be determined.

At year-end, the Retirement Systems have no credit risk exposure to borrowers because the amounts that the Retirement Systems owe the borrowers exceed the amounts the borrowers owe to the Retirement Systems. The Retirement Systems' rights to collateral are defined in the contractual agreements. The borrower's creditworthiness is also proactively reviewed by the lending agent.

Component Units

SIFC

The Commonwealth statutes and the SIFC's board of directors' policies permit SIFC to use its investments to enter into securities lending transactions. The SIFC's securities custodian, as agent of SIFC, manages the securities lending program and receives cash, securities, or irrevocable bank letters of credit as collateral. The collateral securities cannot be pledged or sold by SIFC unless the borrower defaults. The collateral requirement is equal to 102% for securities issued in the United States and 105% for securities issued outside of the United States of the fair value of the securities lent. Additional collateral has to be provided by the next business day if its value falls to less than 100% of the fair value of the securities lent. At year-end, SIFC has no credit risk exposure to borrowers because the amounts SIFC owes the borrowers exceed the amounts the borrowers owe SIFC. Contracts with the lending agents require them to indemnify SIFC if the borrowers fail to return the securities (and if the collateral is inadequate to replace the securities lent) or fail to pay SIFC for income distributions by the securities' issuers while the securities are on loan.

All security loans can be terminated on demand by either SIFC or the borrower, although the average term of the loans is two weeks. In lending securities, the term to maturity of the securities loans is matched with the term to maturity of the investment of the cash collateral. Such matching existed at year-end. Securities

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lending obligations for which cash was received as collateral as of June 30, 2006 consist of the following (expressed in thousands):

Securities lent	Fair value of underlying securities
Equity securities	\$ 58,300
U.S. government, agencies, instrumentalities obligations	47,986
U.S. corporate debt and notes	5,916
	<u>\$ 112,202</u>

Cash collateral received amounted to \$114 million and it was invested in repurchase agreements. These secured lending activities are included in the accompanying statement of net assets, since cash was received as collateral but reinvested as explained above.

In addition, SIFC had the following securities lending obligations collateralized by securities as of June 30, 2006 (expressed in thousands):

Securities lent	Fair value of underlying securities	Securities collateral received
U.S. government, agencies, instrumentalities obligations	\$ 37,630	40,067

These securities lending transactions are collateralized by securities that cannot be pledged or sold unless the borrower defaults; therefore, they are not reported as assets and liabilities in the accompanying balance sheets.

AACA

AACA lends securities to broker/dealers and other entities (borrowers) for collateral that will be returned in the future for the same securities. The custodial bank manages the securities lending program and receives cash, government securities, and letters of credit as collateral. The program provides for an initial minimum collateralization of 102% of the market value of the securities lent plus accrued income. Additional collateral has to be provided by the close of the next business day if its value falls to less than 100%. The contract with the custodial bank requires that should a collateral deficiency occur beyond the custodian's responsibilities, the deficiency should be allocated pro rata among all client lenders within the program.

Either the custodian bank or the borrower can terminate all security loans at any time. Cash collateral is invested in the program's agent short-term investment pools, which at fiscal year-end had a weighted average maturity of approximately 30 days. The relationship between securities of the investment pool and AACA loans cannot be determined.

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The following represents the balances relating to the securities lending transactions as of June 30, 2006 (expressed in thousands):

<u>Securities lent</u>	<u>Fair value of underlying securities</u>	<u>Cash collateral received</u>	<u>Noncash collateral received</u>
U.S. Treasury bills, bonds, and notes	\$ 17,700	15,832	2,161
Common stocks and preferred stocks	20,882	20,790	476
Corporate bonds	2,844	2,603	292
U.S. agencies	8,206	8,349	1
Totals	<u>\$ 49,632</u>	<u>47,574</u>	<u>2,930</u>

Secured lending transactions where cash collateral was received and reinvested are presented as assets and liabilities in the accompanying statement of net assets. Securities lending transactions collateralized by noncash collateral that cannot be pledged or sold unless the borrower defaults are not reported as assets and liabilities in the statement of net assets. At year-end, AACA has no credit risk exposure to borrowers because the amounts AACA owes the borrowers exceed the amounts the borrowers owe AACA.

(8) Investments in Limited Partnerships

Pursuant to the Statement of Investment Guidelines for the Government of Puerto Rico, the pension trust funds and a component unit invested approximately \$7.3 million in limited partnerships during the fiscal year ended June 30, 2006. The investments were as follows:

- During fiscal year 2006, there were no contributions to Guayacán Funds of Funds, L.P., a Delaware limited partnership, organized by Grupo Guayacán, Inc. as general partner, that has total commitments of \$55.5 million (of which \$45 million are from pension trust funds and the remaining balance from the private corporate investors). This fund invests in United States and international private equity partnerships that in turn invest in private companies.
- During fiscal year 2006, there were no contributions to Guayacán Fund of Funds II, L.P., a Delaware limited partnership, organized by Grupo Guayacán, Inc. as general partner, that has total commitments of \$62 million (of which \$50 million are from the pension trust funds and the remaining balance from the private corporate investors in Puerto Rico). This fund invests in a broad range of United States and international private equity investment partnerships that, in turn, will make equity and equity-related investments primarily in private businesses.
- During the fiscal year 2006, \$3.1 million was invested in Guayacán Private Equity Fund, L.P., a Delaware limited partnership, organized by Advent/Morro Partners as general partner, that has total commitments of \$42 million (of which \$10 million is from the pension trust funds, \$22.5 million are from a component unit, and the remaining balance from the private corporate investors in Puerto Rico). This fund invests in Puerto Rico private equity.
- During the fiscal year 2006, \$752,000 was invested in Invesco Venture Partnership Fund III, L.P. a Delaware limited partnership, organized by IPC Partnership Associates III, LLC as general partner in which the pension trust funds have a total commitment of \$5.5 million. The Partnership was

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organized to invest in other collective investment funds investing in alternative assets, including primarily United States and international funds that focus on both early- and later-stage venture capital investments.

- During the fiscal year 2006, \$677,000 was invested in Invesco Non- U.S. Partnership Fund III, L.P. a Delaware limited partnership, organized by IPC Partnership Associates III, LLC as general partner, in which the pension trust funds have a total commitment of \$4.5 million. The Partnership was organized to invest in other collective investment funds investing in alternative assets, including primarily investments focusing on non-U.S. buyouts, expansion capital, turnaround, mezzanine, and distressed investment partnership.
- During the fiscal year 2006, \$910,000 was invested in Invesco U.S. Buyout & Expansion Capital Partnership Fund III, L.P., a Delaware limited partnership, organized by IPC Partnership Associates III, LLC as General Partner in which the pension trust funds have a total commitment of \$3.7 million. The Partnership was organized to invest in other collective funds investing in alternative assets, including primarily investments focusing on small, mid-size, and large domestic buyout transactions.
- During the fiscal year 2006, \$1,900,000 was invested in Chase Capital Partners Private Equity Fund of Funds II, LTD, a limited partnership, organized by Chase as general partner in which the pension trust funds have a total commitment of \$35 million. The fund's investment strategy is to capitalize on a globally diversified portfolio of private equity investments opportunities across various sectors, including buyouts, growth equity, venture capital, and other special situations through partnership, investments, and direct investments.

The fair value of these investments at June 30, 2006 amounted to \$87.8 million and is presented within investments in the statement of net assets. The fair values of these investments have been estimated by the corresponding general partner or fund manager of these partnerships and disclosed in its respective separate audited financial statement. The allocations of net gain and net loss to the limited partners are based on certain percentages, as established in the limited partnership agreements. The difference between the fair value of the investments and the total cumulative contributions is mostly due to distributions made.

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As of June 30, 2006, the pension trust funds and a discretely presented component unit had capital commitments and contributions as follows (expressed in thousands):

	<u>Public sector commitments</u>	<u>Fiscal year contributions</u>	<u>Cumulative contributions</u>
Guayacán Funds of Funds, L.P.			
Primary government:			
Employees' Retirement System of the Government of Puerto Rico and its Instrumentalities	\$ 25,000	—	23,279
Puerto Rico System of Annuities and Pensions for Teachers	<u>20,000</u>	—	<u>18,623</u>
Subtotal	<u>45,000</u>	—	<u>41,902</u>
Guayacán Fund of Funds II, L.P.			
Primary government:			
Employees' Retirement System of the Government of Puerto Rico and its Instrumentalities	25,000	—	19,639
Puerto Rico System of Annuities and Pensions for Teachers	<u>25,000</u>	—	<u>19,639</u>
Subtotal	<u>50,000</u>	—	<u>39,278</u>
Guayacán Private Equity Fund, L.P.			
Primary government:			
Employees' Retirement System of the Government of Puerto Rico and its Instrumentalities	5,000	477	4,407
Puerto Rico System of Annuities and Pensions for Teachers	5,000	477	4,407
Component unit:			
Governmental Development Bank	20,000	1,907	17,624
UPR Employees' Retirement System	<u>2,500</u>	<u>238</u>	<u>2,203</u>
Subtotal	<u>32,500</u>	<u>3,099</u>	<u>28,641</u>
Other Funds			
Primary government:			
Employees' Retirement System of the Government of Puerto Rico and its Instrumentalities	22,596	1,266	18,903
Puerto Rico System of Annuities and Pensions for Teachers	<u>28,714</u>	<u>2,972</u>	<u>23,547</u>
Subtotal	<u>51,310</u>	<u>4,238</u>	<u>42,450</u>
Total	\$ <u>178,810</u>	<u>7,337</u>	<u>152,271</u>

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Public sector commitments represent the overall commitment established since the first day the pension trust funds began investing in the limited partnerships. Cumulative contributions represent the total contributions made through December 31, 2006, without considering distributions already made by the limited partnerships since its inception.

(9) Receivables and Payables

Receivables in the governmental funds include approximately \$1.2 billion of accrued income and excise taxes and \$300 million receivable from the federal government and \$17 million from the Municipal Revenue Collection Center. In addition, the enterprise funds include \$65 million of unemployment, disability, and drivers' insurance premium receivable.

Payables in the governmental funds include approximately \$580 million of trade accounts due to suppliers for purchase of merchandise and services rendered and \$264 million of tax refunds liability. Also at June 30, 2006, excess of checks drawn over the pooled bank balance amounted to approximately \$1.4 billion and is reported within accounts payable and accrued liabilities of the governmental activities.

In accordance with GASB Technical Bulletin No. 2004-1, Tobacco Settlement Recognition and Financial Reporting Entity Issue (the TB), a receivable of \$36 million was recorded in the government-wide financial statements for estimated shipments from January 1 to June 30, 2006, which will be applied to debt service upon collection. Additionally, the TB indicated that the Children's Trust (the Trust) designated as the Tobacco Settlement Authority (TSA) should recognize a liability for the bonds payable and an expense (and liability if unpaid) in the same period in its stand-alone financial statements. The expense (and liability if unpaid) recognizes the contractual obligation to remit the proceeds of the bond sold. Since the Trust is reported as a blended component unit, the TB indicates these remittances should be reported as transfers into the fund receiving the proceeds and transfers out in the fund that accounts for the activities of the TSA. Since the Trust has no contractual obligation, under its enabling legislation or elsewhere, to remit all bond proceeds or assets related to the global settlement agreement (GSA) to the settling government (the Commonwealth), the Trust has not recognized an expense and liability for unpaid proceeds from the bonds since it records the expense as amounts are disbursed as grants to its settling government (including its instrumentalities) or third parties.

(10) Interfund and Intraentity Transactions

Interfund receivables and payables at June 30, 2006 are summarized as follows (expressed in thousands):

<u>Receivable fund</u>	<u>Payable fund</u>	<u>Amount</u>
Nonmajor governmental fund	General fund	\$ 156,142
General fund	Nonmajor governmental fund	373,385
Unemployment insurance	General fund	23,010
Lotteries	General fund	53,174
General fund	Lotteries	59,654
		<u>\$ 665,365</u>

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Transfers from/to other funds for the year ended June 30, 2006 are summarized as follows (expressed in thousands):

<u>Transferee fund</u>	<u>Transferor fund</u>	<u>Amount</u>
General	Nonmajor governmental	\$ 7,259
General	The Children's Trust special revenue	26,688
Nonmajor governmental	General	293,440
Unemployment	General	204,330
General	Unemployment	268,790
Debt service	General	484,368
General	Debt service	100,000
General	Lotteries	204,302
Lotteries	General	21,318
Nonmajor enterprise	General	4,802
The Children's Trust special revenue	General	391
PBA capital projects	General	38,002
		<hr/>
		\$ 1,653,690
		<hr/> <hr/>

The principal purposes of the interfund transfers are to (amounts expressed in thousands):

1. Distribute the increase in net assets of the lotteries fund for the use of the general fund, as required by the lotteries enabling legislation (\$204,302).
2. Make funds available for debt service payments in the debt service fund and the general fund (\$484,368).
3. Reimburse from the debt service fund for a portion of the fiscal year 2006 debt service financed by the general fund.
4. Unemployment insurance trust fund's distribution of surplus cash belonging to the general fund for the payment of administrative expenses (\$268,790).
5. Recognize as transfers the rental payments made by the Commonwealth's agencies on properties leased by PBA, a blended component unit of the Commonwealth (\$293,440 to the nonmajor funds of PBA and \$38,002 to the PBA capital project fund).
6. Transfer from the general fund to the Additional Lottery to cover prizes settlement pursuant Act No. 171 of July 24, 2004 (\$21,318).
7. Transfer from the Children's Trust to the general fund in order to provide financial assistance to carry out project aimed at promoting the well-being of children and youth of Puerto Rico (\$26,688).

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8. Transfer from capital project fund for repayment of general fund's lines of credit, pursuant to such line of credit agreement (\$7,259).
9. To provide local matching funds from the general fund related to the federal capital grants of the Puerto Rico Water Pollution Revolving Fund and Puerto Rico Safe Drinking Water Treatment Revolving Loan Fund, two enterprise funds of the Commonwealth (\$4,802).
10. Transfer of \$391 from the Tobacco Settlement Asset-Backed Bonds debt service fund to the Children's Trust special revenue fund in order to provide funds for operating expenses.

Interfund receivables and payables represent the pending settlements of the aforementioned transfers.

Due from/to primary government and component units are as follows (expressed in thousands):

<u>Receivable entity/fund</u>	<u>Amount</u>	<u>Payable entity/fund</u>	<u>Amount</u>
Business-type activities	\$ 188,055	Puerto Rico Aqueduct and Sewer Authority	\$ 188,055
		Cardiovascular Center Corporation of Puerto Rico and the Caribbean	42,186
		Puerto Rico Medical Services Administration	27,012
		Puerto Rico Health Insurance Administration	25,800
		Puerto Rico Tourism Company	17,993
		Employment & Training Enterprises Corporation	7,108
Governmental activities	<u>125,395</u>	Governing Board of the 911 Service	<u>5,296</u>
	<u>\$ 313,450</u>		<u>\$ 313,450</u>
Puerto Rico Electric Power Authority	\$ 170,362	Governmental activities	\$ 372,902
University of Puerto Rico	106,134		
Puerto Rico Conservatory of Music	23,908		
Puerto Rico Health Insurance Administration	23,857		
Puerto Rico Industrial Development Company	23,403		
Puerto Rico Medical Services Administration	19,937		
Land Authority of Puerto Rico	<u>5,301</u>		
	<u>\$ 372,902</u>		<u>\$ 372,902</u>

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The amount owed by PRASA of \$188 million represents construction loans granted by the Puerto Rico Water Pollution Control Revolving Fund and the Puerto Rico Safe Drinking Water Treatment Revolving Loan Fund, nonmajor enterprise funds, to finance the construction of capital assets for PRASA.

The amount receivable by PREPA from the primary government includes approximately \$43 million representing an agreement with the Commonwealth by which the Commonwealth will pay the outstanding fuel adjustment subsidy and certain other accumulated debt. The amount owed by the Commonwealth is presented within notes payable in the statement of net assets of the governmental activities.

The amount receivable by the UPR from the primary government includes a resolution approved by the Legislature of the Commonwealth to pay \$94.7 million to the UPR on behalf of the Department of Health of the Commonwealth over eight years, including the financing of additional debts of approximately \$71.2 million. The related outstanding balance of \$71.5 million is presented by the Commonwealth within notes payable in the statement of net assets of the governmental activities.

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Due from/to component units are as follows (expressed in thousands):

Receivable entity/fund	Amount	Payable entity/fund	Amount
Puerto Rico Electric Power Authority	\$ 25,844	Puerto Rico Medical Services Administration	\$ 38,720
University of Puerto Rico	18,030	Cardiovascular Center Corporation of Puerto Rico and the Caribbean	5,154
State Insurance Fund Corporation	3,500	Puerto Rico Solid Waste Authority	3,500
Puerto Rico Land Administration	4,627	Puerto Rico Industrial Development Company	4,627
Farm Insurance Corporation of Puerto Rico	13,386	Agricultural Services and Development Administration	23,886
Land Authority of Puerto Rico	<u>16,931</u>	Farm Insurance Corporation of Puerto Rico	<u>6,431</u>
	<u>82,318</u>	Sub total	<u>82,318</u>
Governmental Development Bank for Puerto Rico	2,313,577	Puerto Rico Aqueduct and Sewer Authority	725,150
		Special Communities Perpetual Trust	425,107
		Puerto Rico Ports Authority	301,560
		Puerto Rico Electric Power Authority	172,667
		Puerto Rico Convention Center District Authority	154,846
		Agricultural Services and Development Administration	117,758
		University of Puerto Rico	96,645
		Puerto Rico Solid Waste Authority	84,333
		Puerto Rico Industrial Development Company	69,641
		Puerto Rico Infrastructure Financing Authority	45,014
		Puerto Rico Land Authority	41,444
		Puerto Rico Highways and Transportation Authority	29,996
		Puerto Rico Metropolitan Bus Authority	22,304
		Economic Development Bank for Puerto Rico	12,207
		National Parks Company of Puerto Rico	<u>6,831</u>
			<u>2,305,503</u>
	<u>\$ 2,395,895</u>		<u>\$ 2,387,821</u>

The difference amounting to \$8.1 million between due from/to component units resulted from the time lag between the dates that transactions are recorded by each discretely presented component unit and other reconciling items. The balance due to GDB amounting to approximately \$2.3 billion represents loans payable to GDB at June 30, 2006.

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The rest of the loans receivable reported by GDB consist of the following (expressed in thousands):

Primary government:	
Governmental activities	\$ 3,705,127
Pension trust funds	4
	3,705,131
Other governmental entities and municipalities	737,386
Private sector (net of \$11,748 presented within restricted assets)	512,619
	\$ 4,955,136

The loans to the primary government are presented by the Commonwealth within notes payable in the statement of net assets and in the statement of fiduciary net assets.

Expenses of the primary government include approximately \$2.4 billion in capital and operational contributions made by the primary government to the component units, comprised of the following (expressed in thousands):

Puerto Rico Health Insurance Administration	\$ 1,134,152
University of Puerto Rico	812,594
Puerto Rico Infrastructure Financing Authority	72,450
Government Development Bank for Puerto Rico	65,316
Puerto Rico Aqueduct and Sewer Authority	19,096
Nonmajor component units	323,553
	\$ 2,427,161

(11) Restricted Assets

Restricted assets of the primary government included in the basic financial statements at June 30, 2006 consist of cash, investments, and other assets to be used for the following purposes (expressed in thousands):

Debt service and sinking fund	\$ 1,762,404
Public Housing Administration – funds received from HUD	596,390
Construction and betterment funds	47,155
Emergency fund	100,000
Assets held in trust for repayment of QZAB	39,618
Assets held for development of urban forest	19,200
Investment held for disability insurance benefits	33,473
Construction of governmental agencies	6,200
Residual receipts from sale of properties	17,730
	\$ 2,622,170

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Liabilities of the primary government payable from restricted assets consist of the following (expressed in thousands):

Qualified Zone Academic Bonds	\$	184,124
Tax revenue anticipation notes		1,050,037
Deferred revenue		988,382
Interest payable		<u>302,357</u>
Liabilities payable from restricted assets – governmental activities	\$	<u><u>2,524,900</u></u>
Business-type activities:		
Disability insurance benefit payable	\$	<u>33,473</u>
Liabilities payable from restricted assets – business-type activities	\$	<u><u>33,473</u></u>
Governmental activities restricted net assets:		
Restricted for debt service	\$	192,490
Other purpose		<u>87,588</u>
Total restricted net assets	\$	<u><u>280,078</u></u>

Restricted assets of the component units included in the basic financial statements at June 30, 2006 are to be used for the following purposes (expressed in thousands):

Debts service and sinking fund requirements	\$	4,701,124
Construction and betterments funds		2,164,918
Escrow		597,126
Collateral for underlying securities		418,043
Incentives to farmers		183,286
Other uses		100,055
Industrial incentives		76,298
Malpractice insurance fund		65,654
Maintenance reserve fund		53,591
Educational fund		<u>52,476</u>
Total for components units	\$	<u><u>8,412,571</u></u>

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Notes to Basic Financial Statements

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(12) Capital Assets

Capital assets activity for the year ended June 30, 2006 is as follows (expressed in thousands):

Primary Government

	Beginning balance (as restated)	Increases	Decreases	Ending balance
Governmental activities:				
Capital assets, not being depreciated:				
Land	\$ 930,466	5,655	87,678	848,443
Construction in progress	1,254,123	450,371	322,671	1,381,823
Total capital assets, not being depreciated	<u>2,184,589</u>	<u>456,026</u>	<u>410,349</u>	<u>2,230,266</u>
Capital assets, being depreciated:				
Buildings and building improvements	6,492,175	292,454	189,327	6,595,302
Equipment	373,368	43,949	26,686	390,631
Infrastructure	417,336	24,164	—	441,500
Total capital assets, being depreciated	<u>7,282,879</u>	<u>360,567</u>	<u>216,013</u>	<u>7,427,433</u>
Less accumulated depreciation for:				
Buildings and building improvements	2,115,330	178,604	93,782	2,200,152
Equipment	180,654	35,602	25,838	190,418
Infrastructure	75,363	8,588	—	83,951
Total accumulated depreciation	<u>2,371,347</u>	<u>222,794</u>	<u>119,620</u>	<u>2,474,521</u>
Total capital assets, being depreciated, net	<u>4,911,532</u>	<u>137,773</u>	<u>96,393</u>	<u>4,952,912</u>
Governmental activities capital assets, net	<u>\$ 7,096,121</u>	<u>593,799</u>	<u>506,742</u>	<u>7,183,178</u>
Business-type activities:				
Total capital assets, being depreciated – equipment	\$ 5,014	29	—	5,043
Less accumulated depreciation of equipment	3,647	388	—	4,035
Total business-type activities capital assets, being depreciated, net	<u>\$ 1,367</u>	<u>(359)</u>	<u>—</u>	<u>1,008</u>

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Depreciation expense was charged to functions/programs of the primary government for the year ended June 30, 2006 as follows (expressed in thousands):

Governmental activities:	
General government	\$ 70,038
Public safety	21,573
Health	6,105
Public housing and welfare	81,512
Education	29,335
Economic development	14,231
Total depreciation expense – governmental activities	\$ 222,794
Total depreciation business-type activities – lotteries	\$ 388

The net book value of capital assets of the primary government as of beginning of the year was decreased by approximately \$22.9 million to correct prior years' understatement of depreciation.

The Commonwealth adopted the provision of GASB Statement No. 42, *Accounting and Financial Reporting for Impairment of Capital Assets and for Insurance Recoveries*, an amendment to GASB Statement No. 34. This statement establishes guidance for accounting and reporting for the impairment of capital assets and for insurance recoveries. As a result of the adoption of this statement, the Commonwealth recognized an impairment loss of \$63 million in the statement of activities, related to the closing of educational, health, and correctional facilities (\$51 million) and idle projects due to lack of funding (\$12 million).

General infrastructure assets include \$417 million representing the estimated cost of assets transferred to the Department of Natural and Environmental Resources (DNER) of the Commonwealth in 1997 upon completion of the Cerrillos Dam and Reservoir and the Portugues-River and Bucana-River Projects by the U.S. Army Corps of Engineers. These infrastructure assets are reported within governmental activities and include dams, intake facilities, and similar items built for flood control, water supply, and recreational purposes. The Commonwealth also recorded a payable due to the U.S. Army Corps of Engineers, amounting to \$205 million, for its estimated allocated share of the construction costs associated with these projects, including accrued interest of \$5 million. The final debt agreement between DNER and the U.S. Army Corps of Engineers has not been finalized and therefore terms and conditions could differ from those estimated. The depreciation is computed using the straight-line method over an estimated useful life of 50 years from the transfer date of the property. The related debt is expected to be payable on an annual basis over a 50-year period. However, the debt has been presented as a long-term payable after one year in the accompanying statement of net assets since the commencement date of repayment has not yet been determined.

On August 17, 2001, the Legislature of the Commonwealth approved Act No. 120, which requires the conditional transfer of the ownership of certain real properties under the name of the Department of Recreation and Sports (DRS) of the Commonwealth to the municipalities of the Commonwealth. The land and the facilities were transferred at no cost to the municipalities. During fiscal year ended June 30, 2006, land, building, and building improvements with a total carrying amount of \$79 million, were transferred to several municipalities and recorded as an expense in the accompanying statement of activities.

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Discretely Presented Component Units

	Beginning balance (as restated)	Increases	Decreases	Ending balance
Capital assets, not being depreciated:				
Land	\$ 2,444,784	102,235	7,709	2,539,310
Art works	2,986	71	—	3,057
Construction in progress	<u>5,533,365</u>	<u>1,849,082</u>	<u>1,150,602</u>	<u>6,231,845</u>
Total capital assets, not being depreciated	<u>7,981,135</u>	<u>1,951,388</u>	<u>1,158,311</u>	<u>8,774,212</u>
Capital assets, being depreciated:				
Buildings and buildings improvements	8,474,986	474,624	97,892	8,851,718
Equipment	1,123,649	207,043	26,505	1,304,187
Infrastructure	<u>22,065,174</u>	<u>513,229</u>	<u>1,649</u>	<u>22,576,754</u>
Total capital assets, being depreciated	<u>31,663,809</u>	<u>1,194,896</u>	<u>126,046</u>	<u>32,732,659</u>
Less accumulated depreciation for:				
Buildings and buildings improvements	4,692,692	345,674	35,892	5,002,474
Equipment	680,724	100,678	19,949	761,453
Infrastructure	<u>8,641,970</u>	<u>490,969</u>	<u>930</u>	<u>9,132,009</u>
Total accumulated depreciation	<u>14,015,386</u>	<u>937,321</u>	<u>56,771</u>	<u>14,895,936</u>
Total capital assets, being depreciated, net	<u>17,648,423</u>	<u>257,575</u>	<u>69,275</u>	<u>17,836,723</u>
Capital assets, net	\$ <u>25,629,558</u>	<u>2,208,963</u>	<u>1,227,586</u>	<u>26,610,935</u>

The principal restatement in the beginning balance of capital assets corresponds to Puerto Rico Highways and Transportation Authority's approximately \$4 billion correction for projects included as construction in progress that had already been included as infrastructure assets and for other projects with overcapitalized interest. The remaining \$89.1 million correcting reduction in the beginning balance of capital assets is related to the other component units sustaining restatements included in note 4.

(13) Tax Revenue Anticipation Notes Payable

Tax revenue anticipation notes (TRANS) reported in the general fund were issued on December 29, 2005 at interest rates ranging from 3.79% to 4.5% and were paid on July 28, 2006. The TRANS amounted to \$1,050 million at June 30, 2006 plus accrued interest of approximately \$23 million. The proceeds of the TRANS were used to cover temporary cash deficiencies resulting from the timing differences between tax collections and the payments of current expenditures.

COMMONWEALTH OF PUERTO RICO

Notes to Basic Financial Statements

June 30, 2006

(14) Short and Long-term Obligations

Primary Government

(a) Summary of Short and Long-term Obligations

Short and long-term obligations at June 30, 2006 and changes for the fiscal year then ended are as follows (expressed in thousands):

	<u>Balance at June 30, 2005</u>	<u>Debt issued</u>	<u>Capitalized interest</u>	<u>Debt paid</u>	<u>Original issue (discounts) premiums</u>	<u>Other net increases (decreases)</u>	<u>Balance at June 30, 2006</u>	<u>Due within one year</u>
Governmental activities:								
General obligation and revenue bonds	\$ 12,247,121	101,695	30,409	(209,280)	(323)	25,461	12,195,083	253,559
Commonwealth appropriation bonds	2,715,239	—	1,516	(78,365)	—	3,804	2,642,194	84,190
Qualified Zone Academy Bonds	47,936	39,353	—	—	—	96,835	184,124	—
Notes payable to component units:								
GDB (short-term)	186,510	1,940,096	—	(1,600,562)	—	—	526,044	526,044
GDB	1,871,381	1,377,310	—	(39,608)	—	(30,000)	3,179,083	99,329
Other	136,548	—	—	(21,897)	—	—	114,651	—
Total bonds and notes payable	17,204,735	3,458,454	31,925	(1,949,712)	(323)	96,100	18,841,179	963,122
Compensated absences	1,451,320	—	—	(838,933)	—	1,071,566	1,683,953	962,323
Net pension obligation	4,479,795	—	—	—	—	261,011	4,740,806	—
Obligation under capital lease arrangements	146,676	4,580	—	(6,755)	—	—	144,501	4,476
Other liabilities:								
Employees' Christmas bonus	167,533	—	—	(287,199)	—	222,228	102,562	102,562
Liability for federal cost disallowances	123,368	—	—	(2,867)	—	(67,454)	53,047	—
Liability for legal claims and judgments	941,283	—	—	(43,451)	—	(96,665)	801,167	43,400
Other	150,940	—	—	—	—	54,060	205,000	—
Total governmental activities	24,665,650	3,463,034	31,925	(3,128,917)	(323)	1,540,846	26,572,215	2,075,883
Business-type activities:								
Notes payable to component units	520	—	—	(520)	—	—	—	—
Compensated absences	6,842	—	—	(3,468)	—	3,991	7,365	3,857
Obligation for unpaid lottery prizes	329,108	—	—	—	—	(25,405)	303,703	37,488
Claims liability for insurance benefits	71,028	211,370	—	(211,425)	—	—	70,973	70,973
Total business-type activities	407,498	211,370	—	(215,413)	—	(21,414)	382,041	112,318
Total governmental and business-type	\$ 25,073,148	3,674,404	31,925	(3,344,330)	(323)	1,519,432	26,954,256	2,188,201

COMMONWEALTH OF PUERTO RICO

Notes to Basic Financial Statements

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The balances of long-term debt issued included with other financing sources and debt service principal expenditures as reported in the statement of revenue, expenditures, and changes in fund balances – governmental funds do not agree with amounts reported as debt issued and paid in the above table primarily because the above table includes debt issued and paid on short-term obligations which amounted to approximately \$1.9 billion and \$1.6 billion, respectively. The receipt and payment of short-term obligations is reported as a balance sheet transaction in the fund financial statements.

The other net increases in bonds and notes payable consist of deferred losses on refunding, net of amortization, and net amortization of premiums and discounts on bonds. These adjustments did not require any source or use of cash.

Compensated absences, net pension obligation, obligation for unpaid lottery awards, liability for insurance benefits, and other long-term liabilities reflect other net increases (decreases) resulting from adjustments and changes to agree these obligations to their new estimated balances at June 30, 2006.

(b) Debt Limitation

The Constitution of the Commonwealth authorizes the contracting of debts as determined by the Legislature. Nevertheless, the Constitution of the Commonwealth provides that direct obligations of the Commonwealth evidenced by bonds or notes and backed by the full faith, credit, and taxing power of the Commonwealth are not to be issued if the amounts of the principal of, and interest on, such bonds and notes and on all such bonds and notes issued thereafter, which are payable in any fiscal year, together with any amount paid by the Commonwealth in the preceding fiscal year on account of bonds or notes guaranteed by the Commonwealth, exceeds 15% of the average annual revenue raised under the provisions of Commonwealth legislation and conveyed into the Treasury (hereinafter internal revenue) in the two fiscal years preceding the then current fiscal year. Section 2, Article VI of the Constitution does not limit the amount of debt that the Commonwealth may guarantee so long as the 15% limitation is not exceeded. Internal revenue consists principally of income taxes and excise taxes. Certain revenue, such as federal excise taxes on offshore shipments of alcoholic beverages, tobacco products, and customs duties, which are collected by the U.S. government and returned to the Commonwealth, and motor vehicle fuel taxes and license fees, which are allocated to the PRHTA, a discrete component unit, are not included as revenue for the purpose of calculating the debt limit, although they may be available for the payment of debt service. At June 30, 2006, the Commonwealth is in compliance with the debt limitation requirement.

(c) Bonds Payable

The Constitution of the Commonwealth provides that public debt will constitute a first claim on the available revenue of the Commonwealth. Public debt includes general obligations and notes of the Commonwealth and any payment required to be made by the Commonwealth under its guarantees of bonds issued by blended or discretely presented component units. The good faith, credit, and taxing power of the Commonwealth are irrevocably pledged for the prompt payment of the principal and interest of the general obligation bonds.

COMMONWEALTH OF PUERTO RICO

Notes to Basic Financial Statements

June 30, 2006

Act No. 83 of August 30, 1991, as amended, provides for the levy of an annual special tax of 1.03% of the assessed value of all real and personal property not exonerated from taxation. The levy is made by CRIM, a municipal corporation, not a component unit of the Commonwealth. CRIM is required to remit the 1.03% of property tax collected to the Commonwealth to be used by the Commonwealth's debt service fund for payment of debt service on general obligations of the Commonwealth. During the year ended June 30, 2006, the total revenue and receivable reported by the Commonwealth amounted to approximately \$118 million and \$16.8 million, respectively, which are included in the debt service fund.

For financial reporting purposes, the outstanding amount of bonds represents the total principal to be repaid, net of unamortized premiums, discount, and deferred refunding losses; for capital appreciation bonds, it represents total principal and accreted interest to be repaid.

Bonds payable outstanding at June 30, 2006 are as follows (expressed in thousands):

	<u>General obligation</u>	<u>Revenue bonds</u>	<u>Total</u>
Term bonds payable through 2036; interest payable semiannually at rates varying from 3% to 8%. \$	2,818,195	1,588,655	4,406,850
Serial bonds payable through 2024; interest payable semiannually at rates varying from 3.75% to 7.5%.	4,091,580	1,097,975	5,189,555
Capital appreciation bonds payable through 2031; no interest rate, yield ranging from 4.42% to 7.8%. Net of accreted discount of \$190 million.	256,116	163,518	419,634
The Children's Trust Fund tobacco settlement asset-backed bonds payable through 2026; interest payable annually at rates varying from 4.625% to 6%.	—	1,239,015	1,239,015
Capital Fund Program Bonds, maturing in various dates payable through 2024; interest payable at rates varying from 2% to 5%.	—	641,325	641,325
Bond payment obligation payable through 2010; interest payable at rates varying from 1.5% to 5.5%.	125,910	—	125,910
Balance carried forward	<u>\$ 7,291,801</u>	<u>4,730,488</u>	<u>12,022,289</u>

COMMONWEALTH OF PUERTO RICO

Notes to Basic Financial Statements

June 30, 2006

	<u>General obligation</u>	<u>Revenue bonds</u>	<u>Total</u>
Balance brought forward	\$ 7,291,801	4,730,488	12,022,289
Yield curve bonds payable from 2009 through 2011; no interest rate, yield of 8.914%.	15,000	—	15,000
Yield retail bonds payable from 2009 through 2011; interest payable at rates varying from 2.875% to 5%.	24,000	—	24,000
Tax-exempt components maturing through 2007 and 2008; interest payable at rates ranging from 5.5% to 5.6%.	—	72,160	72,160
Inverse rate bonds payable from 2009 through 2011; interest payable at a rate of 6%.	15,000	—	15,000
Insured bonds payable from 2014 through 2018; interest payable at a rate of 5%.	64,360	—	64,360
Total	7,410,161	4,802,648	12,212,809
Unamortized premium, net	220,204	23,245	243,449
Deferred charges arising from debt refunding	(106,792)	(154,614)	(261,406)
Savings bonds	231	—	231
Total bonds payable	\$ <u>7,523,804</u>	<u>4,671,279</u>	<u>12,195,083</u>

COMMONWEALTH OF PUERTO RICO

Notes to Basic Financial Statements

June 30, 2006

During the year ended June 30, 2006, the following changes occurred in the bonds payable (expressed in thousands):

	Outstanding at June 30, 2005	Issued	Premiums/ discount (redemptions)	Outstanding at June 30, 2006
Term bonds	\$ 4,383,350	23,500	—	4,406,850
Serial bonds	5,272,710	78,195	(161,350)	5,189,555
Capital appreciation bonds	412,031	—	7,603	419,634
The Children's Trust Fund tobacco settlement				
asset-backed bonds	1,240,404	—	(1,389)	1,239,015
Capital Fund Program Bonds	663,060	—	(21,735)	641,325
Appropriation refunding bonds	—	—	—	—
Bond payment obligations	125,910	—	—	125,910
Yield curve bonds	15,000	—	—	15,000
Yield retail bonds	26,000	—	(2,000)	24,000
Tax-exempt components	72,160	—	—	72,160
Inverse rate bonds	79,360	—	—	79,360
Subtotal	<u>12,289,985</u>	<u>101,695</u>	<u>(178,871)</u>	<u>12,212,809</u>
Unamortized premium	267,001	—	(23,552)	243,449
Deferred charges arising from debt refunding	(310,096)	—	48,690	(261,406)
Savings bonds	231	—	—	231
Total	<u>\$ 12,247,121</u>	<u>101,695</u>	<u>(153,733)</u>	<u>12,195,083</u>

COMMONWEALTH OF PUERTO RICO

Notes to Basic Financial Statements

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Maturities of general obligations and of revenue bonds payable, including accrued interest of capital appreciation bonds, are as follows (expressed in thousands):

	<u>Principal</u>	<u>Interest</u>	<u>Total</u>
Year ending June 30:			
2007	\$ 253,559	610,820	864,379
2008	280,914	593,516	874,430
2009	319,191	559,516	878,707
2010	364,425	537,792	902,217
2011	429,800	518,118	947,918
2012-2016	1,946,707	2,269,971	4,216,678
2017-2021	2,559,212	1,817,195	4,376,407
2022-2026	2,114,438	1,232,503	3,346,941
2027-2031	1,892,647	737,479	2,630,126
2032-2036	1,238,766	372,485	1,611,251
2037-2041	545,847	113,308	659,155
2042-2046	88,515	13,478	101,993
Total	<u>12,034,021</u>	\$ <u>9,376,181</u>	<u>21,410,202</u>
Plus accreted discount	179,019		
Plus unamortized premium	243,449		
Less deferred charges arising from debt refunding	<u>(261,406)</u>		
Total	\$ <u>12,195,083</u>		

(d) Commonwealth Appropriation Bonds

Over the years, GDB, as fiscal agent and bank for the Commonwealth, had extended lines of credit, advances, and loans to several agencies and component units in order to finance their capital improvement projects and to cover their operational deficits at the time. At different points in time, these loans were refunded through the issuance of Commonwealth appropriation bonds issued by the Puerto Rico Public Finance Corporation (PFC), a blended component unit of GDB. PFC is the financing arm of GDB, which serves only as a conduit for the issuance of the bonds.

During June 2004, PFC advance refunded through the PFC 2004 Series A and B and PFC 2003 Series A through C Refunding Commonwealth Appropriation Bonds, a portion of certain of its outstanding Commonwealth Appropriation Bonds issued in prior years (except for the Health Facilities and Services Administration bonds described below, where no portion was refunded). The Commonwealth recognized a mirror effect of this advance refunding by PFC in its own debt in proportion to the portion of the Commonwealth's notes included in the PFC refunding. As a result, the Commonwealth considered defeased and therefore removed from the balance sheet the portion refunded of \$775.7 million. The repayment source for these bonds (both the refunding and unrefunded portions) consists of Commonwealth appropriations submitted for approval of the Legislature annually during the budget preparation process of the Commonwealth. The Legislature is not legally bound to appropriate funds for such repayments.

COMMONWEALTH OF PUERTO RICO

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The outstanding balance of the Commonwealth appropriation bonds (both the refunding and unrefunded portion combined) is comprised of the following obligations (expressed in thousands):

Act No. 164 Restructuring	\$ 1,481,583
Health Facilities and Services Administration	447,781
Office for the Improvement of Public Schools	328,602
Puerto Rico Maritime Shipping Authority	278,039
Property tax settlement	<u>106,189</u>
Total Commonwealth appropriation bonds	\$ <u><u>2,642,194</u></u>

On December 17, 2001, Act No. 164 was approved, which authorized certain government agencies and discretely presented component units to refund approximately \$2.4 billion of their outstanding obligations with GDB, for which no repayment source existed, over a period not exceeding 30 years, and to be repaid with annual Commonwealth appropriations not to exceed \$225 million. This refunding was done with Commonwealth appropriation bonds through several series issued by PFC during the period between December 2001 and June 2002.

Approximately \$1.5 billion of the aforementioned outstanding obligations belonged to the primary government, predominantly the Department of Health of the Commonwealth (health reform financing and other costs for approximately \$1.1 billion) and the Department of the Treasury of the Commonwealth (the fiscal year 2001 deficit financing of \$268 million and the obligation assumed for defective tax liens in the amount of approximately \$132 million). The new combined bonds balance of the Act No. 164 restructuring bears interest at rates ranging from 1.25% to 5.80%. Debt service requirements in future years are as follows (expressed in thousands):

	<u>Principal</u>	<u>Interest</u>	<u>Total</u>
Year ending June 30:			
2007	\$ 23,355	83,725	107,080
2008	35,076	81,944	117,020
2009	37,031	79,997	117,028
2010	34,707	80,860	115,567
2011	35,799	77,198	112,997
2012-2016	229,027	347,762	576,789
2017-2021	311,137	264,451	575,588
2022-2026	373,106	136,893	509,999
2027-2031	<u>421,881</u>	<u>45,922</u>	<u>467,803</u>
Total	1,501,119	\$ <u><u>1,198,752</u></u>	<u><u>2,699,871</u></u>
Plus unamortized premium	23,234		
Less deferred charges arising from debt refunding	<u>(42,770)</u>		
Total	\$ <u><u>1,481,583</u></u>		

COMMONWEALTH OF PUERTO RICO

Notes to Basic Financial Statements

June 30, 2006

As of July 1, 1999, approximately \$595 million (including unpaid interest) of a promissory note of the Health Facilities and Services Administration (HFSA) due to GDB was transferred to the Department of Health of the Commonwealth and restructured through Commonwealth appropriation bonds. The bonds bear interest at rates ranging between 5.90% and 6.20%. Principal and interest on the bonds are payable solely from legislative appropriations to be made pursuant to Act No. 223 of August 9, 1998. The act provides that OMB shall include in the annual budget of the Commonwealth an amount equal to \$56.5 million for the fiscal year 1998-99, and for the next succeeding 15 fiscal years the amount necessary to pay the principal of and interest on the bonds, up to a maximum annual amount of \$57.7 million. As of June 30, 2006, approximately \$448 million was still outstanding.

Debt service requirements in future years are as follows (expressed in thousands):

	<u>Principal</u>	<u>Interest</u>	<u>Total</u>
Year ending June 30:			
2007	\$ 37,080	20,652	57,732
2008	39,600	18,133	57,733
2009	42,125	15,607	57,732
2010	44,865	12,867	57,732
2011	25,018	32,714	57,732
2012-2016	219,967	65,623	285,590
2017-2018	39,126	76,297	115,423
Total	\$ <u>447,781</u>	<u>241,893</u>	<u>689,674</u>

Previous public schools infrastructure improvement loans provided additional funds for major repairs and improvements to the public schools in Puerto Rico. This activity is administered by the Office for the Improvement of the Public Schools of Puerto Rico (OIPS), included as part of the general fund of the primary government. These loans were refunded originally through the issuance of Commonwealth appropriation bonds pursuant to Act No. 85 of June 13, 1998 (Act 85). The new combined bonds bear interest at rates ranging from 5.0% to 5.85%. As of June 30, 2006, approximately \$328.6 million was outstanding.

COMMONWEALTH OF PUERTO RICO

Notes to Basic Financial Statements

June 30, 2006

Debt service requirements in future years are as follows (expressed in thousands):

	<u>Principal</u>	<u>Interest</u>	<u>Total</u>
Year ending June 30:			
2007	\$ 9,470	18,121	27,591
2008	9,945	17,648	27,593
2009	10,465	17,125	27,590
2010	10,990	16,602	27,592
2011	11,580	16,011	27,591
2012-2016	74,025	61,401	135,426
2017-2021	82,620	39,124	121,744
2022-2026	<u>127,060</u>	<u>15,570</u>	<u>142,630</u>
Total	336,155	\$ <u>201,602</u>	<u>537,757</u>
Plus unamortized premium	6,503		
Less deferred charges arising from debt refunding	<u>(14,056)</u>		
Total	\$ <u>328,602</u>		

A promissory note payable owed by PRMSA to GDB was assumed by the Commonwealth in connection with the sale of the maritime operations of PRMSA. Commonwealth appropriation bonds were issued to refund this liability. The new combined bonds balance bears interest at a variable rate ranging from 3.00% to 7.30%. Debt service requirements in future years are as follows (expressed in thousands):

	<u>Principal</u>	<u>Interest</u>	<u>Total</u>
Year ending June 30:			
2007	\$ —	16,907	16,907
2008	—	16,907	16,907
2009	—	16,907	16,907
2010	3,415	16,793	20,208
2011	9,390	16,443	25,833
2012-2016	59,910	74,728	134,638
2017-2021	81,845	56,221	138,066
2022-2026	103,990	31,993	135,983
2027-2030	<u>69,945</u>	<u>5,138</u>	<u>75,083</u>
Total	328,495	\$ <u>252,037</u>	<u>580,532</u>
Less unamortized discount	(643)		
Less deferred charges arising from debt refunding	<u>(49,813)</u>		
Total	\$ <u>278,039</u>		

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June 30, 2006

During fiscal year 1996, the Commonwealth refinanced the liability for the settlement of the property taxes owed to the municipalities of Puerto Rico. Commonwealth appropriation bonds were issued to refund this liability. The new combined bonds balance bears interest at rates ranging from 5.87% to 7.25%. Debt service requirements in future years are as follows (expressed in thousands):

	<u>Principal</u>	<u>Interest</u>	<u>Total</u>
Year ending June 30:			
2007	\$ 14,285	4,103	18,388
2008	15,350	3,040	18,390
2009	16,505	1,885	18,390
2010	17,750	643	18,393
2011	13,813	4,582	18,395
2012-2016	<u>47,432</u>	<u>26,152</u>	<u>73,584</u>
Total	125,135	\$ <u>40,405</u>	<u>165,540</u>
Plus accreted discount	7,412		
Less deferred charges arising from debt refunding	<u>(26,358)</u>		
Total	\$ <u>106,189</u>		

(e) Qualified Zone Academy Bonds

During November 2001, the Department of Education of the Commonwealth issued a certification whereby certain Commonwealth public schools were designated as a “qualified zone academy” pursuant to Section 1397E of the U.S. Internal Revenue Code of 1986, as amended. On May 18, 2004, PFC, a blended component unit of GDB, issued \$47.9 million of Qualified Zone Academic Bonds (QZAB) to finance expenditures of the Department of Education of the Commonwealth under the aforementioned program, including rehabilitation and repairs of school buildings and other facilities, the development and implementation of academic curricula, technology training for some schools, and the costs of issuance of the bonds. This May 2004 QZAB is payable upon its maturity on May 2020, since the U.S. government grants tax exemptions to bond holders in lieu of an interest rate. Beginning in August 2004, annual appropriations from the general fund in the amount of approximately \$2.2 million are expected to be made over the next 16 years and deposited in an escrow account, which along with accumulated earned interest will be sufficient to repay these bonds upon their maturity in 2020.

During January 2006, another QZAB in the amount of \$39.4 million was issued for similar purposes. The January 2006 QZAB is payable upon its maturity in January 2022. Beginning in fiscal year 2007, annual appropriations from the general fund in the amount of \$2.1 million are expected to be made over the next 16 years and deposited in an escrow account, which along with accumulated earned interest will be sufficient to repay these bonds upon its maturity in 2022.

Also during January 2006, the Commonwealth unwinded the 2001 defeasance of the QZAB issued in December 2001, therefore, reverting back the transaction and recognizing in the statement of net assets for the governmental activities such QZAB obligation in the amount of \$96.8 million.

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Beginning in fiscal year 2007, annual appropriations from the general fund in the amount of \$8.1 million are expected to be made over the next 10 years and deposited in an escrow account, which along with accumulated earned interest will be sufficient to repay these bonds upon their maturity in 2016. See more details about this transaction, which has been classified as a special item, in note 23.

(f) Notes Payable to Component Units

The Commonwealth has entered into various interim line of credit agreements with GDB. One \$800 million line of credit with the Department of the Treasury had drawings and repayments within the same year for the same amount of \$1.3 billion. These drawings and repayments related to advances in anticipation of the 2006 TRANS and to cover temporary cash deficiencies between tax collections and payments of current expenditures, which were later repaid upon the TRANS issuance and the actual tax collection and replenishment of the aforementioned deficiency. The remaining interim financing outstanding at June 30, 2006 consisted of the following (expressed in thousands):

<u>Agency</u>	<u>Purpose</u>	<u>Interest rate</u>	<u>Line of credit</u>	<u>Outstanding balance</u>
Department of the Treasury	Revolving advances in anticipation of TRANS	175bp over GDB's commercial paper rate	\$ 695,000	319,741
Department of the Treasury	Resources to meet appropriations in annual budget of Commonwealth (Fiscal year 2004) and Federal program expenditures	125bp over three-month LIBOR	640,000	156,744
Public Building Authority	Interim construction activities	150bp over GDB's	256,000	30,598
Department of Transportation and Public Works	Construction and repavement of roads	150bp over GDB's commercial paper rate	15,000	15,000
Department of Recreation and Sports	Recreational projects at various municipalities	150bp over GDB's commercial paper rate	16,000	3,961
			<u>\$ 1,622,000</u>	<u>526,044</u>

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The Commonwealth financed certain other long-term liabilities through GDB and other component units. The outstanding balance on the financing provided by GDB is comprised of the following (expressed in thousands), all within governmental activities:

GDB:

Department of the Treasury	\$	2,570,623
Department of Education		126,575
Public Building Authority		75,000
Department of Transportation and Public Work		72,190
Department of Agriculture		67,022
Office of Management & Budget		54,915
Department of Health		39,682
Puerto Rico Court Administration Office		37,867
Department of Justice		37,549
Correction Administration		21,292
Department of Recreation and Sports		18,241
Office of the Superintendent of the Capitol		17,338
Police Department		14,553
Department of Natural Resources		12,121
Administration for the Care and Development of the Childhood		5,257
Public Housing Administration		4,183
State Office for the Historic Conservation		3,540
Office of Veterans' Affairs		1,135
		<hr/>
Notes Payable to GDB	\$	<u>3,179,083</u>

Other Components Unit:

Health facilities agreement payable to the Medical Science Campus of UPR	\$	71,570
Note payable to PREPA		43,081
		<hr/>
Notes payable to other component unit	\$	<u>114,651</u>

COMMONWEALTH OF PUERTO RICO

Notes to Basic Financial Statements

June 30, 2006

As of June 30, 2006, the Department of the Treasury of the Commonwealth has entered into various line of credit agreements with GDB amounting to a maximum of \$3 billion for different purposes as presented in the following tables. The purpose, interest rate, maturity date, and amount outstanding under each individual agreement at June 30, 2006 consist of the following (expressed in thousands):

<u>Purpose</u>	<u>Interest rate</u>	<u>Maturity</u>	<u>Line of credit</u>	<u>Outstanding balance</u>
To finance payroll and operational expenditures of the Commonwealth for fiscal period 2006	5.50%	June 30, 2036	\$ 741,000	741,000
To provide additional resources to meet the appropriations in the annual budget of the Commonwealth (fiscal year 2005)	125 bp over three-month LIBOR	June 30, 2014	550,000	550,000
Resources for repayment of agencies' old debts	125 bp over three-month LIBOR	September 30, 2015	368,200	368,200
Replenishment of income tax refund reserve (fiscal year 2004)	125 bp over three-month LIBOR	June 30, 2008	250,000	238,924
Resources to meet appropriations in annual budget of Commonwealth and partial repayments of TRANS (fiscal year 2004)	125 bp over three-month LIBOR	June 31, 2009	233,000	233,000
Capital improvement projects of agencies and municipalities	150 bp over GDB's commercial paper rate	June 30, 2019	130,000	96,187
Acquisition of safety and security equipment for certain Commonwealth agencies	150 bp over GDB's commercial paper rate	September 30, 2007	105,000	94,552
Resources to cover the operational needs of the catastrophic disasters fund (fiscal year 2004)	125bp three-month LIBOR	July 31, 2006	100,000	78,130
Balance brought forward			\$ <u>2,477,200</u>	<u>2,399,993</u>

COMMONWEALTH OF PUERTO RICO

Notes to Basic Financial Statements

June 30, 2006

<u>Purpose</u>	<u>Interest rate</u>	<u>Maturity</u>	<u>Line of credit</u>	<u>Outstanding balance</u>
Balance brought forward			\$ 2,477,200	2,399,993
To meet program expenditures of the Puerto Rico Health Insurance Administration and the Department of the Family	125bp over three-month LIBOR	September 30, 2015	79,930	45,716
To cover deficit in certain elderly and child care programs of the Department of the Family	125 bp over three-month LIBOR	September 30, 2011	30,000	29,928
To fund information technology project	150 bp over GDB's commercial paper rate	September 30, 2008	44,868	22,333
To pay debt with Municipal Revenue Collection Center	125 bp over three-month LIBOR	September 30, 2011	16,241	16,241
Resources to various agencies to pay outstanding debt with PBA	125bp over three-month LIBOR	September 30, 2008	40,000	14,182
To estimate economy in municipalities of Ceiba and Naguabo	125 bp over three-month LIBOR	September 30, 2012	14,500	12,665
To pay outstanding debt of various agencies with the Puerto Rico Telephone Company	125 bp over three-month LIBOR	September 30, 2008	16,000	12,157
To acquire correctional facilities	125 bp over three-month LIBOR	September 30, 2012	15,000	11,552
Resources to cover the operational needs of the catastrophic disasters fund (fiscal year 2004)	125 bp over three-month LIBOR	July 31, 2006	8,000	5,825
Purchase of mobile X-ray machines	125bp over three-month LIBOR	June 30, 2008	12,000	31
			<u>\$ 2,753,739</u>	<u>2,570,623</u>

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Notes to Basic Financial Statements

June 30, 2006

On February 6, 2003, the Department of Education of the Commonwealth entered into a \$25 million line-of-credit agreement with GDB for the purchase of equipment and for school improvements. Borrowings under this line-of-credit agreement bear interest at variable rates and are payable upon the maturity of the line of credit on June 30, 2008. As of June 30, 2006, \$11.6 million was outstanding. The line-of-credit agreement will be repaid from future legislative appropriations. On August 4, 2002, the Department of Education entered into an additional \$140 million line-of-credit agreement with GDB in order to reimburse the Department of the Treasury for payments made on their behalf for state funds used to fund federal program expenditures. Borrowings under this line-of-credit agreement bear interest at variable rates and are payable upon the maturity of the line-of-credit on June 30, 2007. As of June 30, 2006, \$115 million was outstanding related to the borrowing. The line-of-credit will be repaid with federal grants. On August 30, 2002, the Department of Education also entered into a \$2.3 million line-of-credit agreement with GDB for the construction of school facilities. Borrowings under this line-of-credit agreement bear interest at variable rates and are payable upon the maturity of the line-of-credit on July 1, 2006. At June 30, 2006, no amounts had been drawn under this line-of-credit.

On April 6, 2006, the Public Building Authority executed a loan agreement with GDB for \$75 million bearing interest at a variable rate based on 125 basis points over the three-month LIBOR index. The loan, obtained for operational needs, is due on June 30, 2010 and is collateralized with two of PBA's properties. Debt service requirements will come from Commonwealth appropriations. On June 30, 2006, PBA exchanged one of the collateralized properties in partial settlement of \$30 million of the loan, upon which a gain of \$8.7 million resulted and was recognized in the accompanying statement of activities. At that moment, PBA borrowed an additional \$30 million. At June 30, 2006, \$75 million remained outstanding.

On March 8, 2004, the Department of Transportation and Public Works (DTPW), entered into a \$26 million line-of-credit agreement with GDB for the improvement and maintenance of the roads around the island. Borrowings under this line-of-credit agreement bear interest at variable rates and are payable upon the maturity of the line of credit on June 30, 2010. As of June 30, 2006, this line-of-credit has an outstanding balance of approximately \$22 million. On November 16, 2004, the DTPW entered into another \$33 million line-of-credit agreement with GDB for similar purposes. Borrowings under this line-of-credit agreement bear interest at variable rates and are payable upon the maturity of the line of credit on October 31, 2010. As of June 30, 2006, \$12 million remains outstanding related to these borrowings. On June 23, 2005, the DTPW entered into an additional \$44 million line-of-credit agreement with GDB to meet program expenditures. Borrowings under this line-of-credit agreement bear interest at a fixed rate of 2.5% and are payable upon the maturity of the line of credit on September 30, 2008. As of June 30, 2006, this line-of-credit has an outstanding balance of approximately \$38 million.

On August 9, 1999, the Department of Agriculture of the Commonwealth entered into a \$125 million nonrevolving line-of-credit agreement with GDB to provide economic assistance to the agricultural sector which sustained severe damages caused by Hurricane Georges in 1998. Borrowings under this line-of-credit agreement bear interest at variable rates and are payable upon the maturity of the line-of-credit on June 30, 2014. As of June 30, 2006, \$67 million remains outstanding. The line-of-credit will be repaid from future legislative appropriations.

COMMONWEALTH OF PUERTO RICO

Notes to Basic Financial Statements

June 30, 2006

On June 5, 2006, the Office of Management and Budget entered into a \$150 million line-of-credit agreement with GDB to provide economic assistance for disasters and emergencies. Borrowings under this line-of-credit agreement bear interest at variable rates based on 125 basis points over three-month LIBOR, and are payable upon the maturity of the line-of-credit on September 30, 2011. As of June 30, 2006, \$54.9 million was outstanding.

On August 2003, the Department of Health of the Commonwealth entered into a \$30 million line-of-credit agreement with GDB in order to repay certain outstanding debts that the Puerto Rico Medical Services Administration (PRMSA) had with other agencies and suppliers. Borrowings under this line-of-credit agreement bear interest at variable rates and are payable upon maturity of the line-of-credit on June 30, 2012. As of June 30, 2006, \$28.9 million related to this line-of-credit agreement was outstanding. On November 8, 2004, the Department of Health entered into an additional \$58.5 million line-of-credit agreement with GDB for the financing of a project of the Department of Health and PRMSA. Borrowings under this line-of-credit agreement bear interest at variable rates and are payable upon the maturity of the line of credit on October 31, 2014. As of June 30, 2006, this line-of-credit agreement amounted to \$10.8 million.

On May 7, 2001, the Puerto Rico Court Administration Office (the Office) entered into a \$49.4 million nonrevolving line-of-credit agreement with GDB for operating purposes. Borrowings under this line-of-credit agreement bear interest at a variable rate of three-month London Inter bank Offered Rate (LIBOR) plus 1%, not to exceed 8%. The Office must deposit \$6 million a year, from the total fees collected on the filing of civil cases, in a special fund created by the Department of the Treasury of the Commonwealth, which is pledged for repayment until July 31, 2015. As of June 30, 2006, approximately \$38 million remains outstanding.

On October 2, 2002, the Department of Justice of the Commonwealth entered into a \$90 million line-of-credit agreement with GDB for the financing of 12 public improvement projects for the Municipality of Ponce pursuant to a court order. Borrowings under this line-of-credit agreement bear interest at variable rates and are payable upon the maturity of the line-of-credit on September 30, 2014. As of June 30, 2006, \$21.5 million related to this line of credit agreement was outstanding. The line-of-credit will be repaid from future Commonwealth appropriations. On July 8, 2005, the Department of Justice entered into an additional \$63.4 million line-of-credit agreement with GDB for various projects in Ponce. Borrowings under this line-of-credit agreement bear interest at variable rates and are payable upon the maturity of the line of credit on September 30, 2014. As of June 30, 2006, this line-of-credit agreement amounted to \$16 million.

On August 28, 2000, GDB approved an amendment to the terms of two line-of-credit agreements of the Correction Administration by which such debts would be repaid between fiscal years 2000 and 2007. The two agreements were issued by GDB in August 1998 to partially fund permanent improvements to correctional facilities. The agreements have variable interest rates and limits of \$60 million and \$15 million. Their outstanding balance as of June 30, 2006 is \$7.5 million. On May 12, 2004, the Correction Administration entered into an additional \$60 million line-of-credit agreement with GDB for improvements to certain correctional facilities. Borrowings under this line-of-credit agreement bear interest at variable rates and are payable upon the maturity of the line-of-credit on June 30, 2010. As of June 30, 2006, \$13.8 million was outstanding. The line-of-credit will be repaid from future Commonwealth appropriations.

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Notes to Basic Financial Statements

June 30, 2006

On October 23, 2002, the Department of Recreation and Sports of the Commonwealth (DRS) entered into a \$17.5 million line-of-credit agreement with GDB for the development of a recreational complex and other facilities in San Juan, which will eventually become the DRS' principal office headquarters. Borrowings under this line-of-credit agreement bear interest at variable rates and are payable upon the maturity of the line-of-credit on September 30, 2008. As of June 30, 2006, \$14.4 million remains outstanding. The line-of-credit will be repaid from future Commonwealth appropriations. On January 18, 2005, the DRS also entered into a \$17.2 million line-of-credit agreement with GDB for the development of a series of recreational projects at different municipalities. Borrowings under this line-of-credit agreement bear interest at variable rates and are payable upon the maturity of the line of credit on June 30, 2010. As of June 30, 2006, \$2.2 million was outstanding. On May 25, 2006, the DRS entered into an additional \$3 million line-of-credit agreement with GDB for the development of a series of recreational projects at different municipalities. Borrowings under this line-of-credit agreement bear interest at variable rates and are payable upon the maturity of the line of credit on September 30, 2008. As of June 30, 2006, \$1.6 million was outstanding.

On June 21, 2001, the Office of the Superintendent of the Capitol (Superintendent) entered into a \$10 million line-of-credit agreement with GDB for the construction of a parking lot. Borrowings under this line-of-credit agreement bear interest at a fixed rate of 8% and are payable from future Commonwealth appropriations commencing in fiscal year 2003 through fiscal year 2007. As of June 30, 2006, \$5.1 million related to the line-of-credit agreement was outstanding. On February 15, 2002, the Superintendent entered into an additional \$35 million line-of-credit agreement with GDB for the acquisition and remodeling of several buildings under their jurisdiction. Borrowings under this line-of-credit agreement bear interest at a fixed rate of 8% and are payable from future legislative appropriations commencing in fiscal year 2003 through fiscal year 2008. As of June 30, 2006, \$12.2 million remained outstanding from the line-of-credit agreement.

On June 10, 2004, the Police Department entered into a \$48 million line-of-credit agreement with GDB for the acquisition of vehicles and high technology equipment. Borrowings under this line-of-credit agreement bear interest at variable rates and are payable upon the maturity of the line of credit on September 30, 2014. The outstanding balance of this line-of-credit agreement amounted to \$14.6 million at June 30, 2006.

On August 21, 2002, the Department of Natural and Environmental Resources of the Commonwealth (DNER) entered into a \$22.7 million line-of-credit agreement with GDB for the canalization of the Bucana River. Borrowings under this line of credit agreement bear interest at variable rates and were payable upon the maturity of the line-of-credit on June 30, 2007. As of June 30, 2006, \$8.3 million remains outstanding under the line-of-credit agreement. The line-of-credit will be repaid from future Commonwealth appropriations. On September 3, 2003, the DNER entered into a \$2 million line-of-credit agreement with GDB for the canalization of Guayanilla River. Borrowings under this line-of-credit agreement bear interest at variable rates and are payable upon the maturity of the line of-credit on June 30, 2007. As of June 30, 2006, \$1 million was outstanding. On August 22, 2005, the DNER entered into an additional \$3.5 million line-of-credit agreement with GDB for the canalization of Fajardo River. Borrowings under this line-of-credit agreement bear interest at variable rates and are payable upon the maturity of the line-of-credit on September 30, 2007. As of June 30, 2006, \$2.8 million was outstanding.

COMMONWEALTH OF PUERTO RICO

Notes to Basic Financial Statements

June 30, 2006

On February 24, 2006 the Administration for the Care & Development of the Childhood entered into an \$8 million line-of-credit agreement with GDB to provide economic assistance for the summer program known as "Care and Development of the Child Program". Borrowings under this line-of-credit agreement bear interest at variable rates and are payable upon the maturity of the line-of-credit on September 30, 2009. As of June 30, 2006, \$5.3 million was outstanding.

The Public Housing Administration has available a \$97.1 million of a line-of-credit secured by The Department of Housing and Urban Development of the United States. It bears interest at the daily weighted average rate of the GDB outstanding commercial paper notes plus a required margin cost (5.67% at June 30, 2006). At June 30, 2006, the outstanding balance under this line of credit was \$4.1 million.

On August 1, 2001, the State Office for the Historic Conservation entered into a \$4.5 million line-of-credit agreement with GDB for the construction and conservation of the Santa Catalina Palace and the Real Audiencia building. Borrowings under this line-of-credit agreement bear interest at variable rates and are payable upon the maturity of the line-of-credit on December 31, 2008. As of June 30, 2006, the outstanding balance of this line-of-credit agreement amounts to \$3.5 million. The line-of-credit will be repaid from future Commonwealth appropriations.

On October 20, 2004, the Office of Veterans' Affairs entered into a \$1.6 million line-of-credit agreement with GDB to provide economic assistance and housing-leasing services to Puerto Rican veterans. Borrowings under this line-of-credit agreement bear interest at variable rates and are payable upon the maturity of the line-of-credit on June 30, 2006. As of June 30, 2006, \$1.1 million was outstanding.

As of July 1, 1999, debts of approximately \$102 million from various agreements payable to UPR, a discretely presented component unit, in relation to outstanding noninterest-bearing debt accumulated in prior years by HFSA were transferred to the Commonwealth. On September 7, 2004, additional debts of approximately \$71.2 million were also restructured and combined with the previous financing arrangement. During fiscal year 2006, an installment of \$15.6 million was paid by the Commonwealth under this arrangement. As of June 30, 2006, \$71.6 million remains outstanding. Future amounts required to pay principal balances at June 30, 2006 are as follows (expressed in thousands):

Year ending June 30:		
2007	\$	15,570
2008		15,570
2009		7,570
2010		7,570
2011		7,570
2012-2014		17,720
Total	\$	<u>71,570</u>

COMMONWEALTH OF PUERTO RICO

Notes to Basic Financial Statements

June 30, 2006

The noninterest-bearing note payable to PREPA, a discretely presented component unit, consists of \$19 million of fuel adjustment subsidy due by the Commonwealth and the refinancing during 2004 of \$24.1 million of other accumulated debt by the Commonwealth's agencies with PREPA. Future amounts required to pay principal balances at June 30, 2006 are as follows (expressed in thousands):

Year ending June 30:		
2007	\$	6,327
2008		6,327
2009		6,327
2010		24,100
		<hr/>
Total	\$	<u>43,081</u>

(g) *Compensated Absences*

Long-term debt includes approximately \$1,691 million accrued vacation and sick leave benefits at June 30, 2006. The total liability of compensated absences recorded as governmental and business-type activities amounted to \$1,684 million and \$7 million, respectively.

(h) *Net Pension Obligation*

The amount reported as net pension obligation of approximately \$4.7 billion represents the cumulative amount owed by the Commonwealth for the unfunded prior years' actuarially required pension contributions to the ERS and the TRS (collectively known as the pension plans) (see note 19). The net pension obligation has been recorded as a liability in governmental activities in the accompanying statement of net assets.

(i) *Unpaid Lottery Prizes*

The amount reported as unpaid lottery prizes represents the lottery prizes payable of the Lottery of Puerto Rico (commonly known as Traditional Lottery) and the additional lottery system (commonly known as Lotto) jointly known as the Lottery Systems at June 30, 2006. The minimum annual payments related to unpaid awards of both lotteries are as follows (expressed in thousands):

	<u>Principal</u>	<u>Interest</u>	<u>Total</u>
Year ending June 30:			
2007	\$ 37,488	—	37,488
2008	32,890	1,733	34,623
2009	31,297	3,326	34,623
2010	29,806	4,817	34,623
2011	24,409	10,214	34,623
2012-2016	98,363	39,386	137,749
2017-2021	40,602	33,186	73,788
2022-2026	8,848	11,725	20,573
	<hr/>	<hr/>	<hr/>
Total	\$ <u>303,703</u>	<u>104,387</u>	<u>408,090</u>

COMMONWEALTH OF PUERTO RICO

Notes to Basic Financial Statements

June 30, 2006

The liability for unpaid lottery prizes is reported in the accompanying statement of net assets and the statement of net assets – business-type activities – proprietary funds.

(j) *Claims Liability for Insurance Benefits*

The Commonwealth provides unemployment compensation, nonoccupational disability, and drivers' insurance coverage to public and private employees through various insurance programs administered by the Department of Labor and Human Resources of the Commonwealth. These insurance programs cover workers against unemployment, temporary disability, or death because of work or employment-related accidents or because of illness suffered as a consequence of their employment.

The Commonwealth establishes liabilities for incurred but unpaid benefits and benefit adjustment expenses based on the ultimate cost of settling the benefits. Insurance benefit claim liabilities are reevaluated periodically to take into consideration recently settled claims, the frequency of claims, and other economic and social factors. The liability for insurance benefits claims is reported as a current liability in the accompanying statement of net assets and the statement of net assets – business-type activities – proprietary funds.

(k) *Obligations Under Capital Lease Arrangements*

The Commonwealth is obligated under capital leases with third parties that expire through 2034 for land, buildings, and equipment. At June 30, 2006, the capitalized cost of the land, buildings, and equipment amounted to approximately \$165 million and is included in the accompanying government-wide statement of net assets within capital assets.

The present value of future minimum capital lease payments at June 30, 2006 reported in the accompanying government-wide statement of net assets is as follows (expressed in thousands):

Year ending June 30:		
2007		\$ 4,476
2008		15,365
2009		14,331
2010		14,068
2011		13,660
2012-2016		66,495
2017-2021		59,782
2022-2026		56,934
2027-2031		52,516
2032-2034		18,057
	Total future minimum lease payments	315,684
	Less amount representing interest costs	(171,183)
	Present value of minimum lease payments	\$ 144,501

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Notes to Basic Financial Statements

June 30, 2006

Leased land, buildings, and equipment under capital leases in capital assets at June 30, 2006, include the following (expressed in thousands):

Land	\$	7,960
Buildings		146,202
Equipment		<u>11,060</u>
Subtotal		165,222
Less accumulated amortization		<u>(25,738)</u>
Total	\$	<u><u>139,484</u></u>

Amortization charge applicable to capital leases and included within depreciation expense of capital assets amounted to approximately \$6 million in 2006.

The Commonwealth is also committed under numerous operating leases, covering land, office facilities, and equipment. Rental expenditures within the governmental funds for the year ended June 30, 2006 under such operating leases were approximately \$145 million.

The future minimum lease payments for these leases are as follows (expressed in thousands):

Year ending June 30:		
2007	\$	93,160
2008		74,839
2009		54,279
2010		30,177
2011		19,074
2012-2016		49,201
2017-2021		4,848
2022-2026		<u>2,923</u>
Total future minimum lease payments	\$	<u><u>328,501</u></u>

(l) Other Long-term Liabilities

The remaining long-term liabilities of governmental activities at June 30, 2006 include (expressed in thousands):

Employees' Christmas bonus	\$	102,562
Liability for federal cost disallowances		53,047
Liability for legal claims and judgments (note 18)		801,167
Liability to U.S. Army Corps of Engineers (note 12)		<u>205,000</u>
Total	\$	<u><u>1,161,776</u></u>

COMMONWEALTH OF PUERTO RICO

Notes to Basic Financial Statements

June 30, 2006

As described in note 12, the Commonwealth has a debt obligation with the U.S. Army Corps of Engineers in relation to the construction of the Cerrillos Dam and Reservoir project and the Portugues river and the Bucana river projects.

(m) Advance Refunding, Defeased Bonds, and Refunding of Special Promissory Notes

In prior years, the Commonwealth defeased certain general obligation and other bonds by placing the proceeds of bonds in an irrevocable trust to provide for all future debt service payments on the refunded bonds. Accordingly, the trusts' account assets and liabilities for the defeased bonds are not included in the basic financial statements. At June 30, 2006, approximately \$1.4 billion of bonds outstanding from prior years advance refunding are considered defeased.

In addition, PBA, a blended component unit, has defeased certain revenue bonds in prior years by placing the proceeds of new bonds in an irrevocable trust to provide for all future debt service payments on the old debts. Accordingly, the trusts' account assets and liabilities for the defeased bonds are not included in the statement of net assets. As of June 30, 2006, approximately \$656 million of PBA bonds are considered defeased.

Fiduciary Funds

On June 29, 2006, the GRS entered into a line of credit agreement with a commercial bank for a amount not to exceed \$112 million at a variable rate subject to LIBOR plus the Applicable Margin (50 basis point in the case of LIBOR rate or 0 basis points in the cases of Base Rate Advances). At June 30, 2006, the outstanding balance of the line of credit amounts to \$60 million.

On August 1, 1996, the TRS entered into a loan agreement with AFICA, a discretely presented component unit, to secure AFICA's issuance of \$26.9 million of industrial revenue term bonds. The bonds were issued under a trust agreement and are secured by a pledge of certain marketable securities of the TRS.

The proceeds from the sale of the bonds were lent by AFICA to TRS to finance the acquisition of certain buildings and related facilities and to pay certain expenses incurred in connection with the issuance and sale of the bonds.

Bonds payable outstanding at June 30, 2006, are as follows (expressed in thousands):

Term Bonds Series A payable through 2012, interest payable on a monthly basis at rates varying from 6.50% to 6.65%	\$	5,220
Term Bonds Series B payable through 2021, interest payable semiannually at 5.50%		15,210
Total	\$	<u>20,430</u>

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Notes to Basic Financial Statements

June 30, 2006

Maturities of the term bonds are as follows (expressed in thousands):

	<u>Principal</u>	<u>Interest</u>	<u>Total</u>
Year ending June 30:			
2007	\$ 915	1,184	2,099
2008	975	1,123	2,098
2009	1,040	1,058	2,098
2010	1,110	989	2,099
2011	1,180	915	2,095
2012-2016	6,575	3,499	10,074
2017-2021	8,635	1,476	10,111
Total	<u>\$ 20,430</u>	<u>10,244</u>	<u>30,674</u>

The Series A and Series B Bonds are subject to redemption, at the option of the TRS, in whole or in part on July 1, 2006, or any date thereafter at the determined redemption prices plus accrued interest to the redemption date as follows:

July 1, 2006 through June 30, 2007	102%
July 1, 2007 through June 30, 2008	101
July 1, 2008 and thereafter	100

The TRS has also entered into a \$15 million line-of-credit agreement with GDB, due on October 31, 2010, and guaranteed by a pool of investments of the TRS. At June 30, 2006, the outstanding balance of the line of credit was approximately \$4 bearing interest at a variable rate subject to LIBOR, but not less than an annual interest rate of 5%.

Discretely Presented Component Units

Notes and bonds payable are those liabilities that are paid out of resources pledged by the other component units. These notes and bonds do not constitute a liability or debt of the Commonwealth.

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Notes to Basic Financial Statements

June 30, 2006

The outstanding balance of notes payable at June 30, 2006 is as follows (expressed in thousands):

<u>Component unit</u>	<u>Interest rate</u>	<u>Maturity through</u>	<u>Beginning balance</u>	<u>Additions</u>	<u>Reductions</u>	<u>Ending balance</u>	<u>Due within one year</u>
Government Development Bank for Puerto Rico	4.1% – 5.85%	2031	\$ 1,212,677	14,901,196	13,378,916	2,734,957	1,048,867
Puerto Rico Electric Power Authority	2.60% – 5.47%	2013	41,585	200,000	4,750	236,835	204,835
State Insurance Fund Corporation	Discounted notes from 6.31% – 6.84%	2019	55,252	—	1,660	53,592	1,956
Economic Development Bank for Puerto Rico	4.20% – 5.20%	2025	400,000	200,000	100,000	500,000	—
Puerto Rico Industrial Development Company	5.00% – 6.73%	2024	63,033	7,319	2,033	68,319	2,693
Land Authority of Puerto Rico	4.87	2010	10,604	—	2,121	8,483	2,121
Puerto Rico Ports Authority Agricultural & Services Development Co.	5.72% – 7.5%	2024	122,763	18,400	6,214	134,949	122,464
Puerto Rico Trade & Export Company	Variable	2007	—	10,238	—	10,238	—
	5.20% – 5.80%	2026	—	400,000	—	400,000	—
Total notes payable – component units			<u>\$ 1,905,914</u>	<u>15,737,153</u>	<u>13,495,694</u>	<u>4,147,373</u>	<u>1,382,936</u>

Notes payable of \$175 million of PREPA, not included in the table above, have no fixed maturity date and variable interest rates. For financial reporting purposes, these notes have been classified as due within one year. These had increases of \$25 million during 2006.

Debt service requirements on component units' notes payable with fixed maturities at June 30, 2006 were as follows (expressed in thousands):

	<u>Principal</u>	<u>Interest</u>	<u>Total</u>
Year ending June 30:			
2007	\$ 1,557,936	179,214	1,737,150
2008	131,875	124,984	256,859
2009	132,479	122,287	254,766
2010	86,847	120,008	206,855
2011	76,452	118,768	195,220
2012-2016	473,876	618,878	1,092,754
2017-2021	86,560	503,094	589,654
2022-2026	901,038	419,801	1,320,839
2027-2031	885,000	243,482	1,128,482
Premium/discount	(9,690)	—	(9,690)
Total	<u>\$ 4,322,373</u>	<u>2,450,516</u>	<u>6,772,889</u>

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Notes to Basic Financial Statements

June 30, 2006

Commonwealth appropriation bonds payable outstanding at June 30, 2006 are as follows (expressed in thousands):

<u>Component unit</u>	<u>Interest rate</u>	<u>Maturity through</u>	<u>Beginning balance</u>	<u>Additions</u>	<u>Reductions</u>	<u>Ending balance</u>	<u>Due within one year</u>
Puerto Rico Aqueduct and Sewer Authority	5.50%	2031	\$ 709,276	—	2,508	706,768	2,733
Tourism Company of Puerto Rico	4% – 6.15%	2031	126,918	181	572	126,527	489
Land Authority of Puerto Rico	4% – 6.15%	2031	161,432	3,429	1,526	163,335	718
Government Development Bank of Puerto Rico	4% – 6.15%	2031	10,339	—	95	10,244	45
Puerto Rico Infrastructure Financing Authority	4% – 6%	2031	10,651	—	98	10,553	46
Puerto Rico Solid Waste Authority	1.25% – 5.75%	2031	7,702	—	1	7,701	—
Total appropriation bonds – component units			\$ 1,026,318	3,610	4,800	1,025,128	4,031

Debt service requirements on component units' appropriation bonds payable with fixed maturities at June 30, 2006 were as follows (expressed in thousands):

	<u>Principal</u>	<u>Interest</u>	<u>Total</u>
Year ending June 30:			
2007	\$ 4,031	55,132	59,163
2008	13,316	57,667	70,983
2009	16,027	56,840	72,867
2010	15,511	57,526	73,037
2011	13,512	56,758	70,270
2012-2016	111,428	240,832	352,260
2017-2021	159,540	192,123	351,663
2022-2026	202,901	139,917	342,818
2027-2031	506,914	58,652	565,566
2032-2036	2,272	41	2,313
Deferred loss, net	(43,295)	—	(43,295)
Premium, net	22,971	—	22,971
Total	\$ 1,025,128	915,488	1,940,616

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Bonds payable outstanding at June 30, 2006 are as follows (expressed in thousands):

<u>Component unit</u>	<u>Interest rate</u>	<u>Maturity through</u>	<u>Beginning balance (as restated)</u>	<u>Additions</u>	<u>Reductions</u>	<u>Ending balance</u>	<u>Amounts due within one year</u>
Government Development for Puerto Rico	2.10% – 7.50%	2,037	\$ 1,458,049	264,191	342,143	1,380,097	94,111
Puerto Rico Infrastructure Financing Authority	1.10% – 7.90%	2,045	2,587,892	23,848	29,483	2,582,257	30,695
University of Puerto Rico	3% – 5.75%	2,030	483,272	—	17,086	466,186	20,625
Puerto Rico Municipal Finance Authority	3.50% – 8.62%	2,030	1,248,977	764,128	396,541	1,616,564	114,210
Puerto Rico Ports Authority	5.00% – 7.30%	2,021	70,260	194	4,250	66,204	4,545
Puerto Rico Aqueduct and Sewer Authority	3.5% – 8.22%	2,045	863,257	—	33,899	829,358	26,641
Puerto Rico Highway and Transportation Authority	2.25% – 6.50%	2,045	5,834,915	1,625,594	819,297	6,641,212	98,520
Puerto Rico Industrial Development Company	1.50% – 6.71%	2,028	298,541	1,889	10,458	289,972	10,458
Puerto Rico Convention Center Company	4.00% – 5.00%	2,037	—	482,801	212	482,589	—
Puerto Rico Electric Power Authority	3.00% – 7.00%	2,035	5,263,374	—	106,844	5,156,530	377,532
Total bonds – component units			<u>\$ 18,108,537</u>	<u>3,162,645</u>	<u>1,760,213</u>	<u>19,510,969</u>	<u>777,337</u>

Debt service requirements on component units' bonds payable with fixed maturities at June 30, 2006, were as follows (expressed in thousands):

	<u>Principal</u>	<u>Interest</u>	<u>Total</u>
Year ending June 30:			
2007	\$ 777,337	1,127,138	1,904,475
2008	536,222	966,116	1,502,338
2009	552,834	952,720	1,505,554
2010	545,949	927,515	1,473,464
2011	568,156	1,060,203	1,628,359
2012-2016	3,517,386	3,865,021	7,382,407
2017-2021	3,351,294	3,070,840	6,422,134
2022-2026	3,534,938	2,277,877	5,812,815
2027-2031	2,756,850	1,926,583	4,683,433
2032-2036	2,068,325	1,251,417	3,319,742
2037-2041	1,474,235	600,125	2,074,360
2042-2046	402,903	312,992	715,895
2047-2051	178,653	—	178,653
Premium/(discount), net	(754,113)	—	(754,113)
Total	<u>\$ 19,510,969</u>	<u>18,338,547</u>	<u>37,849,516</u>

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The bonds payable amount of Puerto Rico Infrastructure Financing Authority as of beginning of the year was decreased by approximately \$829.3 million, in order to recognize retroactively the effect of a June 30, 2005 defeasance not previously recognized. This is part of the net assets restatements described in note 4.

Several component units have defeased certain revenue bonds by placing the proceeds of new bonds in irrevocable trusts to provide for all future debt service payments on the old debts. Accordingly, the trust accounts' assets and liabilities for the defeased bonds are not included in the statement of net assets. As of June 30, 2006, the following bonds are considered defeased:

	Amount outstanding (In millions)
Puerto Rico Electric Power Authority	\$ 1,353
Puerto Rico Highway and Transportation Authority	1,158
Puerto Rico Infrastructure Finance Authority	818
Puerto Rico Municipal Finance Agency	441
Puerto Rico Industrial Development Company	175
	<u>\$ 3,945</u>

(15) Guaranteed and Appropriation Debt

(a) *Guaranteed Debt*

The Commonwealth may provide guarantees for the repayment of certain borrowings of component units to carry out designated projects. At June 30, 2006, the following component unit debts are guaranteed by the Commonwealth (expressed in thousands):

	Maximum guarantee	Outstanding balance
Blended component unit Public Buildings Authority	\$ 3,325,000	2,851,121
Discretely presented component units:		
Puerto Rico Aqueduct and Sewer Authority	801,084	692,774
Port of the Americas Authority	250,000	23,848
Government Development Bank for Puerto Rico	342,000	267,000
Total	<u>\$ 4,718,084</u>	<u>3,834,743</u>

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The Commonwealth has guaranteed the payments of rentals of its departments, agencies, and component units to PBA, a blended component unit, under various lease agreements executed pursuant to the law that created PBA. Such rental payments include the amounts required by PBA for the payment of principal and interest on the guaranteed debt as authorized by law. The rental commitment to cover principal and interest on the guaranteed debt (excluding premiums and deferred refunding losses) as of June 30, 2006 and for the next five years and thereafter follows (expressed in thousands):

	<u>Principal</u>	<u>Interest</u>	<u>Total</u>
Year ending June 30:			
2007	\$ 56,855	152,464	209,319
2008	73,057	138,934	211,991
2009	80,684	134,992	215,676
2010	86,740	128,119	214,859
2011	89,455	123,273	212,728
2012-2016	318,442	484,229	802,671
2017-2021	397,340	488,678	886,018
2022-2026	396,700	392,901	789,601
2027-2031	494,190	288,261	782,451
2032-2036	593,624	188,197	781,821
2037-2040	297,400	14,263	311,663
	<u>2,884,487</u>	<u>2,534,311</u>	\$ <u>5,418,798</u>
Add (deduct) accreted discount	37,821	(37,821)	
Unamortized premiums, discounts, and deferred losses, net	<u>(71,187)</u>	<u>—</u>	
	\$ <u>2,851,121</u>	<u>2,496,490</u>	

Rental income of PBA funds amounted to approximately \$314 million during the year ended June 30, 2006, of which \$173 million was used to cover debt service obligations.

Act No. 45 of July 28, 1994 states that the Commonwealth guarantees the payment of principal and interest of all outstanding bonds at the date the law was enacted and of all future bond issues to refinance those outstanding bonds of PRASA. During December 1995, PRASA issued refunding bonds to refinance all outstanding bonds amounting to approximately \$400.3 million. The outstanding balance of these refunding bonds at June 30, 2006, amounted to \$277 million. Act No. 140 of August 3, 2000, amended Act No. 45 to extend the Commonwealth guarantee to include the principal and interest payments of the Rural Development Serial Bonds and the loans under the State Revolving Fund Program (SRFP) outstanding at the effective date of Act No. 140, and of all future bonds and SRFP loans that may be issued until June 30, 2005. Act No. 386 of September 21, 2004, extended the Commonwealth guarantee to June 30, 2010. The outstanding balance of the Rural Development Serial Bonds and SRFP loans at June 30, 2006, amounted to \$208 million and \$188 million, respectively.

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The Commonwealth guarantees the Adjustable Refunding Bonds, Series 1985, issued by GDB, a discretely presented component unit. The outstanding balance of these bonds amounts to \$267 million at June 30, 2006. The Puerto Rico Housing Bank, a former component unit of the Commonwealth, which merged with and into GDB during 2002, insured mortgages granted to low- and moderate-income families through its mortgage loan insurance program. The Commonwealth guarantees up to \$75 million of such mortgage loans. As of June 30, 2006, the mortgage loan insurance program was insuring loans aggregating \$480.5 million. Currently, the Commonwealth has not been called to make any direct payments pursuant to these guarantees.

At various times during fiscal years ended 2005 and 2006, the Port of the Americas Authority, currently a unit of the Puerto Rico Infrastructure Financing Authority, entered into bond purchase agreements with GDB, whereby GDB agreed to disburse to the Port of the Americas Authority from time to time certain bond principal advances up to a maximum aggregate principal amount of \$70 million (Port of the Americas Authority 2005 Series A Bond), \$40 million (Port of the Americas Authority 2005 Series B Bond) and \$140 million (Port of the Americas Authority 2005 Series C Bond). The proceeds of the bonds are to be used to finance the cost of development and construction of the Port of the Americas. The aggregate unpaid principal balance of all outstanding bond principal advances shall be payable in full on January 1, 2015. The principal amount may be paid with any of the following: a long-term bond issuance once the projects is completed, other revenue of the Port of the Americas Authority or legislative appropriations as established in Act 409 of September 22, 2004 (Act No. 409). Principal and interests payments are guaranteed by the Commonwealth of Puerto Rico by Act No. 409. As of June 30, 2006, the principal outstanding under those bond purchase agreements amounted to \$23.8 million.

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(b) *Appropriation Debt*

At June 30, 2006, the outstanding balances of debt payable by Commonwealth appropriations, which are included in the individual financial statements of the following discretely presented component units, are as follows (expressed in thousands):

Puerto Rico Aqueduct and Sewer Authority	\$	1,213,449
Special Communities Perpetual Trust		425,107
Puerto Rico Land Administration		163,335
Puerto Rico Convention Center District Authority		154,846
Puerto Rico Tourism Company		126,527
Puerto Rico Housing Finance Authority (as a blended component unit of GDB)		119,489
Puerto Rico Solid Waste Authority		97,127
Agricultural Services and Development Administration		62,578
Puerto Rico Industrial Development Company		43,403
Puerto Rico Electric Power Authority		41,708
Institute of Puerto Rican Culture		21,341
Puerto Rico Infrastructure Financing Authority		14,743
Government Development Bank for Puerto Rico		10,244
University of Puerto Rico		8,212
National Parks Company of Puerto Rico		6,831
Other Governmental entities		3,473
Total	\$	<u>2,512,413</u>

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(16) Conduit Debt Obligations and No-Commitment Debt

From time to time, certain of the Commonwealth's component units issue revenue bonds to provide financial assistance to private-sector entities for the acquisition and construction of transportation, environmental, industrial, tourism, educational, and commercial facilities, deemed to be in the public interest and that are expected to provide benefits to Puerto Rico. These bonds are secured by the property financed and are payable solely from payments received on the underlying mortgage loans. Upon repayment of the bonds, ownership of the acquired facilities is retained by the private-sector entity served by the bond issuance. Neither the Commonwealth nor any political subdivision or component unit thereof is obligated in any manner for the repayment of the bonds. Accordingly, the bonds are not reported as liabilities in the basic financial statements of the issuing entities. As of June 30, 2006, conduit debt obligations consisted of the following bonds issued by component units (expressed in thousands):

<u>Issuing entity</u>	<u>Issued since inception to date</u>	<u>Amount outstanding</u>
Discretely presented component units:		
Puerto Rico Ports Authority	\$ 155,410	155,410
Puerto Rico Highway and Transportation Authority	\$ 270,000	155,369
Government Development Bank for Puerto Rico	\$ 663,000	641,000
Puerto Rico Industrial, Tourist, Educational, Medical, and Environmental Control Facilities Financing Authority	\$ 5,973,000	1,677,000

(a) Puerto Rico Ports Authority (PRPA)

PRPA issued Special Facilities Revenue Bonds under the provisions of two trust agreements between PRPA and a private bank. The proceeds from the sale of the bonds were used to finance the construction, acquisition of equipment, and improvement of certain facilities at Luis Munoz Marin International Airport, for the benefit of a major private airline. The property is owned by PRPA and leased to the private company. Pursuant to the agreements between PRPA and the private company, the bonds will be paid from the rent collected from the airline in amounts sufficient to pay principal, premium (if any), and interest on the bonds. The airline has guaranteed these payments.

(b) Puerto Rico Highways and Transportation Authority (PRHTA)

In March 1992, PRHTA issued Special Facility Revenue Bonds for approximately \$117 million for the construction of a toll bridge. The proceeds from the sale of these bonds were transferred by PRHTA to a private entity, Autopistas de Puerto Rico (Autopistas), pursuant to a signed agreement for the construction, transfer, and operation of the bridge. On October 2003, the PRHTA issued Special Facility Revenue Refunding Bonds, 2004 Series A amounting to approximately \$153 million for the purpose of refunding the Authority's Special Facility Revenue Bonds, 1992 Series A, B, and C, which were issued to fund the construction of the Bridge, and to pay the cost of issuance of the bonds. The bonds shall be paid from the proceeds received by Autopistas from the operation of the bridge.

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Under certain circumstances, the concession agreement may be terminated and the Authority is then obligated to assume all of the Autopista's obligation to pay principal of and interest, which pursuant to the signed agreement will be paid from the net revenues of the use and operation of the Bridge. The Authority does not currently expect the concession agreement to terminate. The outstanding bonds (including accrued interest) at June 30, 2006 amounted to approximately \$155.4 million.

(c) GDB

The GDB, through its Housing Finance Authority, issued \$663 million in Capital Fund Program Bonds Series 2003 to Fund PHA in its financing of improvements to various public low and moderate-income housing projects. Certain of the obligations issued are considered no-commitment debt and are excluded, along with the related assets held in trust, from the accompanying basic financial statements. These bonds are limited obligations of the Housing Finance Authority, which will be paid solely from an annual allocation of Public housing capital funds when received from the U.S. Department of Housing and Urban Development, accordingly, these bonds are considered no-commitment debt. The outstanding balance of these bonds amounted to \$641 million at June 30, 2006.

(d) AFICA

The revenue bonds of AFICA are used to finance facilities for environmental control, development of industrial and commercial companies, tourism projects, hospitals, and educational facilities. Pursuant to the loan agreements, the proceeds from the sales were borrowed by corporations and partnerships operating in Puerto Rico. The bonds are limited obligations of AFICA and, except to the extent payable from bond proceeds and investment thereof, will be payable solely from and secured by a pledge and assignment of the amounts payable under the loan agreements between AFICA and each borrower. Furthermore, payment of the principal and interest on the revenue bonds is unconditionally guaranteed by each of the borrowers, their parent companies, or letters of credit from major U.S. banks or U.S. branches of international banks.

(17) Risk Management

The risk management program of the Commonwealth and most of its discretely component units are described in note 1(y). The following describes the risk management programs separately administered by certain discretely presented component units.

(a) UPR

The UPR is exposed to various risks of loss related to torts; theft of, damage to, and destruction of assets; errors and omissions; injuries to employees; and natural disasters. The UPR carries commercial insurance for these risks of loss. Settled claims resulting from these risks have not exceeded commercial insurance coverage in any of the past three fiscal years.

Under Act No. 98 of August 24, 1994, the responsibility of UPR on medical malpractice claims is limited to a maximum amount of \$75,000 per person, or \$150,000 if it involves actions for damages to more than one person or where a single injured party is entitled to several causes of action. Self-insured risks liabilities are reported when it is probable that a loss has occurred and the amount of the loss can be reasonably estimated. Liabilities include an amount for claims that have been

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incurred but not reported. Because actual claims liabilities depend on such complex factors as inflation, changes in legal doctrines, and damage awards, the process used in computing claim liabilities does not necessarily result in an exact amount. Claim liabilities are reevaluated periodically to take into consideration recently settled claims, the frequency of claims, and other economic and social factors.

Changes in the claim liabilities amount for the two most recent fiscal years were as follows (expressed in thousands):

	<u>2006</u>	<u>2005</u>
Claims payable at beginning of year	\$ 20,260	13,598
Incurred claims and changes in estimates	27,378	27,299
Net payments for claims and adjustment expenses	<u>(29,306)</u>	<u>(20,637)</u>
Claims payable at end of year	<u>\$ 18,332</u>	<u>20,260</u>

Claims payable are reported as accounts payable and accrued liabilities in the accompanying statement of net assets.

(b) **PREPA**

PREPA is exposed to various risks of losses related to torts; thefts of, damage to, and destruction of assets; errors and omissions; injuries to employees; and natural disasters. PREPA obtains insurance policies covering all-risk property (excluding transmission and distribution lines), boiler and machinery, and public liability. The all-risk property and boiler and machinery policies have a combined coverage of \$650 million per occurrence. The policies' self-retention in case of earthquake and windstorm losses is \$25 million and \$2 million for all other covered risks. The public general liability policy covers property damage and bodily injury to third parties with a \$75 million aggregate limit in excess of the self-retention limit of a \$1 million occurrence.

In addition, PREPA is self-insured for damage to its transmission and distribution lines. Transmission and distribution lines amounted to approximately \$3.4 billion at June 30, 2006. PREPA's self-insurance fund provides for its self-insurance risk. This fund represents principally net assets and restricted assets set aside for self-insurance amounting to approximately \$65.1 million as of June 30, 2006.

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PREPA has a cost plus health insurance program covering substantially all its employees. PREPA contracted an administrator for the processing, approval, and payment of claims at cost plus an administrative fee. The accrual includes claims processed and an estimate for claims incurred but not reported. Changes in the balances of the health insurance program and other self-insurance risks for the two most recent fiscal years were as follows (expressed in thousands):

	<u>2006</u>	<u>2005</u>
Claims payable at beginning of year	\$ 32,603	31,640
Incurred claims	130,755	127,207
Claim payments	<u>(119,306)</u>	<u>(126,244)</u>
Claims payable at end of year	<u>\$ 44,052</u>	<u>32,603</u>

Claims payable is reported as accounts payable and accrued liabilities in the accompanying statement of net assets.

(c) **PRASA**

PRASA is exposed to various risk losses related to torts; thefts of, damage to, and destruction of assets; errors and omissions; injuries to employees; and natural disasters. Under the property insurance program, PRASA has \$300 million blanket insurance on all real and personal property. The deductible for windstorm and flood is 2%, and 5% for earthquake with a maximum amount of \$7.5 million and \$3 million for flood. For property in transit, the deductible is \$150,000 per occurrence. This policy has a general limit of \$10 million per occurrence.

The comprehensive general liability and automobile liability have basic limits of \$2 million and the umbrella is \$20 million in excess of \$3 million, per occurrence. Also, there is an excess of loss coverage of \$45 million for losses in excess of \$28 million. In the past three years, PRASA has not settled claims in excess of insurance coverage.

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(d) SIFC

SIFC provides workers' compensation insurance to public and private employees. This insurance covers workers against injuries, disability, or death because of work or employment-related accidents, or because illness is suffered as a consequence of their employment. SIFC establishes liabilities for estimated incurred but unpaid benefits and benefit adjustment expenses based on the ultimate cost of settling the benefits. The following table provides a reconciliation of the beginning and ending liability for incurred but unpaid benefits and benefit adjustment expenses for the two most recent fiscal years (expressed in thousands):

	<u>2006</u>	<u>2005</u>
Liability for incurred but unpaid benefits and benefit adjustment expenses at beginning of year	\$ 733,762	772,827
Total incurred benefits	380,629	403,866
Total benefit payments	<u>(417,469)</u>	<u>(442,931)</u>
Liability for incurred but unpaid benefits and benefit adjustment expenses at end of year	\$ <u>696,922</u>	<u>733,762</u>

The liability for incurred but unpaid benefits and benefit adjustment expenses is reported as liabilities for automobile accident insurance and workmen compensation claims in the accompanying statement of net assets.

The liability for compensation benefits is based on historical claims experience data, assumptions and projections as to future events, including claims frequency, severity, persistency, and inflationary trends determined by an independent actuary. The actuarial study also included estimates for medical benefits, benefit adjustment expenses, and reimbursement of premiums. The assumptions used in estimating and establishing the liabilities are reviewed annually based on current circumstances and any adjustments resulting thereof are reflected in operations in the current period.

(e) AACA

AACA operates a system of compulsory insurance for vehicles licensed to be used on public roads and highways in Puerto Rico. This insurance covers death and bodily injuries caused by automobile accidents. The annual premium is \$35 per motor vehicle.

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The following table provides a reconciliation of the beginning and ending liability for the future benefits for the two most recent fiscal years (expressed in thousands):

	<u>2006</u>	<u>2005</u>
Liability for incurred but unpaid benefits and benefit adjustment expenses at beginning of year	\$ 107,817	109,845
Total incurred benefits	64,835	58,524
Total benefit payments	<u>(58,264)</u>	<u>(60,552)</u>
Liability for incurred but unpaid benefits and benefit adjustment expenses at end of year	<u>\$ 114,388</u>	<u>107,817</u>

The liability for future benefits is reported as liability for automobile accident insurance and workmen compensation claims in the accompanying statement of net assets. AACA has recorded this liability, including administrative expenses for claim processing, based on the results of actuarial reports prepared by independent actuaries, determined under two different methods. Death, funeral, disability, dismemberment, and the basic medical hospitalization liabilities were determined using a triangulation method. The extended benefits medical hospitalization reserve uses a regression methodology to predict the ultimate incurred claims for each incurred calendar quarter. Additionally, assumptions are made about the mortality rates of the extended benefit claimants, recognizing the impact of their traumatic injuries on life span.

Changes in the ultimate liabilities for benefit payments may be required as information develops which varies from experience, provides additional data, or, in some cases, augments data, which previously were not considered sufficient for use in determining the claim liabilities.

(18) Commitments and Contingencies

Primary Government

The Commonwealth is a defendant in numerous legal proceedings pertaining to matters incidental to the performance of routine governmental operations. Under Act No. 104 of June 25, 1955, as amended, persons are authorized to sue the Commonwealth only for causes of actions set forth in said act to a maximum amount of \$75,000 or \$150,000 if it involves actions for damages to more than one person or where a single injured party is entitled to several causes of action. Under certain circumstances, as provided in Act No. 9 of November 26, 1975, as amended, the Commonwealth may provide its officers and employees with legal representation, as well as assume the payment of any judgment that may be entered against them. There is no limitation on the payment of such judgments.

With respect to pending and threatened litigation, excluding the litigation mentioned in the following paragraphs, the Commonwealth reported approximately \$306 million as an amount to cover for awarded and anticipated unfavorable judgments at June 30, 2006. This amount was included as other long-term liabilities in the accompanying statement of net assets, and represents the amount estimated as probable liability or a liability with a fixed or expected due date that will require future available financial resources for its payment. The amounts claimed exceed \$9 billion; however, the ultimate liability cannot be presently

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determined. It is the opinion of management that the claims are excessive and exaggerated. Management believes that the ultimate liability in excess of amounts provided, if any, would not be significant.

The Commonwealth is also a defendant in a lawsuit filed in a local district court by an association of primary care health centers seeking to recover from the Commonwealth \$800 million of Medicaid funds retained by the Department of Health of the Commonwealth since 1997. In June 2004, the First Circuit Court of San Juan determined that the Commonwealth must return these funds. The Commonwealth appealed this decision. As of June 30, 2006, the Commonwealth accrued \$55 million for this legal contingency.

The Commonwealth is a defendant in a class action presented by parents of special education students in the areas of education and health care. In October 2006, the San Juan Court of Appeals decided in favor of the parents' request to include damage claims pursuant to the same class action case although not as a remedy in the class action per se. The court now may award damages to the members of the class action and to do so it may look at the claims by dividing them into groups or consider each case individually. This will require that the parents prove the damages suffered. The Commonwealth plans to defend vigorously each individual case. As of June 30, 2006, the Commonwealth accrued \$440 million for this legal contingency.

The Commonwealth receives financial assistance from the federal government in the form of grants and entitlements. Receipt of grants is generally conditioned upon compliance with terms and conditions of the grant agreements and applicable federal law and regulations, including the expenditure of resources for eligible purposes. Substantially all grants are subject to audit under Circular A-133 of the Office of Management and Budget of the United States of America (OMB Circular A-133), all of which are performed at the individual agency level. Disallowance as a result of these audits may become liabilities of the Commonwealth. At June 30, 2006, based on an evaluation of pending federal disallowances, the Commonwealth has recorded approximately \$53 million as other long-term liabilities in the accompanying statement of net assets. Expenditures that are still subject to audit could be disallowed but management believes any such future disallowances would not be material to the basic financial statements.

Construction commitments at June 30, 2006, entered by PBA, amounted to approximately \$274 million. In addition, the Commonwealth's construction commitments for public housing facilities amounted to approximately \$239 million at June 30, 2006.

On November 23, 1998, a global settlement agreement (the Agreement) was entered into by and between certain tobacco companies and certain states, territories, and other jurisdictions of the United States of America, including the Commonwealth. The Agreement calls for annual payments through the year 2025, which will vary due to inflationary and volume adjustments. After 2025, the tobacco companies are to continue making contributions in perpetuity. Pursuant to Act No. 173 of July 30, 1999, which created the Children's Trust (a blended component unit), the Commonwealth assigned and transferred to The Children's Trust all payments that the Commonwealth is entitled to receive under the Agreement. Payments received under the Agreement and recognized as revenue during the year ended June 30, 2006, amounted to approximately \$65.6 million.

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Following is a summary of estimated payments to be received by The Children's Trust through the year ending June 30, 2025 (expressed in thousands):

Year ending June 30:		
2007	\$	92,634
2008		94,017
2009		95,624
2010		96,626
2011		97,500
2012-2016		487,500
2017-2021		487,500
2022-2025		381,106
Total	\$	<u>1,832,507</u>

At June 30, 2006, The Children's Trust, a blended component unit of the Commonwealth, had approved commitments to provide assistance to several entities through 85 contracts with balances amounting to approximately \$104 million.

Discretely Presented Component Units

In the normal course of their operations, the various component units are subject to guarantees, actions brought by third parties seeking damages or entering into commitments. Such actions are disclosed in the separately issued reports of the component units, some of which are summarized below:

(a) GDB

At June 30, 2006, GDB has financial guarantees for public entities for approximately \$125 million and for private sector of approximately \$29 million. In addition, stand by-letters of credit to public entities were approximately \$113 million and to private sector were approximately \$126 million. Commitments to extend credit to public entities were approximately \$3.5 billion and to private sector were approximately \$22 million.

GDB enters into sales of securities under agreements to repurchase. These agreements generally represent short-term debts and are presented as a liability in the statement of net assets. The securities underlying these agreements are usually held by the broker, or its agent, with whom the agreement is transacted. As of June 30, 2006, there were agreements outstanding for \$515 million and during the year the average amount outstanding was approximately \$508 million, the maximum amount outstanding at any month-end was approximately \$610 million, and the weighted average interest rate for the year and at year-end was approximately 4.01% and 4.69%, respectively.

GDB issues commercial paper in the U.S. taxable and tax-exempt commercial paper markets, the Eurodollar commercial paper market, and to corporations that have tax exemption under the Commonwealth's Industrial Incentives Act. Commercial paper represents unsecured obligations of GDB. The carrying amount of commercial paper at June 30, 2006 was approximately \$1.2 billion.

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At June 30, 2006, GDB had outstanding interest rate swap agreements with other financial institutions in the aggregate notional amounts of \$1.3 billion, having a fair value (payable position) of approximately \$39 million. GDB is exposed to credit loss in the event of nonperformance by the other parties to swap agreements. However, GDB does not anticipate nonperformance by counterparties.

On August 6, 2003, GDB initiated foreclosure on the mortgage note it holds as collateral for the guarantee on the AFICA Cayo Largo bonds. The indenture of the bonds requires the repayment of the bonds before the execution of the mortgage note. Therefore, in order to execute the mortgage note, GDB called the outstanding balance of the bonds. Said bonds amounted to \$75.6 million. Resulting from the above-mentioned foreclosure proceedings, several of the principals of the Cayo Largo Hotel development (Cayo Largo Resort Associates, Cayo Largo Hotel, and D. Group Equity Holdings) have counterclaimed by filing complaints for alleged damages and breach of contract by GDB aggregating to approximately \$210 million. In addition, United States Fidelity and Guaranty Company (the Insurer) has filed an action to obtain a declaration that it is not bound to perform under the performance and payment bond executed in connection with the constructions and development of the project. Management believes that the ultimate outcome of all the counterclaims and other actions will not be material.

(b) PRHTA

PRHTA has entered into a System and Test Track Turnkey Contract (STTT Contract) with Siemens Transportation Partnership Puerto Rico, S.E., Juan R. Requena y Asociados, and Alternate Concepts, Inc. for the purpose of operating and maintaining the urban train system known as "Tren Urbano". The STTT Contract became effective during 2005 upon the execution of the contract for an initial term of five years with an option by PRHTA to extend the term for an additional five years. The compensation is based on a schedule included in the master agreement which approximates \$4 million on a monthly basis. The total estimated annual operation and maintenance cost including cost of insurance and electricity for the first year of operations is approximately \$40.5 million.

During 2001, a number of contractors presented claims related to the PRHTA's Urban Train project. These contractors' claims, which are at various stages of analysis to reach a final resolution, amount to \$289 million. From this amount, \$166 million has been categorized as merited claims and most of it settled. The outstanding balance of this claim at June 30, 2006 amounted to \$3.1 million, which has been accrued in the accompanying statement of net assets.

In connection with the responsibilities of the PRHTA for mass transportation systems, the Metrobus project was developed. The project consists of bus operations in part of the San Juan metropolitan area named Metrobus I, which operations are conducted by First Transit, a private company, under an agreement of \$2.8 million, which will expire on December 31, 2006. In addition, the project consists of bus operations between Bayamón and Stop 18 named Metrobus II, which operations are conducted by the Metropolitan Bus Authority (MBA), a public corporation, under a thirty-six month agreement of \$13.5 million, which expires on December 31, 2006.

On January 28, 2004, the PRHTA amended the MBA service contract for the purpose of adding certain additional routes to the mass transportation system. This service contract amounting to \$22.1 million with a term of thirty-six months expires on December 31, 2007.

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During 1995, MBA entered into a contract agreement with the PRHTA to operate and maintain one of Metrobus' routes from Río Piedras to Old San Juan, provide service for Paratransit and maintain the transfer stations. This contract is renewable every year with an increase of 6% over the last year contract amount. The total amount of this contract is approximately \$1 million and expires on June 30, 2007.

(c) **PREPA**

In May 1998, the Municipality of Ponce filed a complaint against PREPA in the San Juan Superior Court requesting the payment by PREPA of the full contributions in lieu of taxes (CLT) and electric energy sales set aside in prior fiscal years. The complaint challenges the application of the "Net Revenues" used by PREPA in making deposits to certain funds required under the 1974 Bond Indenture Agreement and under a prior trust indenture (now terminated) for the purposes of paying costs of capital improvements. The Municipality of Ponce seeks a payment from PREPA in the amount by which the amount available to pay contributions in lieu of taxes and electric sales set aside to the Municipality of Ponce has been reduced as a result of such application. PREPA understands that the enabling act which created PREPA (the Act) provides that the contributions in lieu of taxes and electric energy sales set aside are only payable after complying with PREPA's deposit obligations under the 1974 Agreement and the prior indenture and that short falls do not carry forward as future liabilities of PREPA as described above.

On April 14, 2003, PREPA made a settlement offer consisting of a payment in cash of \$68 million and \$57 million for electric infrastructure projects in the municipalities. As part of the settlement agreement, the municipalities supported an amendment to the Act that was proposed by PREPA, that the amount payable to municipalities be calculated based on a percentage of the net revenues defined on the 1974 Bond Indenture Agreement. Prior to fiscal year 2005, 76 of the 78 municipalities of Puerto Rico had accepted the settlement receiving an aggregate amount of \$63.6 million. During fiscal year 2005, the remaining two municipalities accepted the settlement offer, receiving \$4.4 million. The settlement required PREPA to submit legislation to change the CLT calculation. The new law signed in August 2004 included a transition clause regarding the \$68 million payment, stating that this amount was a special CLT that the accepting municipalities would receive with financing provided by GDB. The debt to GDB is guaranteed with the CLT. In connection with the same litigation, GDB approved a line of credit of \$57 million, for electric infrastructure projects on municipalities. As of June 30, 2006, PREPA has drawn \$34.9 million.

In October 1994, PREPA signed a contract with AES Puerto Rico, L.P. (AES) to purchase power of approximately 454 megawatts generated from a coal fluidized bed combustion facility. The term of the agreement is for 25 years. This project commenced operations in November 2002. In March 1995, PREPA also signed a contract with EcoElectrica, L.P. (EcoElectrica) to purchase power of approximately 507 megawatts from a gas-fired combined cycle power plant. The term of the agreement is for 22 years. This project has been in operation since 2000.

In June 2004, the Office of the Comptroller of the Commonwealth of Puerto Rico issued a report stating that PREPA overcharged its clients by approximately \$49.8 million and should reimburse this amount to such clients. After this report was made public, two lawsuits were filed by customers of

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PREPA demanding the reimbursement of such alleged overcharges. PREPA denies that any overcharges have been made.

(d) PRIFA

The law that created PRIFA (as amended) requires that the first \$70 million up to fiscal year 2006, and the first \$90 million in each fiscal year thereafter through 2052, of federal excise taxes received by the Commonwealth be transferred to PRIFA for deposit to PRIFA's infrastructure fund (the Infrastructure Fund). Federal excise taxes consist of taxes received by the Commonwealth from the United States in connection with rum and other articles produced in Puerto Rico and sold in the United States that are subject to federal excise tax.

A related trust agreement requires PRIFA to deposit to the credit of a sinking fund the federal excise taxes and other moneys deposited to the credit of the Infrastructure Fund in such amounts as are required to meet debt service requirements with respect to the bonds. Rum is the only article currently produced in Puerto Rico subject to federal excise tax, the proceeds of which are required to be transferred from the federal government to the Commonwealth.

The federal excise taxes securing the bonds are subject to a number of factors, including the continued imposition and remittance of such taxes to the Commonwealth and conditions affecting the Puerto Rico rum industry. If the federal excise taxes received by the Commonwealth in any fiscal year are insufficient to deposit the amount required by the law into the Infrastructure Fund, the law that enacted PRIFA requires that PRIFA request and the director of the OMB include in the annual budget of the Commonwealth for the corresponding fiscal year an appropriation necessary to cover such deficiency. The Commonwealth's Legislature, however, is not legally obligated to make the necessary appropriation to cover such deficiency.

(e) PRTA

PRTA, through its subsidiary PRTA Holdings, holds shares of Telecomunicaciones de Puerto Rico, Inc. (TELPRI). TELPRI is the Puerto Rico corporation that was organized for the purpose of acquiring the stock of Puerto Rico Telephone Company (PRTC) and Celulares Telefonica (CT) from PRTA in connection with the sale transaction of March 2, 1999, where a subsidiary of Verizon, Popular, Inc., and TELPRI's employee stock ownership plan acquired 57% of TELPRI and completed the privatization of PRTC and CT. It is contemplated that all shares of TELPRI held by PRTA Holdings will be sold in public offerings and private placements, and all dividends and proceeds received from the sale of the shares will be distributed to the ERS. The PRTA's 43% investment in TELPRI was carried on the equity method of accounting through December 28, 2000. Although the ownership of the common stock of PRTA Holdings entitles PRTA to the voting right over TELPRI shares, no carrying value is recorded for its investment after the transfer of PRTA Holdings preferred stock to the Retirement System on December 28, 2000, since such preferred stock entitles the Retirement System to all the economic benefits of the investments in TELPRI.

Verizon delivered a notice of claim for indemnity to PRTA related to certain alleged actions of PRTA that occurred before the closing of the sale transaction described above. The amount of indemnity sought by Verizon is approximately \$105 million, related to several matters including PRTC's exposure to a potential reduction in tariffs or required rebate to clients as a result of an

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adverse decision by the Federal Communications Commission (FCC) on a regulatory matter. The FCC's decision has been appealed by PRTC and the FCC denied such request. In June 2000, PRTA requested Verizon to provide additional information that would enable it to evaluate the merit of claims made; however, the additional information has not been submitted. Additionally, in connection with the privatization, the PRTA agreed to indemnify, defend, and hold TELPRI harmless for specified litigation in excess of \$50 million in the aggregate.

Management believes that the final resolution of the legal cases will not have a material adverse effect on the financial position and results of operations of PRTA.

(f) PCSDIPRC

PCSDIPRC provides insurance coverage over the stocks and deposits of all the cooperatives and the Federation of Cooperatives of Puerto Rico. The deposit base of the cooperatives approximates \$5.9 billion at June 30, 2006.

(g) LAPR

At year-end, LAPR had approximately \$28.5 million in accruals to cover the estimated costs related to the liquidation of the Sugar Corporation of Puerto Rico, a blended component unit of LAPR, including, among others: employee severance, pending legal cases, environmental clean up costs, refinery repair costs, and estimated future losses to be incurred. Management believes these accruals to be sufficient; however, given the many uncertainties involved, the ultimate outcome cannot be determined with certainty at this time and the actual liquidation costs could be higher or lower than the estimates made. LAPR is also a defendant in various claims amounting to approximately \$161 million. LAPR is in the process of litigating such claims and the ultimate liability, if any, cannot be presently determined.

Fiduciary Component Unit

ERS enters into sales of securities under agreements to repurchase. These agreements generally represent short-term debts and are presented as a liability in the statement of net assets. The securities underlying these agreements are usually held by the broker, or its agent, with whom the agreement is transacted. As of June 30, 2006, there were agreements outstanding for \$139 million and the weighted average interest rate at year-end was 5.07%.

Environmental Commitments and Contingencies

The following component units' operations include activities that are subject to state and federal environmental regulations:

- **PREPA** – Facilities and operations of PREPA are subject to regulations under numerous federal and Commonwealth environmental laws, including the Clean Air Act, Clean Water Act, and the National Pollutant Discharge Elimination System (NPDES). In February 1992, the U.S. Environmental Protection Agency (EPA) performed an inspection of various facilities of PREPA and became aware of deficiencies in different areas, principally air opacity; water quality; spill prevention control and countermeasures; and underground storage tanks. As a result, PREPA agreed to, among other things,

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make certain capital improvements, undertake supplemental environment project (SEPs), and use fuel oil not exceeding certain predetermined levels of sulfur, vanadium, and asphalt in its content.

- **PRASA** – Facilities and operations of PRASA’s water and sewer system are subject to regulation under numerous federal and Commonwealth environmental laws. Under agreements with the federal government, acting on behalf of EPA, PRASA and the Commonwealth are subject to consent decrees to enforce compliance with environmental laws. During the year ended June 30, 2006, noncompliance penalties amounted to \$18.4 million. In addition, PRASA has committed to perform environmental projects, in lieu of penalties, in the amount of \$120 million as of June 30, 2006.
- **PRSWA** – Is currently involved in the implementation and development of the Infrastructure Regional Plan for Recycling and Disposal of Solid Waste in Puerto Rico. As of June 30, 2006, PRSWA has no insurance coverage for environmental risks and management believes that, at this time, there is no sufficient information available to determine the potential amount of related losses, if any, and no provision for losses has been made in the PRSWA’s financial statements. Nevertheless, preventive infrastructure has been constructed and operational plans have been developed to minimize any possible impact or events that could occur.
- **PRIDCO** – Financial responsibility for cleanup costs has been and/or is being undertaken by the industrial potential responsible parties (PRPs) at the two Comprehensive Environmental Response Compensation and Liability Act of 1980 (CERCLA) sites (Vega Alta and Guayama), where the federal government named PRIDCO as a PRP solely for being a part owner of both sites. PRIDCO’s participation in the site remediation efforts to date has been limited to providing in-kind support to the industrial PRP’s implementation of the cleanup programs and, consequently, has not involved any cash disbursements to the federal government or the industrial PRP groups. Under CERCLA and its regulations, liability for the cleanup costs and damage to natural resources and any assessment of health effects may be imposed on the present and past owners or operators of a facility from which there was a release of hazardous substances. In addition, any person who arranged for the disposal or treatment of hazardous substances at a site from which there was a release may also be liable.

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Construction Commitments

As of June 30, 2006, the following component units maintained various unspent construction agreements as follows (expressed in thousands):

Puerto Rico Highways and Transportation Authority	\$	747,559
Special Communities Perpetual Trust		511,670
Puerto Rico Aqueduct and Sewer Authority		393,000
Puerto Rico Electric Power Authority		350,000
Puerto Rico Infrastructure Financing Authority		230,800
University of Puerto Rico		144,409
Puerto Rico Ports Authority		125,903
Puerto Rico Solid Waste		110,722
Puerto Rico Industrial Development Company		57,047
Puerto Rico Medical Service Administration		14,717
Puerto Rico Conservatory of Music Corporation		11,400
Puerto Rico Convention Center District Authority		5,733
Fine Arts Center Corporation		712
Cardiovascular Center Corporation Puerto Rico and the Caribbean		567
Institutional Trust of National Guard		149
Total	\$	<u>2,704,388</u>

(19) Retirements Systems

The Commonwealth sponsors three contributory pension plans (collectively known as the Retirement Systems), which are reported in the accompanying statement of fiduciary net assets:

- Employees' Retirement System of the Government of Puerto Rico and its Instrumentalities
- The Puerto Rico Judiciary Retirement System
- Puerto Rico System of Annuities and Pensions for Teachers

Each system is independent; thus their assets or liabilities may not be transferred from one system to another or used for any purpose other than to benefit the participants of each system.

The Retirement Systems issue financial reports, which are publicly available and include the basic financial statements, the required trend information, and any other required supplementary information. These reports may be obtained by written request to the corresponding retirement system administrator at the addresses detailed in note 1 of each retirement system's basic financial statements.

(a) ERS

Plan Description

The System is a cost-sharing multiemployer defined-benefit plan sponsored by the Commonwealth. ERS was created under Act No. 447 (the Act), approved on May 15, 1951, as amended, and became effective on January 1, 1952. ERS covers substantially all full-time employees of: (1) the

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Commonwealth's primary government and (2) certain municipalities of Puerto Rico and certain component units of the Commonwealth not having their own retirement systems. Appointed and temporary Commonwealth employees become plan members upon their date of employment. Plan members are eligible for a retirement annuity upon reaching the following age:

<u>Police and firemen</u>	<u>Other employees</u>
50 with 25 years of credited services	55 with 25 years of credited services
58 with 10 years of credited services	58 with 10 years of credited services

Plan members are eligible for merit annuity with a minimum of 30 years or more of credited service.

On the coordinated plan, a participating employee contributes 5.775% of the monthly salary for the first \$550 and 8.275% for the excess over \$550. By the time the employee reaches 65 years of age and begins to receive Social Security benefits, the pension benefits are reduced by the following:

- \$165 per month if retired with 55 years of age and 30 years of credited service
- \$110 per month if retired with less than 55 years of age and 30 years of credited service
- All other between \$82 and \$100 per month
- Disability annuities under the coordinated plan are also adjusted at age 65 and in some cases are reduced over \$165 per month.

On the noncoordinated plan, the participating employee contributes 8.275% of the monthly salary and does not have any change on the pension benefits upon receipt of Social Security benefits.

Death benefits are divided into occupational, nonoccupational, and postretirement. Under the occupational benefits, a surviving spouse may receive an annuity equal to 50% of the participating employee's salary at the date of death and each child may receive \$10 per month for minor, or student, up to a maximum benefit per family of 100% of the participating employee's salary at the date of death. If no spouse survives, or dies while receiving the annuity payments, each child, 18 or under, is eligible to receive an annuity of \$20 per month up to the attainment of 18 years of age or the completion of his/her studies. Under the nonoccupational benefits, the contributions and interest accumulated as of the date of the death plus an amount equal to the annual compensation at the time of death are paid. Under the postretirement benefit, the beneficiary with a surviving spouse and child 18 or under receive up to 50% (60%, if not covered under Title II of the Social Security Act) of the retiree's pension or otherwise the excess, if any, of the accumulated contributions at the time of retirement over the total annuity benefits received before death, limited to a minimum of \$750.

On September 24, 1999, an amendment to the Act, which created ERS, was enacted to establish a defined-contribution plan known as System 2000.

System 2000 became effective on January 1, 2000. Employees participating in the defined-benefit plan system at December 31, 1999, had the option to either stay in the defined-benefit plan or transfer to System 2000. Persons employed on or after January 1, 2000, are only allowed to become members of System 2000.

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System 2000 is a hybrid defined-contribution plan, also known as a cash balance plan. Under this new plan, there will be a pool of plan assets, which will be invested by ERS, together with those of the defined-benefit plan. Benefits at retirement age will not be guaranteed by the Commonwealth. The annuity will be based on a formula which assumes that each year the participants' contributions (with a minimum of 8.275% of the participants' salary up to a maximum of 10%) will be invested as instructed by the participant in an account which will either: (1) earn a fixed rate based on the two-year Constant Maturity Treasury Notes; (2) earn a rate equal to 75% of the return of ERS's investment portfolio (net of management fees); or (3) earn a combination of both alternatives. Participants receive periodic account statements similar to those of defined-contribution plans showing their accrued balances. Disability pensions are not being granted under System 2000. The sponsors' contributions (9.275% of the participants' salary) will be used to fund the defined benefit plan.

System 2000 reduces the retirement age from 65 years to 60 for those employees who joined the original plan on or after January 1, 2000.

Funding Policy

Contribution requirements, which are established by law and are not actuarially determined, are as follows:

Commonwealth and other sponsors	9.275% of applicable payroll
Participants:	
Hired on or before March 31, 1990	5.775% of monthly gross salary up to \$550
	8.275% of monthly gross salary in excess of \$550
Hired on or after April 1, 1990	8.275% of monthly gross salary

(b) JRS

Plan Description

The JRS is a single-employer defined-benefit plan, which is also administered by the ERS. The system was created under Act No. 12, approved on October 19, 1954. Membership is made up of all judges of the Judiciary Branch of the Commonwealth.

The system provides retirement as well as death and disability benefits. Benefits vest after 10 years of service and upon reaching 60 years of age.

Retirement benefits are determined by the application of stipulated benefit ratios to the plan member's average compensation. Average compensation is computed based on the last month of compensation.

The retirement annuity, for which the plan participant is eligible, is limited to a minimum of 25% and a maximum of 75% of the average compensation, except for judges of the Supreme Court for whom the annuity is limited to a minimum of 50% and a maximum of 100% of the average compensation.

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Death benefits are divided into occupational, nonoccupational, and postretirement. Under the occupational benefits, a surviving spouse may receive an annuity equal to 50% of the participating employee's salary at the date of death and each child may receive \$10 per month for each child, minor, or student, up to a maximum benefit per family of 75% of the participating employee's salary at the date of death. If no spouse survives or dies while receiving the annuity payments, each child, 18 or under, is eligible to receive an annuity of \$20 per month up to the attainment of 18 years of age or the completion of his/her studies. Under the nonoccupational benefits, the contributions and interest accumulated as of the date of the death plus an amount equal to the annual compensation at the time of death is paid. Under the postretirement benefit, the beneficiary with surviving spouse age 60 or over and child 21 or under receive up to 60% of the retiree's pension or otherwise the excess, if any, of the accumulated contributions at the time of retirement over the total annuity benefits received before death, limited to a minimum of \$500.

During 1997, JRS enacted Act No. 177 which provides, effective January 1, 1999, for increases of 3%, every three years, of the pension benefits paid by JRS to those plan participants with three or more years of retirement.

Funding Policy

All participants are required to make contributions to the plan equal to 8% of the applicable payroll. The Commonwealth, as sponsor, must contribute 20% of the applicable payroll. Contributions are established by law and are not actuarially determined.

(c) TRS

Plan Description

The TRS is a single-employer defined-benefit plan sponsored by the Commonwealth. All active teachers of the Department of Education of the Commonwealth are covered by the system under the terms of Act No. 91 of March 29, 2004 that superseded Act No. 218 of 1951. Licensed teachers working in private schools may also participate in the system as long as the required employer and employee contributions are satisfied.

The plan provides retirement, death, and disability benefits. Benefits vest after completion of a given number of years of credited service based on age. Benefits are determined by the application of stipulated benefit ratios to the members' average compensation. Average compensation is computed based on the highest three years of compensation recognized by TRS.

The annuity for which a plan member is eligible is limited to a minimum of \$300 per month and a maximum of 75% of the average compensation.

Funding Policy

Effective January 27, 2000, participant contributions were increased to 9% of their compensation, as provided by Act No. 45 of 2000. The Commonwealth, as sponsor, matches the participants' contributions at a rate of 8.5% of the applicable payroll. Contribution rates are established by law and are not actuarially determined.

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Other relevant information on the Commonwealth's Retirement Systems is presented below (as of July 1, 2005, for JRS and ERS, and July 1, 2004 for TRS, for latest valuation date):

Membership

	<u>ERS</u>	<u>JRS</u>	<u>TRS</u>	<u>Total</u>
Retirees and beneficiaries currently receiving benefits	\$ 88,333	367	27,944	116,644
Current employees	<u>177,054</u>	<u>370</u>	<u>51,026</u>	<u>228,450</u>
Total	<u>\$ 265,387</u>	<u>737</u>	<u>78,970</u>	<u>345,094</u>

Annual Pension Cost and Net Pension Obligation (Asset)

The Commonwealth's annual pension cost and net pension obligation (asset) of the three pension plans for the year ended June 30, 2006, were as follows (expressed in thousands):

	<u>ERS</u>	<u>JRS</u>	<u>TRS</u>	<u>Total</u>
Annual required contributions	\$ 564,218	9,735	220,821	794,774
Interest on net pension obligation (asset)	332,802	(859)	40,037	371,980
Adjustment to annual required sponsors' contributions	<u>(262,137)</u>	<u>677</u>	<u>(39,409)</u>	<u>(300,869)</u>
Annual pension cost	634,883	9,553	221,449	865,885
Statutory sponsors' contributions made	<u>(415,056)</u>	<u>(6,727)</u>	<u>(180,265)</u>	<u>(602,048)</u>
Increase in net pension obligation	219,827	2,826	41,184	263,837
Net pension obligation (asset) at beginning of year	<u>3,915,316</u>	<u>(10,111)</u>	<u>564,479</u>	<u>4,469,684</u>
Net pension obligation (asset) at end of year	<u>\$ 4,135,143</u>	<u>(7,285)</u>	<u>605,663</u>	<u>4,733,521</u>

The net pension obligation for ERS and TRS, and the net pension asset of JRS of \$4,741 million and \$7 million, respectively, are recorded in the accompanying statement of net assets.

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The annual required contribution was determined by actuarial valuations for each of the pension plans as described below:

	<u>ERS</u>	<u>JRS</u>	<u>TRS</u>
Date of latest actuarial valuation	July 1, 2005	July 1, 2005	July 1, 2004
Actuarial-cost method	Projected unit credit cost	Projected unit credit cost	Entry age normal
Amortization method	Level percentage of the projected payroll	Level percentage of the projected payroll	Level percentage closed 5% payroll increase per year
Remaining amortization period	21 years	21 years	16 years
Amortization approach	Closed	Closed	Closed
	<u>ERS</u>	<u>JRS</u>	<u>TRS</u>
Asset-valuation method	Market value	Market value	Market value
Actuarial assumptions:			
Inflation	3.5%	3.5%	3.5%
Investment rate of return	8.5	8.5	8.5
Projected salary increases per annum	5.0	5.0	5.0
Cost-of-living adjustments	None	None	None

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Three-Year Trend Information

The three-year trend information is as follows (expressed in thousands):

	<u>ERS</u>	<u>JRS</u>	<u>TRS</u>
Annual pension cost (APC):			
Year ended June 30, 2006	\$ 634,882	9,553	221,449
Year ended June 30, 2005	652,252	8,380	221,449
Year ended June 30, 2004	652,252	8,380	219,168
Percentage of APC contributed:			
Year ended June 30, 2006	65.0%	70.0%	81.0%
Year ended June 30, 2005	60.0	77.0	82.0
Year ended June 30, 2004	53.0	66.0	69.00
Net pension obligation (asset):			
Year ended June 30, 2006	\$ 4,135,141	(7,285)	605,663
Year ended June 30, 2005	3,915,315	(10,111)	564,480
Year ended June 30, 2004	3,652,617	(12,021)	524,770

Schedule of Funding Progress (Required Supplementary Information – Unaudited)

Employees' Retirement System of the Government of Puerto Rico and its Instrumentalities (expressed in thousands):

<u>Actuarial valuation date</u>	<u>Actuarial value of assets</u>	<u>Actuarial accrued liability (AAL)</u>	<u>Unfunded AAL (UAAL)</u>	<u>Funded ratio</u>	<u>Covered payroll</u>	<u>UAAL as a percentage of covered payroll</u>
July 1, 2005	\$ 2,327,871	12,283,865	9,955,994	19%	\$ 4,125,866	241%
July 1, 2004	2,141,442	N/A	N/A	N/A	N/A	N/A
July 1, 2003	1,947,402	11,191,357	9,243,955	17	3,334,441	277

The Puerto Rico Judiciary Retirement System (expressed in thousands):

<u>Actuarial valuation date</u>	<u>Actuarial value of assets</u>	<u>AAL</u>	<u>UAAL</u>	<u>Funded ratio</u>	<u>Covered payroll</u>	<u>UAAL as a percentage of covered payroll</u>
July 1, 2005	\$ 69,797	174,454	104,657	40%	\$ 29,331	357%
July 1, 2004	67,851	N/A	N/A	N/A	N/A	N/A
July 1, 2003	61,781	166,732	104,951	37	25,711	408

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Puerto Rico System of Annuities and Pensions for Teachers (expressed in thousands):

Actuarial valuation date	Actuarial value of assets	AAL	UAAL	Funded ratio	Covered payroll	UAAL as a percentage of covered payroll
July 1, 2004	\$ 2,403,000	4,702,000	2,299,000	51%	\$ 1,294,000	178%
July 1, 2003	2,143,000	4,540,000	2,397,000	47	1,195,000	201
July 1, 2002	2,167,000	4,155,000	1,988,000	52	991,000	201

On August 12, 2000, Act No. 174 was approved to allow certain ERS participants to be eligible for early retirement upon attaining at least age 55 with 25 years of service, provided they made their election on or before April 1, 2001. Those who elected early retirement under this law will receive monthly benefits of 75% (if 25 or more years of service and age 55, or 30 or more years of service and age 50) or benefits of 65% (if 25 years of service by less than age 55) of their average compensation which is computed based on the highest 36 months of compensation recognized by ERS. In these cases, the sponsor is responsible for contributing to ERS amounts to cover the benefit payments and the sponsor contribution with respect to the participants covered until the participants reach the normal retirement age.

(20) Subsequent Events

Primary Government

In an effort to address the Commonwealth's structural budget imbalance, the Legislature enacted Act No. 117 of July 4, 2006 (Act 117), which amended the Puerto Rico Internal Revenue Code of 1994 to provide, among other things, for a general sales and use tax of 5.5% (the Sales Tax) to be imposed by the Commonwealth. The Act also eliminated the 5% general excise tax imposed on imported goods and the 3.6% general excise tax on goods manufactured in Puerto Rico, and provides certain income tax reductions to taxpayers. The Sales Tax went into effect on November 15, 2006. Act 117 also imposes other measures to address the structural budget imbalance, such as fiscal reform, government reorganization plan, and special income tax rates to certain transactions occurring during the first semester of fiscal year 2007.

In addition, on December 26, 2006 and July 6, 2007, Acts 291 and 56 were enacted to amend Act 91 of May 13, 2006 to create, among other things the Puerto Rico Sales Tax Financing Corporation known by its Spanish acronym "COFINA". This newly created component unit of GDB will have the capacity to issue bonds or other mechanisms to repay or refinance Commonwealth debt obligations payable to GDB with Commonwealth budgetary appropriations referred as extra-constitutional debt. Act 91 also created the Dedicated Sales Tax Fund known by its Spanish acronym FIA Fund, as a separate fund to be administered by GDB. The FIA Fund will generate revenues from collections of the first one percent of the sales tax or a minimum amount, as the defined by law, whichever is greater. Such revenues shall be used for, among other things, paying, refinancing, or restructuring the extra-constitutional debt of the Commonwealth that was outstanding at June 30, 2006. COFINA will administer the FIA Fund and will use the collections of the sales tax to repay or refinance the Commonwealth's extra-constitutional debt, including amounts due GDB and any obligations issued under any financing arrangement.

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On September 8, 2006, PBA executed a loan agreement with GDB for interim financing of its capital improvement program in an amount not to exceed \$223.6 million, bearing interest at 1.5% over the cost of the tax-exempt commercial paper issued by GDB

The board of directors of PBA decided to enter into two Swap transactions in order to fix the interest rates on bonds Series J and K to eliminate the risk of increase in interest rates. On August 8, 2006, the PBA entered into the first Swap transaction with the Bank of New York in the notional amounts of the \$89 million. The transaction's effective date and termination date is July 2027. The interest rate is a fixed rate of 3.77310%. On September 8, 2006, the PBA entered into another Swap transaction with the Royal Bank of Canada. The notional amount of this transaction was \$150 million, with a termination date of July 1, 2006 and a final rate of 3.63907%.

On May 22, 2007, Standard & Poor's Ratings Services lowered its long-term rating on the Commonwealth of Puerto Rico's General Obligation (GO) debt one notch to 'BBB-' from 'BBB', reflecting a long history of structural imbalance and the ongoing difficulties anticipated with further efforts to reduce the accrued deficit. The outlook is stable. Standard & Poor's noted that Puerto Rico's debt, which is already high, is likely to increase. Although a major new revenue source--a 5.5% sales tax--was added in the current fiscal year, balance remains difficult to achieve, requiring expense cuts and use of one-time revenue sources. Gap forecasts suggest that balance will not be achieved until 2010 and those forecasts are based on the expectation of flat expense growth.

Component Units

(a) GDB

Subsequent to June 30, 2006, the Public Finance Corporation, as a blended component unit of GDB, disbursed approximately \$303 million to pay the fiscal year 2007 debt service of its no-commitment debt on behalf of the Commonwealth. On October 4, 2006, the Department of Treasury and GDB, as administrator of the Dedicated Sales Tax Fund (known by its Spanish acronym as FIA Fund), entered into a memorandum of understanding whereby the FIA Fund agrees that the payment of principal of and interest on this advance will be paid from collections received by the FIA Fund.

On August 23, 2006, the Housing Finance Authority, another blended component unit of GDB, issued Mortgage-Backed Certificates, 2006 series A (the Certificates) amounting to \$166 million. The Certificates are collateralized by certain GNMA and FNMA certificates and mature at various dates through 2030. Proceeds from issuance of the Certificates will be used for the defeasance of certain outstanding debt of the Housing Finance Authority, to fund escrow accounts and reserves for the payment of principal and interest of Certificates, for the payment of related costs of issuance, bond defeasance costs and other expenses, and for general business purposes.

Standard & Poor's lower the GDB rating of 'BBB/A-2' to 'BBB-/A-3' (see more below).

As previously disclosed, on December 26, 2006 and July 6, 2007, Acts 291 and 56 were enacted to amend Act 91 which created, the Puerto Rico Sales Tax Financing Corporation (PRSTFC). The PRSTFC is a newly-created component unit of GDB created by Act 91 for the purpose of financing the payment, retirement or defeasance of the extra-constitutional debt outstanding as of June 30, 2006. Act 91 vested the PRSTFC with all the powers conferred on GDB under its charter (other than

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the power to act as fiscal agent), including the power to issue bonds for its corporate purposes, to the extent required in order for the PRSTFC to carry out the purpose for which was created. The PRSTFC is also known by its acronym in Spanish "COFINA". Act 91 provides that present and future collections of the pledge sales tax be transferred to the FIA Fund to pay, all or part of the extra-constitutional debt outstanding as of June 30, 2006 with the net proceeds of the bonds issued by PRSTFC and with other funds and resources available to the PRSTFC. Act 91 provides that the board of directors of PRSTFC shall consist of the members of the board of directors of GDB.

On July 17, 2007 the PRSTFC issued \$2.6 billion Sales Tax Revenue Bonds Series 2007 A and \$1.3 billion Sales Tax Revenue Bonds Series 2007 B to provide funds to the Commonwealth to be applied to the repayment of certain of its debt obligations owed to GDB.

(b) UPR

On December 13, 2006, the UPR issued \$547 million in bonds payable, consisting of Series P for \$286 million and Series Q for \$260 million. The proceeds from Series P were used principally for the refinancing of portions of previously issued Series M and Series O. The proceeds of Series Q were used principally for the payment of an amount owed on the line of credit with GDB and provided funds to the capital improvement program of the UPR.

The rating on the University of Puerto Rico (UPR) system revenue bonds has been lowered to 'BBB-' from 'BBB'. The outlook is stable. The downgrade reflects the lower rating on the Commonwealth's GO debt and UPR's high and increasing dependence upon the Commonwealth for its revenues. Under Commonwealth Act 2 of 1966, UPR is allocated an amount equal to 9.6% of the average total revenue collected by the Commonwealth during the prior two fiscal years. Appropriations account for about 90% of UPR's operating budget and in fiscal 2006 appropriations from the Commonwealth were \$812.6 million, or nearly \$13,000 per student.

(c) PRHTA

Subsequent to June 30, 2006, PRHTA made an agreement with a commercial bank in which the PRHTA may borrow up to \$400 million in a revolving line of credit. The proceeds from the loan will be used to finance the PRHTA's capital improvement program and to repay the amount due to GDB under the line of credit agreement.

The ratings for the Puerto Rico Ports Authority (A-/Stable) and Puerto Rico Highways and Transportation Authority's highway revenue bonds (A-/Stable), transportation revenue bonds (BBB+/Stable), subordinate transportation revenue bonds (BBB/Stable), and special facility revenue refunding bonds, 2003 series A (BBB-/Stable) will not change, despite the lowering of the Commonwealth's rating. Standard & Poor's considers pledged revenues for these credits as fairly insulated. However, further deterioration in the Commonwealth's credit quality could be a rating concern for these transportation credits.

(d) PREPA

On July 20, 2006, PREPA and JP Morgan Chase Bank National Association, as Administrative Agent and Issuing Bank, entered into an agreement for a revolving line of credit of \$100 million to be used for operational purposes.

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On September 13, 2006, PREPA and Citibank, N.A., as Administrative Agent, entered into an agreement for a revolving line of credit of \$400 million to be used for interim financing of a portion of the cost of various projects under its Capital Improvement Program.

On December 22, 2006, PREPA and a syndicate of banks lead by Banco Popular de Puerto Rico, as Administrative Agent, entered into an agreement for a line of credit of \$200 million to be used to refund prior lines of credit in use by PREPA. In addition, on that date, PREPA also entered into an eight year annual installment loan agreement with the same syndicate to refinance the outstanding balance of \$64 million.

On May 3, 2007, PREPA issued \$644 million Power Revenue Bonds, Series TT and \$1 billion Power Revenue Refunding Bonds, Series UU. The refunding will allow PREPA to realize savings on its debt service requirements on bonds outstanding under the 1974 Agreement.

On May 30, 2007, PREPA issued \$557 million Power Revenue Refunding Bonds, Series VV. The refunding will allow PREPA to realize savings on its debt service requirements on bonds outstanding under the 1974 Agreement.

(e) PRASA

On September 8, 2006, PRASA entered into \$250 million term loan agreement with various banks. The proceeds were used to repay various lines of credit with GDB and pay costs and fees associated with the term loan.

On December 22, 2006, PRASA entered into a \$850 million bond anticipation note agreement with a commercial bank. The proceeds were used to repair various line of credits with GDB and fees associated with the anticipation note.

On January 9, 2007, PRASA entered into a Final Settlement Agreement in which PRASA and Ondeo agreed that PRASA will assume the outstanding claims that have not been resolved as of that date, which include unpaid invoices and legal, environmental, and labor claims that arose during the Service Agreement and Transition Service Agreement period.

PRASA experienced a significant reduction in the financial assistance from the government during the year ended on June 30, 2006. To mitigate the effect of such information or reduction in the financial report, PRASA has implemented a gradual increase process in the water and sewer rates.

(f) PRIFA

On September 19, 2006, the PRIFA issued \$470 million Special Tax Revenue Bonds, Series 2006, for the purpose of developing the infrastructure necessary for the XXI Central American and Caribbean Games (the Games) to be held in 2010. The proceeds of this issuance will provide for (1) the acquisition, improvements, and construction of sports and other facilities necessary for the Games; (2) the construction of certain capital projects of the Commonwealth instrumentalities and municipalities; and (3) the payment of capitalized interest and cost of issuance of the Series 2006 Bonds. The Series 2006 Bonds were deposited into a Special Construction Fund administered by PRIFA on behalf the applicable benefited entities. The Series 2006 Bonds bear interest at various rates ranging from 4.25% to 5.00% maturing on various dates from July 1, 2010 to July 1, 2046.

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Interest is payable semiannually on January 1 and July 1 of each year commencing January 1, 2007. Bonds are secured by a pledge of federal excise taxes and other monies deposited to the credit of the sinking fund.

(g) PRHIA

On November 19, 2006, the Governor of the Commonwealth signed the Act No. 249 which creates the Special Workers Health Fund (SWHF). The SWHF is financed by a loan of \$253 million from GDB. The loan is guaranteed and will be paid by the State Insurance Fund Corporation (SIF). This act assigns to the PRHIA the amount of \$203 million of the SWHF for the fiscal year 2006-2007 for the payment of premiums of the health insurance system. The SIF loan repayment will be funded through annual legislative appropriation.

(21) Debt Service Deposit Agreements

On May 26, 2005 (but effective on July 1, 2005), the Commonwealth, PFC, and GDB (together the Commonwealth) and Lehman Brothers Special Financing Inc. (Lehman) entered into Debt Service Deposit Agreements (DSD Agreements), the objective of which was for the Commonwealth to secure an upfront payment in exchange for granting Lehman the rights to earnings generated from eight of its debt service funds. Seven of the funds are associated with the Commonwealth's PFC bonds, presented in the accompanying basic financial statements as Commonwealth appropriation bonds, and one fund is associated with the Commonwealth's general obligation bonds. The upfront payment, which amounted to \$82.7 million, was received on May 26, 2005 and equaled the present value of the projected earnings income adjusted for credit timing risks as well as an appropriate amount of compensation for Lehman.

With the upfront payment made as explained above, the Commonwealth will now deliver to Lehman the required and scheduled debt service deposits and Lehman will deliver qualified government debentures which will mature before the next debt service payment date at an amount approximating such next debt service payment. Lehman will attempt to earn sufficient funds on the debt service deposit amounts, less their cost for the qualified government debentures, to make back the \$82.7 million over time. At the same time, the Commonwealth will be managing its borrowings and investments by increasing the predictability of its cash flows from earnings on its investments and not for purpose of speculation. The Commonwealth acknowledges that in exchange for the upfront payment received, it is foregoing its right to receive investment earnings on the deposit amounts referred to above in the future and that by accepting the upfront payment, the Commonwealth has minimized the risks resulting from fluctuations in interest rates during the term of the DSD Agreements but also has foregone the possibility of receiving greater returns on such amounts from such fluctuations.

Under the DSD Agreements, the Commonwealth will be exposed to the payment to Lehman of a Termination Amount, as defined in the agreement, principally upon the occurrence of redemption or a defeasance of the related bonds on or prior to the last scheduled deposit date. The amount of the Termination Amount will vary depending on various market conditions, as defined in the DSD Agreements. Under certain market conditions, the Termination Amount owed to Lehman by the Commonwealth may exceed the amount of the original upfront payment received.

The \$82.7 million upfront payment received by the Commonwealth was recognized as other revenue for budgetary purposes in 2005; however, under generally accepted accounting principles, such upfront

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payment was deferred and is being recognized proportionally over the future periods the Commonwealth would have otherwise earned such interest earnings. As the effective date of DSD Agreements was July 1, 2005, all of the \$82.7 million upfront payment received in 2005 had been recorded as deferred revenue. During fiscal year 2006, approximately \$5.8 million was amortized into other revenue in the accompanying statement of revenue, expenditures, and changes in fund balance of the general fund.

(22) Derivatives

At of June 30, 2006 the Commonwealth was party to the following interest-rate swap agreements (notional amount and fair value in thousands).

Date	Notional amount	Floating rate indicator (pays)	June 30, 2006				Maturity date	Fair value June 30, 2006
			Receives		Pays			
			Type	Rate	Type	Rate		
April 13, 2004	\$ 55,925	LIBOR	Fixed	3.3080%	Variable	3.4403%	May 27, 2021	\$ 1,257
April 13, 2004	56,000	LIBOR	Fixed	3.5820	Variable	3.4403%	June 27, 2024	443
April 13, 2004	56,000	LIBOR	Fixed	3.5590	Variable	3.3569	June 29, 2027	(459)
April 13, 2004	55,975	LIBOR	Fixed	3.5750	Variable	3.3535	June 29, 2028	(544)
April 13, 2004	19,290	LIBOR	Fixed	3.5700	Variable	3.3303	June 29, 2029	(170)
April 13, 2004	30,710	LIBOR	Fixed	3.5700	Variable	3.3535	June 29, 2029	(273)
April 13, 2004	50,000	LIBOR	Fixed	3.5730	Variable	3.3590	June 29, 2029	(464)
April 13, 2004	61,975	LIBOR	Fixed	3.5740	Variable	3.3568	June 29, 2029	(551)
April 13, 2004	62,000	LIBOR	Fixed	3.5090	Variable	3.3034	June 29, 2029	(380)
June 21, 2006	1,273,778	3 m LIBOR BMA	3 m LIBOR X .67 Fixed	3.0820 0.0441	BMA	3.9700	July 1, 2035	(18,916)
	<u>\$ 1,721,653</u>							<u>(26,362)</u>

The purpose of the interest rate agreements issued on April 13, 2004 in the notional amount of \$448 million was to hedge the Commonwealth's variable rate debt exposure and the interest rate risks associated therewith in relation to the Puerto Rico Public Improvement Refunding Bonds, Series 2004 B.

On June 21, 2006 (with effective date of July 1, 2006), the Commonwealth entered into a basis swap agreement in the notional amount of \$1.3 billion with an amortization schedule matching the long-term maturities of outstanding general obligation and refunding bonds issued in various years from 1998 to 2005. Additional basis swap agreements are expected to cover the 2006 General Obligation Bonds awaiting issuance. Under the terms of a master swap agreement, the Commonwealth will pay quarterly commencing on October 1, 2006 a floating rate equal to the tax-exempt Bond Market Association index (BMA) in exchange for receiving a floating rate equal to 67% of the taxable London Inter-Bank Offering Rate (LIBOR) index reset each week and a fixed rate payment of 0.4409% per annum, quarterly for the term of swaps. This basis swap provides the Commonwealth the cash flow benefit of the Basis Annuity in exchange for the Commonwealth taking tax and other basis risks similar to the risks taken in its outstanding LIBOR hedged synthetic fixed rate Public Refunding Bonds, Series 2004 described above.

By using derivative financial instruments to hedge the exposure to changes in interest rates, the Commonwealth exposes itself to credit risk, market-access risk and basis risk. Credit risk is the failure of the counterparty to perform under the terms of the derivative contract. When the fair value of a derivative contract is positive, the counterparty owes the Commonwealth, which creates a credit risk for the Commonwealth. When the fair value of the derivative contract is negative, the Commonwealth owes to the

COMMONWEALTH OF PUERTO RICO

Notes to Basic Financial Statements

June 30, 2006

counterparty and, therefore, does not possess credit risk. The Commonwealth minimizes the credit risk in derivative instruments by entering into transactions with high-quality counterparties whose credit rating is acceptable under the investment policies of the Commonwealth.

Market risk is the adverse effect on the value of a financial statement instrument that results from a change in interest rates. The market risk associated with an interest rate swap contract is managed by establishing and monitoring parameters that limit the types and degree of market risk that may be undertaken. The Commonwealth assesses interest rate cash flows risk by continually identifying and monitoring changes in interest rate exposures that may adversely impact expected cash flows and evaluating hedging opportunities. The Commonwealth maintains risk management control systems to monitor interest rate cash flow risk attributable to both the Commonwealth outstanding or forecasted debt obligations as well as the Commonwealth offsetting hedge positions.

Basis risk arises when different indexes are used in connection with a derivative. The 2006 swap exposes the government to basis risk should the relationship between LIBOR and BMA converge, changing the synthetic rate on the bonds. If a change occurs that results in the rates moving to convergence, the expected cost savings may not be realized. The Commonwealth assesses basis risk by following the aforementioned market risks control system.

(23) Special Items

On December 12, 2001, PFC, a blended component unit of GDB, issued \$96.8 million of QZAB to finance expenditures of the Department of Education of the Commonwealth under the QZAB program described in note 14(e). Simultaneous with this QZAB issuance, The Children's Trust, a blended component unit of the Commonwealth, granted \$47.2 million to the Department of Education of the Commonwealth, which in turn deposited the money to the credit of an escrow trust account invested in guaranteed investment contracts that will be used solely for the repayment in 2015 of these QZAB. At the moment, these November 2001 QZAB were considered defeased and since then, the difference between the bond amount and the amount deposited in the escrow account has been deferred and amortized into income over the term of the bonds.

During January 2006, the Commonwealth, with Legislative approval, decided to revert the funds at the escrow account back to The Children's Trust for program expenditures and at the same time recognized in the accompanying statement of net assets of the governmental activities the QZAB obligation of \$96.8 million. Upon recognition of the QZAB, the Commonwealth derecognized the unamortized deferred difference referred to above, which amounted to approximately \$56.6 million. On the other hand, The Children's Trust recognized as revenue the funds at the escrow account which reverted back in the amount of approximately \$54.1 million. The net result of approximately \$2.5 million loss represents certain cancellation and penalties fees for unwinding the 2001 defeasance and other reconciling differences. The net effect of this transaction has been classified within special items in the accompanying statement of activities.

**COMBINING, INDIVIDUAL FUND
FINANCIAL STATEMENTS AND SCHEDULES**

GENERAL FUND

The general fund is the primary operating fund of the Commonwealth. The general fund is used to account for resources traditionally associated with government, which are not required legally or by sound financial management to be accounted for in another fund. Included are transactions for services such as general government, public safety, health, public housing and welfare, education, and economic development. Following is the supplemental schedule of expenditures – budget and actual – general fund.

COMMONWEALTH OF PUERTO RICO

Supplemental Schedule of Expenditures by Agency – Budget and Actual –
Statutory Basis – General Fund

Year ended June 30, 2006
(In thousands)

	<u>Original budget</u>	<u>Final budget</u>	<u>Actual</u>	<u>Variance</u>
Expenditures:				
Current:				
General government:				
Senate of Puerto Rico	\$ 35,718	35,718	35,718	—
House of Representatives of Puerto Rico	44,206	44,206	43,658	548
Comptroller's Office	40,293	40,293	40,398	(105)
Governor's Office	4,942	4,934	4,952	(18)
Office of Management and Budget	25,590	25,178	69,817	(44,639)
Planning Board	16,192	16,177	16,026	151
Constructions and Land Subdivisions Appeals Board	1,326	1,326	1,326	—
Department of State	8,007	8,106	8,095	11
Department of the Treasury	161,004	160,696	163,675	(2,979)
Central Office of Personnel Administration	7,113	7,113	7,119	(6)
Commonwealth Elections Commission	35,884	35,884	41,742	(5,858)
Federal Affairs Administration	7,296	7,296	8,012	(716)
General Services Administration	713	790	784	6
Municipal Complaints Hearing Commission	4,612	9,610	4,845	4,765
Civil Rights Commission	686	686	686	—
Office of the Citizen's Ombudsman	3,652	3,652	3,652	—
Commission of Appeals of the Human Resources System	1,482	1,482	1,484	(2)
Rules and Permits Administration	5,792	5,768	5,768	—
Commonwealth's Commission to Settle Municipal Complaints	185	170	170	—
Legislative Affairs Office	375	375	295	80
Commission for the Public Service Work Relations	1,938	1,935	1,933	2
Government Ethics Board	9,890	9,890	9,890	—
Legislative Affairs Office	8,161	8,161	8,131	30
Office of the Superintendent of the Capitol	7,204	7,204	7,174	30
Comptroller's Special Reports Joint Commission	518	518	518	—
Legislative Donation Commission	534	534	483	51
Coordination Office for Special Communities of Puerto Rico	7,252	7,492	7,470	22
Public Affairs	4,258	3,988	3,960	28
Governor's Secretary Office	9,540	9,425	9,269	156
Total general government	<u>454,363</u>	<u>458,607</u>	<u>507,050</u>	<u>(48,443)</u>
Public safety:				
Puerto Rico General Court of Justice	294,587	294,587	313,948	(19,361)
State Civil Defense Agency	—	—	3,895	(3,895)
Commission of Investigation, Processing, and Appeals Board	574	574	574	—
Department of Justice	154,720	153,930	147,694	6,236
Puerto Rico Police Department	806,157	827,365	839,524	(12,159)
Puerto Rico Firefighters Corps	72,436	69,432	70,634	(1,202)
Puerto Rico National Guard	8,336	8,668	8,667	1
Public Service Commission	11,229	11,633	11,633	—
Consumer Affairs Department	14,519	14,549	13,733	816
Juvenile Institutions Administration	77,125	87,451	88,254	(803)
Corrections Administration	319,225	386,165	413,039	(26,874)
Department of Correction and Rehabilitation	3,891	5,288	6,828	(1,540)
Natural Resources Administration	30,272	39,059	41,196	(2,137)
Parole Board	2,473	2,412	2,430	(18)
Forensic Sciences Institute	13,422	13,422	13,422	—
Special Prosecutor Panel	1,425	1,425	(32)	1,457
Pre-Trial Services Office	5,090	5,025	5,025	—
Correctional Health	81,678	81,669	95,463	(13,794)
Medical Emergencies Service	23,094	26,389	26,557	(168)
Criminal Justice University College	7,485	7,485	7,485	—
Total public safety	<u>\$ 1,927,738</u>	<u>2,036,528</u>	<u>2,109,969</u>	<u>(73,441)</u>

COMMONWEALTH OF PUERTO RICO
 Supplemental Schedule of Expenditures by Agency – Budget and Actual –
 Statutory Basis – General Fund
 Year ended June 30, 2006
 (In thousands)

	Original budget	Final budget	Actual	Variance
Health:				
Environmental Quality Board	\$ 8,100	9,225	9,225	—
Department of Health	283,213	311,039	336,788	(25,749)
Mental Health and Drug Addiction Services Administration	112,191	119,671	135,074	(15,403)
Drug Control	—	—	(2)	2
Cardiovascular Center Corporation of Puerto Rico and the Caribbean	3,200	21,210	21,210	—
Solid Waste Authority of Puerto Rico	5,119	5,119	5,119	—
Puerto Rico Health Insurance Administration	987,852	1,134,152	1,154,895	(20,743)
Total health	1,399,675	1,600,416	1,662,309	(61,893)
Public housing and welfare:				
Youth Affairs Office	4,375	4,323	4,705	(382)
Rural Housing Administration	7,153	7,153	7,153	—
Puerto Rico Volunteers Service Corps	9,055	9,055	9,287	(232)
Department of Labor and Human Resources	5,517	5,515	5,554	(39)
Labor Relations Board	1,006	1,005	1,005	—
Department of Housing	12,075	12,097	12,097	—
Department of Recreation and Sports	57,331	57,140	68,189	(11,049)
Administration for the Horse Racing Sport and Industry	2,320	2,620	2,620	—
Women's Affairs Commission	5,331	5,309	5,092	217
Office of the Veteran's Ombudsman	2,260	2,205	3,242	(1,037)
Department of Family	52,967	52,966	55,869	(2,903)
Family and Children Administration	145,000	144,973	145,348	(375)
Child Support Administration	10,961	10,887	10,887	—
Vocational Rehabilitation Administration	13,493	13,486	13,486	—
Social Economic Development Administration	97,776	97,110	103,029	(5,919)
Office of the Disabled Persons Ombudsman	3,212	3,210	3,210	—
Office for Elderly Affairs	3,752	3,655	3,510	145
Communities Rehabilitation Administration	—	—	(3)	3
Patient Ombudsman	4,441	4,424	4,424	—
Office of the General Auditor-Department of Family	—	—	—	—
Institutional Trust of the National Guard of Puerto Rico	332	—	—	—
Right to Employment Administration	13,958	14,958	14,958	—
Cantera's Peninsula Integral Development Company	163	163	163	—
Puerto Rico Housing Bank and Finance Authority	616	616	616	—
Industries for the Blind, Mentally Retarded, and Other Disabled Persons of Puerto Rico	150	150	150	—
Puerto Rico Infrastructure Financing Authority	—	—	—	—
Administration for the Care and Development of the Childhood	5,158	5,032	7,009	(1,977)
Total public housing and welfare	458,402	458,052	481,600	(23,548)
Education:				
Department of Education	2,207,236	2,540,926	2,678,154	(137,228)
State Office for Historic Preservation	2,159	1,927	1,920	7
General Education Council	1,734	1,720	1,720	—
Athenaeum of Puerto Rico	500	500	500	—
Institute of Puerto Rico Culture	29,068	29,068	29,068	—
Plastic Arts School	2,996	2,973	2,973	—
University of Puerto Rico	802,539	802,539	802,339	200
Musical Arts Corporation	6,295	6,295	6,295	—
Fine Arts Center Corporation	3,642	3,642	3,642	—
Puerto Rico Public Broadcasting Corporation	19,329	19,329	19,329	—
Puerto Rico Conservatory of Music Corporation	4,556	4,556	4,556	—
Puerto Rico Higher Education Council	29,553	29,553	29,553	—
Total education	\$ 3,109,607	3,443,028	3,580,049	(137,021)

COMMONWEALTH OF PUERTO RICO

Supplemental Schedule of Expenditures by Agency – Budget and Actual –
Statutory Basis – General Fund

Year ended June 30, 2006
(In thousands)

	<u>Original budget</u>	<u>Final budget</u>	<u>Actual</u>	<u>Variance</u>
Economic development:				
Vieques Commissioner's Office	\$ —	108	108	—
Department of Transportation and Public Works	78,250	78,247	75,301	2,946
Department of Natural and Environmental Resources	4,109	9,109	11,339	(2,230)
Department of Agriculture	24,025	22,875	36,280	(13,405)
Department of Economic Development and Commerce	—	—	—	—
Cooperative Enterprises Development Administration	3,198	3,250	3,297	(47)
Puerto Rico Highway and Transportation Authority	1,000	1,000	1,000	—
Cooperative Enterprises Inspector's Office	802	802	802	—
Rural Development Corporation	6,615	6,608	5,910	698
Department of Economic Development and Commerce	4,297	4,036	2,868	1,168
Energy Affairs Administration	150	150	150	—
Culebra Conservation and Development Authority	700	700	700	—
Puerto Rico Infrastructure Financing Authority	70,634	70,634	70,634	—
Puerto Rico Aqueduct and Sewer Authority	70,916	70,916	70,917	(1)
Puerto Rico Industrial Development Company	33,107	33,107	33,107	—
Puerto Rico Electric Power Authority	6,327	6,327	6,327	—
Government Development Bank for Puerto Rico	3,000	3,000	3,000	—
Puerto Rico Metropolitan Bus Authority	4,000	4,000	4,000	—
Puerto Rico Maritime Transportation Authority	15,500	15,569	15,569	—
Tourism Company of Puerto Rico	33,594	33,594	33,572	22
Agricultural Services and Development Administration	75,450	76,598	76,598	—
National Parks Company of Puerto Rico	13,314	15,114	15,114	—
Puerto Rico Land Authority	2,999	2,999	2,999	—
Corporation for the Development of the Film Industry in Puerto Rico	1,164	1,134	1,134	—
Puerto Rico Land Administration	—	—	—	—
Port of the Americas Authority	3,500	3,500	3,500	—
Puerto Rico Trade and Export Corporation	11,734	11,734	11,734	—
Corporation for the Development of Caño Martín Peña	—	—	—	—
Authority for Redevelopment of Roosevelt Roads	—	—	—	—
Sugar Corporation	6,819	6,819	6,819	—
Total economic development	<u>475,204</u>	<u>481,930</u>	<u>492,779</u>	<u>(10,849)</u>
Intergovernmental:				
CRIM	—	—	—	—
Municipal Service Administration	384,321	384,376	416,949	(32,573)
Total intergovernmental	<u>384,321</u>	<u>384,376</u>	<u>416,949</u>	<u>(32,573)</u>
Debt service:				
Principal	78,365	78,365	78,365	—
Interest and other	131,689	131,689	131,689	—
Total expenditures	<u>\$ 8,419,364</u>	<u>9,072,991</u>	<u>9,460,759</u>	<u>(387,768)</u>
Transfers-out to other funds:				
Office of Management and Budget	\$ 165,763	165,763	165,763	—
Employees' Retirement System of the Government of Puerto Rico and its Instrumentalities	178,298	221,198	221,198	—
Teachers' Pensions Board	960	960	960	—
Contributions to Political Parties	603	603	603	—
Office for the Improvements of Public Schools	2,300	2,300	2,183	117
Puerto Rico Maritime Shipping Authority	29,668	29,668	29,667	1
Public Buildings Authority	15,000	15,000	15,000	—
Public Housing Administration	—	—	—	—
Budgetary Fund	—	—	—	—
Emergency Fund	—	—	—	—
Voluntary Elections Fund	—	—	—	—
Transfer of Unused Appropriation Fund (Legislative Branch only)	16,231	16,231	16,231	—
Department of Treasury – Transfer to debt service	116,812	485,012	485,012	—
Total operating transfers-out to other funds	<u>\$ 525,635</u>	<u>936,735</u>	<u>936,617</u>	<u>118</u>

See accompanying independent auditors' report.

NONMAJOR GOVERNMENTAL FUNDS

Special Revenue Funds

Special revenue funds are used to account for the proceeds of specific revenue sources that are legally restricted to expenditure for specific purposes.

Public Buildings Authority Special Revenue Fund: The operating fund of a blended component unit used to account for the operation, maintenance, equipment replacement, and other extraordinary operation and maintenance costs of the buildings and facilities that, when constructed, are leased to the Commonwealth's primary government agencies.

Debt Service Funds

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

The Children's Trust Debt Service Fund: The debt service fund of The Children's Trust (a blended component unit) accounts for the accumulation of resources for payment of interest and principal on long-term obligations financed with moneys to be received by the Commonwealth from the global settlement agreement signed by certain tobacco companies.

Public Buildings Authority Debt Service Fund: A blended component unit engaged in the construction and/or acquisition of building facilities for lease mainly to the Commonwealth's primary government agencies. Its debt service fund is used to account for the accumulation of resources for the payment of revenue bonds and other liabilities incurred to finance the construction of the buildings and facilities.

Puerto Rico Maritime Shipping Authority Debt Service Fund: This is the remainder of a former shipping company owned by the Commonwealth. Its debt service fund is used to account for the accumulation of resources for the payment of the long-term liability that resulted from the sale of its marine operations. This fund is mainly subsidized from appropriations and operating transfers from the general fund.

Capital Project Funds

Capital project funds are used to account for the financial resources used for the acquisition or construction of major capital facilities not being financed by proprietary fund types, pension trust funds, and discretely presented component units.

Commonwealth Public Improvements Funds and Other Funds: These funds present the activities of the capital improvements program of the Commonwealth, financed with the proceeds of the general obligation bonds.

COMMONWEALTH OF PUERTO RICO
Combining Balance Sheet -- Nonmajor Governmental Funds
 June 30, 2006
 (In thousands)

Assets	Special revenue	Debt service			Total	Capital projects	Total nonmajor governmental funds
	Public Buildings Authority	The Children's Trust	Public Buildings Authority	Puerto Rico Maritime Shipping Authority		Commonwealth of Puerto Rico	
Cash and cash equivalents in commercial banks	\$ 31,359	—	143,712	2,127	145,839	260,099	437,297
Cash and cash equivalents in component unit banks	57,180	—	—	2,593	2,593	382,845	442,618
Investments	—	114,453	—	—	114,453	—	114,453
Receivables:							
Accounts	12,364	—	—	—	—	671	13,035
Loans	—	—	—	—	—	36	36
Accrued interest	—	460	—	9	469	—	469
Due from:							
Other funds	101,891	—	24,103	—	24,103	30,148	156,142
Component units	42,186	—	—	—	—	—	42,186
Other governmental	13,866	—	—	—	—	—	13,866
Restricted cash and cash equivalents	16	—	—	—	—	—	16
Real estate held for future development	14,386	—	—	—	—	1,853	16,239
Total assets	<u>\$ 273,248</u>	<u>114,913</u>	<u>167,815</u>	<u>4,729</u>	<u>287,457</u>	<u>675,652</u>	<u>1,236,357</u>
Liabilities and Fund Balances							
Liabilities:							
Accounts payable and accrued liabilities	\$ 36,629	—	—	678	678	26,481	63,788
Due to component units	13,681	—	—	—	—	—	13,681
Due to other funds	—	—	—	—	—	373,385	373,385
Notes payable	30,598	—	—	—	—	—	30,598
Bonds payable	—	—	69,925	—	69,925	10	69,935
Interest payable	—	—	71,640	1,482	73,122	—	73,122
Total liabilities	<u>80,908</u>	<u>—</u>	<u>141,565</u>	<u>2,160</u>	<u>143,725</u>	<u>399,876</u>	<u>624,509</u>
Fund balances:							
Reserved for encumbrances	—	—	—	—	—	24,587	24,587
Unreserved reported in:							
Debt service funds	—	114,913	26,250	2,569	143,732	—	143,732
Special revenue funds	192,340	—	—	—	—	—	192,340
Capital projects funds	—	—	—	—	—	251,189	251,189
Total fund balances	<u>192,340</u>	<u>114,913</u>	<u>26,250</u>	<u>2,569</u>	<u>143,732</u>	<u>275,776</u>	<u>611,848</u>
Total liabilities and fund balances	<u>\$ 273,248</u>	<u>114,913</u>	<u>167,815</u>	<u>4,729</u>	<u>287,457</u>	<u>675,652</u>	<u>1,236,357</u>

See accompanying independent auditors' report.

COMMONWEALTH OF PUERTO RICO
Combining Statement of Revenue, Expenditures, and Changes in
Fund Balances – Nonmajor Governmental Funds

Year ended June 30, 2006

(In thousands)

	<u>Special revenue</u>		<u>Debt service</u>			<u>Capital projects</u>	<u>Total nonmajor governmental funds</u>
	<u>Public Buildings Authority</u>	<u>The Children's Trust</u>	<u>Public Buildings Authority</u>	<u>Puerto Rico Maritime Shipping Authority</u>	<u>Total</u>	<u>Commonwealth of Puerto Rico</u>	
Revenue:							
Revenue from global tobacco settlement agreement	\$ —	65,602	—	—	65,602	—	65,602
Interest and investment earnings	7,473	4,648	—	394	5,042	—	12,515
Intergovernmental	—	—	—	—	—	22,310	22,310
Other	7,556	—	—	271	271	8,948	16,775
Total revenue	15,029	70,250	—	665	70,915	31,258	117,202
Expenditures:							
Current:							
General government	144,249	—	—	—	—	10,518	154,767
Public safety	—	—	—	—	—	797	797
Health	—	—	—	—	—	5,988	5,988
Public housing and welfare	—	—	—	—	—	11,362	11,362
Economic development	—	—	—	788	788	47,822	48,610
Intergovernmental	—	—	—	—	—	1,688	1,688
Capital outlays	—	—	—	—	—	64,820	64,820
Debt service:							
Principal	—	8,810	69,925	—	78,735	—	78,735
Interest and other	—	60,880	103,237	16,956	181,073	—	181,073
Total expenditures	144,249	69,690	173,162	17,744	260,596	142,995	547,840
Excess (deficiency) of revenue over expenditures	(129,220)	560	(173,162)	(17,079)	(189,681)	(111,737)	(430,638)
Other financing sources (uses):							
Transfers in	108,417	—	168,067	16,956	185,023	—	293,440
Transfers out	—	(391)	—	—	(391)	(6,868)	(7,259)
Long-term debt issued	105,000	—	—	—	—	16,421	121,421
Total other financing sources (uses)	213,417	(391)	168,067	16,956	184,632	9,553	407,602
Net change in fund balances	84,197	169	(5,095)	(123)	(5,049)	(102,184)	(23,036)
Fund balances, beginning of year	108,143	114,744	31,345	2,692	148,781	377,960	634,884
Fund balances, end of year	\$ 192,340	114,913	26,250	2,569	143,732	275,776	611,848

See accompanying independent auditors' report.

NONMAJOR PROPRIETARY FUNDS

Proprietary funds are used to account for operations that are financed and operated in a manner similar to private business enterprises where the intent of the government is that the costs of providing goods or services to the general public on a continuing basis be financed or recovered primarily through user charges.

Disability Insurance: It was created by Act 139 on June 26, 1968. It is used to account for disability benefits to remedy temporarily the loss of income as a result of disability caused by sickness or accident unrelated to the employment.

Drivers' Insurance: It was created by Act 428 on May 15, 1950. It is used to account for contributions made by the drivers and their employers to provide a social security plan for the benefit of the drivers in Puerto Rico. The plan also includes payment of benefits for health and life insurance.

Puerto Rico Water Pollution Control Revolving Fund: It was created by Act No. 44 on June 21, 1988, as amended. It is administered, pursuant to Act No. 9 of June 18, 1970, as amended, by the Puerto Rico Environmental Quality Board (EQB). Pursuant to such Act, EQB is authorized to enter into operating agreements and capitalization grant agreements with the U.S. Environmental Protection Agency (EPA) for lending activities.

Puerto Rico Safe Drinking Water Treatment Revolving Loan Fund: It was created by Act No. 32 on July 7, 1997. It is administered, pursuant to Act No. 9 of June 18, 1970, as amended, by the Puerto Rico Department of Health (DOH). Pursuant to such act, DOH, on behalf of the Commonwealth, is authorized to enter into operating and capitalization grant agreements with the EPA for lending activities.

COMMONWEALTH OF PUERTO RICO

Combining Statement of Net Assets –
Nonmajor Proprietary Funds

June 30, 2006

(In thousands)

Assets	Business-type activities – nonmajor enterprise funds				Total
	Disability insurance	Drivers' insurance	Puerto Rico Water Pollution Control Revolving Fund	Puerto Rico Safe Drinking Water Treatment Revolving Loan Fund	
Current assets:					
Cash and cash equivalents in commercial banks	\$ —	37,757	—	—	37,757
Cash and cash equivalents in government bank	82,827	—	50,454	6,342	139,623
Receivables, net:					
Insurance premiums, net	7,039	995	—	—	8,034
Component units	—	—	7,131	474	7,605
Accrued interests	190	77	1,563	457	2,287
Other	314	33	107	88	542
Restricted investments	33,473	—	—	—	33,473
Total current assets	123,843	38,862	59,255	7,361	229,321
Noncurrent assets:					
Loans receivable, excluding current portion, net:					
Component units	—	—	132,141	48,309	180,450
Intergovernmental	—	—	1,819	—	1,819
Total assets	123,843	38,862	193,215	55,670	411,590
Liabilities and Net Assets					
Current liabilities:					
Accounts payable and accrued liabilities	1,747	93	832	312	2,984
Deferred revenue	—	26	—	—	26
Compensated absences	1,042	477	—	—	1,519
Insurance benefits payable	783	357	—	—	1,140
Total current liabilities	3,572	953	832	312	5,669
Noncurrent liabilities – compensated absences	809	789	—	—	1,598
Total liabilities	4,381	1,742	832	312	7,267
Net assets:					
Restricted for:					
Payment of insurance benefits	119,462	37,120	—	—	156,582
Capital projects	—	—	192,383	55,358	247,741
Total net assets	\$ 119,462	37,120	192,383	55,358	404,323

See accompanying independent auditors' report.

COMMONWEALTH OF PUERTO RICO
Combining Statement of Revenue, Expenses, and Changes in Net Assets –
Nonmajor Proprietary Funds
Year ended June 30, 2006
(In thousands)

	Business-type activities – nonmajor enterprise funds				Total
	Disability insurance	Drivers' insurance	Puerto Rico Water Pollution Control Revolving Fund	Puerto Rico Safe Drinking Water Treatment Revolving Loan Fund	
Operating revenue:					
Insurance premiums	\$ 19,162	4,937	—	—	24,099
Interest	—	—	4,617	1,109	5,726
Total operating revenue	<u>19,162</u>	<u>4,937</u>	<u>4,617</u>	<u>1,109</u>	<u>29,825</u>
Operating expenses:					
Disability and drivers insurance benefits	3,601	676	—	—	4,277
General, administrative, and other operating expenses	15,136	4,418	463	749	20,766
Total operating expenses	<u>18,737</u>	<u>5,094</u>	<u>463</u>	<u>749</u>	<u>25,043</u>
Operating income (loss)	425	(157)	4,154	360	4,782
Nonoperating revenue:					
Interest and investment earnings	144	749	—	—	893
Contributions from federal government	—	—	12,000	12,195	24,195
Income before transfers	569	592	16,154	12,555	29,870
Transfers from general fund	—	—	2,387	2,415	4,802
Net change in net assets	569	592	18,541	14,970	34,672
Net assets, beginning of year	<u>118,893</u>	<u>36,528</u>	<u>173,842</u>	<u>40,388</u>	<u>369,651</u>
Net assets, end of year	<u>\$ 119,462</u>	<u>37,120</u>	<u>192,383</u>	<u>55,358</u>	<u>404,323</u>

See accompanying independent auditors' report.

COMMONWEALTH OF PUERTO RICO

Combining Statement of Cash Flows –
Nonmajor Proprietary Funds

Year ended June 30, 2006

(In thousands)

	Business-type activities – nonmajor enterprise funds				Total
	Disability insurance	Drivers' insurance	Puerto Rico Water Pollution Control Revolving Fund	Puerto Rico Safe Drinking Water Treatment Revolving Loan Fund	
Cash flows from operating activities:					
Receipts from customers and users	\$ 15,986	5,039	—	—	21,025
Payments to suppliers and employees	(15,991)	(4,610)	—	—	(20,601)
Other receipts	—	—	13,971	1,277	15,248
Other payments	—	—	(21,676)	(22,083)	(43,759)
Payments of insurance benefits	(3,714)	(618)	—	—	(4,332)
Net cash used in operating activities	(3,719)	(189)	(7,705)	(20,806)	(32,419)
Cash flows from noncapital financing activities:					
Intergovernmental grants and contributions	—	—	12,000	12,107	24,107
Transfers from general fund	—	—	2,386	2,416	4,802
Net cash provided by noncapital financing activities	—	—	14,386	14,523	28,909
Cash flows from investing activities:					
Interests received on deposits and investments	676	715	—	—	1,391
Net cash provided by investing activities	676	715	—	—	1,391
Net increase (decrease) in cash and cash equivalents	(3,043)	526	6,681	(6,283)	(2,119)
Cash and equivalents, beginning of year	85,870	37,231	43,773	12,625	179,499
Cash and cash equivalents, end of year	\$ 82,827	37,757	50,454	6,342	177,380
Reconciliation of operating income (loss) to net cash used in operating activities:					
Operating income (loss)	\$ 425	(157)	4,154	360	4,782
Adjustments to reconcile operating income (loss) to net cash provided by (used in) operating activities:					
Decrease (increase) in accounts and loans receivable	(3,176)	102	(11,679)	(20,811)	(35,564)
Interest earned on deposits, loans, and investments	—	—	(213)	(158)	(371)
Changes in operating assets and liabilities:					
Decrease in deferred revenue	—	(3)	—	—	(3)
Increase in compensated absences	1,056	395	—	—	1,451
Increase (decrease) in liability for insurance benefits payable	(465)	58	—	—	(407)
Increase (decrease) in accounts payable and accrued liabilities	(1,559)	(584)	33	(197)	(2,307)
Total adjustments	(4,144)	(32)	(11,859)	(21,166)	(37,201)
Net cash used in operating activities	(3,719)	(189)	(7,705)	(20,806)	(32,419)

See accompanying independent auditors' report.

FIDUCIARY FUNDS

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

Pension Trust Funds

The pension trust funds are used to account for the assets, liabilities, and net assets available for pension benefits held in trust for the public employees of the Commonwealth.

Employees' Retirement System of the Government of Puerto Rico and its Instrumentalities (ERS): ERS is the administrator of a defined-benefit pension plan which covers all regular employees of the Commonwealth and its instrumentalities and of certain municipalities and component units not covered by their retirement systems. On September 24, 1999, an amendment to the Law that created ERS was enacted with the purpose of establishing a new defined-contribution pension plan (System 2000) for persons joining the government on or after January 1, 2000.

Puerto Rico System of Annuities and Pensions for Teachers (TRS): TRS provides retirement benefits to all teachers of the Department of Education of the Commonwealth, all pensioned teachers who work in the Teachers' Association of Puerto Rico, and those who practice in private institutions accredited by the Department of Education. TRS provides retirement, death, and disability benefits.

Puerto Rico Judiciary Retirement System (JRS): JRS is administered by the ERS and covers all individuals holding a position as Justice of the Supreme Court, Judge of the former Superior Court, Judge of District Court, or the Municipal Judges of the Commonwealth. The system provides retirement as well as death and disability benefits.

Agency Fund

Agency fund is used to account for assets held by the Commonwealth as an agent for individuals, private organizations, and other governments. This fund is custodial in nature (assets equal liabilities) and does not involve measurement of the results of operations.

Special Deposits: This fund acts in a fiduciary capacity in order to account for moneys received with specified purposes for which the law does not specify its recording in any other fund. It mainly includes deposits under the custody of the courts of justice for alimony payments.

COMMONWEALTH OF PUERTO RICO

Combining Statement of Fiduciary Net Assets – Pension Trust Funds

June 30, 2006

(In thousands)

Assets	Pension Trust Funds			Totals
	Employees' Retirement System (ERS)	Teachers' Retirement System (TRS)	Judiciary Retirement System (JRS)	
Cash and cash equivalents in commercial banks:				
Unrestricted	\$ 27,849	53,515	1,599	82,963
Restricted	—	1,717	—	1,717
Cash and cash equivalents in governmental banks:				
Unrestricted	25,778	2,993	180	28,951
Restricted	2,156	—	—	2,156
Investments:				
Debt and equity securities, at fair value	1,531,726	2,350,099	75,930	3,957,755
Investment in PRTA Holdings, at appraised value	495,318	—	—	495,318
Other	41,609	46,215	—	87,824
Receivables, net:				
Accounts	44,622	—	—	44,622
Loans and advances	528,552	352,333	274	881,159
Accrued interests and dividends	26,105	6,371	250	32,726
Due from (to) other pension trust funds	3,161	—	(3,161)	—
Due from general fund	10,401	—	—	10,401
Other	23,579	27,095	606	51,280
Capital assets, net	7,694	25,665	—	33,359
Other assets	7,592	691	—	8,283
Total assets	<u>2,776,142</u>	<u>2,866,694</u>	<u>75,678</u>	<u>5,718,514</u>
Liabilities				
Accounts payable and accrued liabilities	35,737	39,373	2,828	77,938
Repurchase agreements	139,074	—	—	139,074
Bonds payable	—	20,430	—	20,430
Other	60,000	—	—	60,000
Due to component unit	—	4	—	4
Total liabilities	<u>234,811</u>	<u>59,807</u>	<u>2,828</u>	<u>297,446</u>
Net Assets				
Net assets held in trust for pension and other benefits	<u>\$ 2,541,331</u>	<u>2,806,887</u>	<u>72,850</u>	<u>5,421,068</u>

See accompanying independent auditors' report.

COMMONWEALTH OF PUERTO RICO
Combining Statement of Changes in Fiduciary Net Assets – Pension Trust Funds
Year ended June 30, 2006
(In thousands)

	Pension Trust Funds			Totals
	Employees' Retirement System (ERS)	Teachers' Retirement System (TRS)	Judiciary Retirement System (JRS)	
Additions:				
Contributions:				
Sponsor	\$ 398,372	119,199	6,727	524,298
Participants	342,697	129,473	2,960	475,130
Special	16,684	61,066	—	77,750
Total contributions	<u>757,753</u>	<u>309,738</u>	<u>9,687</u>	<u>1,077,178</u>
Interest	63,486	57,899	1,220	122,605
Dividends	49,938	14,684	205	64,827
Net change in fair value of investments, including realized gains on sale and maturities of investments	189,515	258,182	5,818	453,515
Investment expenses	(10,123)	(5,792)	(279)	(16,194)
Net interest and investment income	<u>292,816</u>	<u>324,973</u>	<u>6,964</u>	<u>624,753</u>
Other income	23,270	13,085	—	36,355
Total additions	<u>1,073,839</u>	<u>647,796</u>	<u>16,651</u>	<u>1,738,286</u>
Deductions:				
Pension and other benefits	804,315	375,262	12,403	1,191,980
Refunds of contributions	22,373	4,135	—	26,508
General and administrative expenses	33,691	22,651	1,195	57,537
Total deductions	<u>860,379</u>	<u>402,048</u>	<u>13,598</u>	<u>1,276,025</u>
Net change in net assets held in trust for pension and other benefits	213,460	245,748	3,053	462,261
Net assets held in trust for pension and other benefits:				
Beginning of year	2,327,871	2,561,139	69,797	4,958,807
End of year	<u>\$ 2,541,331</u>	<u>2,806,887</u>	<u>72,850</u>	<u>5,421,068</u>

See accompanying independent auditors' report.

COMMONWEALTH OF PUERTO RICO
Statement of Changes in Assets and Liabilities – Agency Fund
Year ended June 30, 2006
(In thousands)

Assets	Balance June 30, 2005	Additions	Deletions	Balance June 30, 2006
Cash and cash equivalents in commercial banks and U.S. Treasury	\$ 467,319	115,877	—	583,196
Cash and cash equivalents in governmental banks	110,102	2,864,683	2,927,801	46,984
Investments	16,115	10,898	—	27,013
Total assets	<u>\$ 593,536</u>	<u>2,991,458</u>	<u>2,927,801</u>	<u>657,193</u>
Liabilities				
Accounts payable and accrued liabilities	\$ 593,536	1,521,669	1,458,012	657,193
Total liabilities	<u>\$ 593,536</u>	<u>1,521,669</u>	<u>1,458,012</u>	<u>657,193</u>

See accompanying independent auditors' report.

NONMAJOR COMPONENT UNITS

These entities are presented because the nature and significance of their relationship with the primary government are such that their exclusion would cause the basic financial statements to be misleading. These are discretely presented in a separate column in the basic financial statements due to nature of the services they provide. The accounting principles followed by each of the component units included herein may vary depending on the type of industries they are involved in (that is, banking, construction, public utilities, and so forth). The detailed information for each of these entities may be obtained directly from the administrative offices of the corresponding entities, as described in note 1 to the basic financial statements included in the financial section of this report.

COMMONWEALTH OF PUERTO RICO
Nonmajor Discretely Presented Component Units – Statement of Net Assets
June 30, 2006
(In thousands)

Assets	Agricultural Services and Development Administration	Automobile Accident Compensation Administration	Cardiovascular Center Corporation of Puerto Rico and the Caribbean	Caribbean Basin Projects Financing Authority	Culebra Conservation & Development Authority	Economic Development Bank for Puerto Rico	Employment and Training Enterprises Corporation	Farm Insurance Corporation of Puerto Rico	Fine Arts Center Corporation	Governing Board of the 9-1-1 Service	Institutional Trust of the National Guard of Puerto Rico	Land Authority of Puerto Rico
Current assets:												
Cash and cash equivalents	\$ 11	392	2,428	—	376	3,290	—	6,247	1,180	—	—	2,092
Cash and cash equivalents in governmental banks	—	4,118	—	104	—	—	637	—	—	18,557	55,064	27,456
Investments, including collateral from securities lending transactions	—	219,600	—	—	—	210,041	—	—	—	—	654	—
Receivables, net:												
Insurance premiums	—	—	—	—	—	—	—	—	—	—	—	—
Intergovernmental Accounts	75	4,825	19,752	—	—	—	1,033	693	154	3,840	—	13,089
Loans and advances	—	—	—	—	—	53,028	—	—	—	—	—	379
Accrued interest	—	1,043	—	—	—	10,561	—	—	—	51	—	—
Other governmental entities	11,263	—	—	—	—	—	—	—	251	255	—	—
Other	5,637	12,105	1,233	—	—	—	—	—	—	—	3,418	1,302
Due from:												
Primary government	—	—	—	—	—	—	—	—	—	—	—	5,301
Component units	—	—	—	—	—	—	—	—	—	—	—	16,931
Inventories	17,623	—	1,824	—	—	—	595	—	—	30	—	—
Prepays	569	—	652	—	—	—	—	331	160	—	—	—
Total current assets	35,178	242,083	25,889	104	376	276,920	2,265	7,271	1,745	22,733	59,136	66,550
Noncurrent assets:												
Restricted assets:												
Cash and cash equivalents	183,286	336	1,067	—	—	—	1,959	—	—	—	—	895
Cash and cash equivalents in governmental banks	—	—	—	—	—	—	30	—	—	15,408	3,000	983
Investments	—	—	—	—	—	—	—	—	620	—	—	—
Investments	—	—	—	—	—	649,922	—	—	2,428	—	—	4,865
Receivables:												
Loans, interest and other	—	—	—	—	—	109,431	—	—	—	—	—	605
Interest-bearing deposits with other	—	—	—	—	—	—	—	—	—	—	—	—
Other governmental entities	—	—	—	—	—	—	—	958	—	127	—	—
Other	—	—	—	—	—	—	—	—	—	—	—	—
Due from:												
Component units	—	—	—	—	—	—	—	13,386	—	—	—	—
Property held for sale and future development	—	—	—	—	—	—	—	—	—	—	—	—
Capital assets, not being depreciated	6,787	901	5,015	—	651	—	—	—	3,100	—	1,483	81,544
Capital assets, depreciable, net	26,444	8,982	5,647	—	375	10,597	416	225	15,527	5,766	3,938	10,110
Deferred expenses and other assets	540	28	—	—	—	4,640	—	—	—	—	2,059	78
Total noncurrent assets	217,057	10,247	11,729	—	1,026	774,590	2,405	14,569	21,675	21,301	10,480	99,080
Total assets	\$ 252,235	252,330	37,618	104	1,402	1,051,510	4,670	21,840	23,420	44,034	69,616	165,630

See accompanying independent auditors' report.

COMMONWEALTH OF PUERTO RICO
Nonmajor Discretely Presented Component Units – Statement of Net Assets
 June 30, 2006
 (In thousands)

Assets	Musical Arts Corporation	National Parks Company of Puerto Rico	Public Corporation for the Supervision and Deposit Insurance of Puerto Rico Cooperatives	Puerto Rico Conservatory of Music Corporation	Puerto Rico Convention Center District Authority	Puerto Rico Council on Higher Education	Puerto Rico Industrial Development Company	Puerto Rico Industrial, Tourist, Educational, Medical, and Environmental Control Facilities Financing Authority	Puerto Rico Land Administration	Puerto Rico Medical Services Administration	Puerto Rico Metropolitan Bus Authority	Puerto Rico Municipal Finance Agency
Current assets:												
Cash and cash equivalents	\$ 2,219	365	—	342	21,343	—	12,863	—	1,037	5,730	34	—
Cash and cash equivalents in governmental banks	—	1,713	1,193	—	1,030	2,186	9,100	8,223	85,662	—	9	3,598
Investments, including collateral from securities lending transactions	—	—	97,349	—	—	—	—	—	23,304	—	—	357,739
Receivables, net:												
Insurance premiums	—	—	—	—	—	—	—	—	—	—	—	—
Intergovernmental Accounts	52	796	—	—	6,944	247	21,697	—	3,353	12,878	1,925	—
Loans and advances	—	—	—	—	—	—	469	—	—	—	—	—
Accrued interest	—	—	1,797	—	—	—	3,398	30	836	—	—	—
Other governmental entities	555	25	—	286	—	—	—	—	8	28,144	—	—
Other	21	—	210	41	40	—	20,411	—	7	—	4,120	—
Due from:												
Primary government	—	—	—	23,908	—	—	23,403	—	—	19,937	—	—
Component units	—	—	—	—	—	—	—	—	710	—	—	—
Inventories	—	—	—	—	—	—	—	—	—	4,711	6,438	—
Prepays	—	618	—	16	1,348	—	1,447	—	119	—	—	—
Total current assets	2,847	3,517	100,549	24,593	30,705	2,433	92,788	8,253	115,036	71,400	12,526	361,337
Noncurrent assets:												
Restricted assets:												
Cash and cash equivalents	—	1,005	—	856	—	—	82,694	—	—	2,372	—	82
Cash and cash equivalents in governmental banks	—	34,039	—	—	—	7,675	25,581	—	442	—	267	—
Investments	—	—	—	—	92,233	—	—	—	—	—	—	1,718,918
Investments	—	—	35,942	—	—	—	4,422	—	—	—	—	—
Receivables:												
Loans, interest and other	—	—	—	—	—	—	3,475	—	—	—	—	—
Interest-bearing deposits with other	—	—	—	—	6,659	—	—	—	—	—	—	—
Other governmental entities	—	—	—	—	—	—	—	—	778	—	—	—
Other	—	—	—	—	—	—	531	—	—	—	—	—
Due from:												
Component units	—	—	—	—	—	—	—	—	3,917	—	—	—
Property held for sale and future development	—	—	—	—	150	—	5,832	—	135,217	—	—	—
Capital assets, not being depreciated	153	27,573	—	19,871	196,966	—	280,077	—	23,341	7,322	2,569	—
Capital assets, depreciable, net	439	211,737	160	1,922	454,525	407	440,741	—	5,669	36,180	65,032	—
Deferred expenses and other assets	—	—	—	—	17,098	—	3,525	—	18	—	—	1,853
Total noncurrent assets	592	274,354	36,102	22,649	767,631	8,082	846,878	—	169,382	45,874	67,868	1,720,853
Total assets	\$ 3,439	277,871	136,651	47,242	798,336	10,515	939,666	8,253	284,418	117,274	80,394	2,082,190

See accompanying independent auditors' report.

COMMONWEALTH OF PUERTO RICO
Nonmajor Discretely Presented Component Units – Statement of Net Assets
June 30, 2006
(In thousands)

Assets	Puerto Rico Ports Authority	Puerto Rico Public Broadcasting Corporation	Puerto Rico School of Plastic Arts	Puerto Rico Solid Waste Authority	Puerto Rico Telephone Authority	Puerto Rico Tourism Company	Puerto Rico Trade and Export Company	Right to Employment Administration	Special Communitia Perpetual Trust	State Insurance Fund Corporation	Total
Current assets:											
Cash and cash equivalents	\$ 1,367	4,203	—	—	—	49,875	1,771	—	—	2,690	119,855
Cash and cash equivalents in governmental banks	—	—	456	420	463	—	8,917	5,612	—	204,267	438,785
Investments, including collateral from securities lending transactions	—	—	—	—	—	102,151	—	—	—	641,694	1,652,532
Receivables, net:											
Insurance premiums	—	—	—	—	—	—	—	—	—	109,780	109,780
Intergovernmental	—	—	—	—	—	—	—	—	—	1,925	1,925
Accounts	79,841	499	85	1,733	—	4,385	112	—	—	—	176,283
Loans and advances	—	—	—	—	—	—	—	—	—	—	53,876
Accrued interest	—	—	—	—	—	—	7,065	—	89	10,462	35,332
Other governmental entities	—	98	—	—	—	—	92	1,015	—	—	41,992
Other	—	296	—	—	—	1,427	—	16	—	22,738	73,022
Due from:											
Primary government	—	—	—	—	—	—	—	—	—	—	72,549
Component units	—	—	—	—	—	—	—	—	—	3,500	21,141
Inventories	563	—	—	—	—	—	—	—	—	7,681	39,465
Prepays	5,048	136	—	—	—	4	59	96	—	—	10,603
Total current assets	86,819	5,232	541	2,153	463	158,042	18,016	6,739	89	1,002,812	2,847,140
Noncurrent assets:											
Restricted assets:											
Cash and cash equivalents	39,506	4,180	16	3,461	—	—	5,261	—	—	—	326,976
Cash and cash equivalents in governmental banks	1,875	—	318	19,201	21,375	—	15,956	458	569,414	—	716,022
Investments	—	—	771	—	1,850	—	400,000	303	—	—	2,214,695
Investments	1,000	—	—	800	—	16,087	—	—	—	754,632	1,470,098
Receivables:											
Loans, interest and other	—	—	—	—	6,808	—	895	—	—	—	121,214
Interest-bearing deposits with other	—	—	—	—	—	—	—	—	—	—	6,659
Other governmental entities	30,800	—	—	—	—	—	—	—	—	—	32,663
Other	—	—	—	—	—	—	—	—	—	—	531
Due from:											
Component units	—	—	—	—	—	—	—	—	—	—	17,303
Property held for sale and future development	—	—	—	—	—	—	—	—	—	—	141,199
Capital assets, not being depreciated	483,967	10,100	—	41,841	—	11,635	70,953	—	—	13,010	1,288,859
Capital assets, depreciable, net	316,491	12,671	8,702	153,608	—	26,535	37,712	345	—	99,799	1,960,702
Deferred expenses and other assets	6,368	358	—	—	—	7,907	26	—	—	—	44,498
Total noncurrent assets	880,007	27,309	9,807	218,911	30,033	62,164	530,803	1,106	569,414	867,441	8,341,419
Total assets	\$ 966,826	32,541	10,348	221,064	30,496	220,206	548,819	7,845	569,503	1,870,253	11,188,559

See accompanying independent auditors' report.

COMMONWEALTH OF PUERTO RICO
Nonmajor Discretely Presented Component Units – Statement of Net Assets
June 30, 2006
(In thousands)

Liabilities and Net Assets	Agricultural Services and Development Administration	Automobile Accident Compensation Administration	Cardiovascular Center of Puerto Rico and the Caribbean	Caribbean Basin Projects Financing Authority	Culebra Conservation & Development Authority	Economic Development Bank for Puerto Rico	Employment and Training Enterprises Corporation	Farm Insurance Corporation of Puerto Rico	Fine Arts Center Corporation	Governing Board of the 9-1-1 Service	Institutional Trust of the National Guard of Puerto Rico	Land Authority of Puerto Rico
Liabilities:												
Current liabilities:												
Accounts payable and accrued liabilities	\$ 196,357	12,118	19,630	5	89	—	2,542	3,257	247	2,005	2,014	57,920
Deposits and escrow liabilities	—	—	—	—	—	288,246	—	—	176	—	—	9,703
Due to:												
Primary government	—	—	42,186	—	—	—	—	—	—	5,296	—	—
Component units	23,886	—	5,154	—	—	331	—	6,431	—	—	—	41,444
Other governmental entities	—	—	—	—	—	—	—	—	3	—	—	—
Securities lending transactions and reverse repurchase agreements	—	47,573	—	—	—	116,140	—	—	—	—	—	—
Interest payable	—	—	—	—	—	8,812	—	—	—	—	—	3,580
Deferred revenue	—	37,036	—	—	36	—	—	7,066	1,183	—	—	605
Notes payable, current portion	—	—	—	—	—	—	—	—	—	—	—	2,121
Commonwealth appropriation bonds, current portion	—	—	—	—	—	—	—	—	—	—	—	718
Bonds payable, current portion	—	—	—	—	—	—	—	—	—	—	—	—
Accrued compensated absences	10,761	3,990	2,102	—	71	—	266	520	56	563	170	1,646
Worker's compensation claims	—	—	—	—	—	—	—	—	—	—	—	—
Reserves for automobile accident benefit payments	—	114,388	—	—	—	—	—	—	—	—	—	—
Current portion of other long-term liabilities	236	—	365	—	—	4,550	—	—	59	—	—	3,826
Total current liabilities	<u>231,240</u>	<u>215,105</u>	<u>69,437</u>	<u>5</u>	<u>196</u>	<u>418,079</u>	<u>2,808</u>	<u>17,274</u>	<u>1,724</u>	<u>7,864</u>	<u>2,184</u>	<u>121,563</u>
Noncurrent liabilities:												
Due to:												
Primary government	—	—	—	—	—	—	7,108	—	—	—	—	—
Component units	117,758	—	—	—	—	11,876	—	—	—	—	—	—
Interest payable	—	—	—	—	—	—	—	—	—	—	—	—
Deferred revenue	—	—	—	—	—	—	788	—	—	—	—	—
Notes payable	10,238	—	—	—	—	500,000	—	—	—	—	—	6,362
Commonwealth appropriation bonds	—	—	—	—	—	—	—	—	—	—	—	162,617
Bonds payable	—	—	—	—	—	—	—	—	—	—	—	—
Accrued compensated absences	—	—	—	—	19	2,118	—	—	613	—	—	—
Other long-term liabilities	673	—	1,070	—	—	537	—	—	19	—	—	—
Total noncurrent liabilities	<u>128,669</u>	<u>—</u>	<u>1,070</u>	<u>—</u>	<u>19</u>	<u>514,531</u>	<u>7,896</u>	<u>—</u>	<u>632</u>	<u>—</u>	<u>—</u>	<u>168,979</u>
Total liabilities	<u>359,909</u>	<u>215,105</u>	<u>70,507</u>	<u>5</u>	<u>215</u>	<u>932,610</u>	<u>10,704</u>	<u>17,274</u>	<u>2,356</u>	<u>7,864</u>	<u>2,184</u>	<u>290,542</u>
Net assets:												
Invested in capital assets, net of related debt	—	9,883	10,662	—	1,026	(1,610)	416	225	18,100	5,505	5,420	91,604
Restricted for:												
Trust – nonexpendable	—	—	—	—	—	—	—	—	—	—	—	—
Capital projects	—	—	567	—	—	—	—	—	620	—	—	752
Debt service	—	—	—	—	—	—	—	—	—	—	—	—
Affordable housing and related loan insurance programs	—	—	—	—	—	—	—	—	—	—	—	—
Student loans and other educational purposes	—	—	—	—	—	—	—	—	—	—	—	—
Other specified purposes	—	336	—	—	—	8,984	—	—	—	15,408	2,500	—
Unrestricted	(107,674)	27,006	(44,118)	99	161	111,526	(6,450)	4,341	2,344	15,257	59,012	(217,268)
Total net assets	<u>(107,674)</u>	<u>37,225</u>	<u>(32,889)</u>	<u>99</u>	<u>1,187</u>	<u>118,900</u>	<u>(6,034)</u>	<u>4,566</u>	<u>21,064</u>	<u>36,170</u>	<u>67,432</u>	<u>(124,912)</u>
Total liabilities and net assets	<u>\$ 252,235</u>	<u>252,330</u>	<u>37,618</u>	<u>104</u>	<u>1,402</u>	<u>1,051,510</u>	<u>4,670</u>	<u>21,840</u>	<u>23,420</u>	<u>44,034</u>	<u>69,616</u>	<u>165,630</u>

See accompanying independent auditors' report.

COMMONWEALTH OF PUERTO RICO
 Nonmajor Discretely Presented Component Units – Statement of Net Assets
 June 30, 2006
 (In thousands)

Liabilities and Net Assets	Musical Arts Corporation	National Parks Company of Puerto Rico	Public Corporation for the Supervision and Deposit Insurance of Puerto Rico Cooperatives	Puerto Rico Conservatory of Music Corporation	Puerto Rico Convention Center District Authority	Puerto Rico Council on Higher Education	Puerto Rico Industrial Development Company	Puerto Rico Industrial, Tourist, Educational, Medical, and Environmental Control Facilities Financing Authority	Puerto Rico Land Administration	Puerto Rico Medical Services Administration	Puerto Rico Metropolitan Bus Authority	Puerto Rico Municipal Finance Agency
Liabilities:												
Current liabilities:												
Accounts payable and accrued liabilities	\$ 952	8,079	9,412	1,472	15,603	556	62,810	101	2,654	47,764	31,415	3,768
Deposits and escrow liabilities	—	—	—	—	2,184	—	3,576	—	1,477	—	—	340,501
Due to:												
Primary government	—	—	—	—	—	—	—	—	—	27,012	—	—
Component units	—	6,831	—	—	154,846	—	70,351	—	—	38,720	3,153	—
Other governmental entities	—	4,848	—	—	—	—	—	—	—	30,436	—	—
Securities lending transactions and reverse repurchase agreements	—	—	—	—	—	—	—	—	—	—	—	—
Interest payable	—	1,227	—	212	19,577	—	5,197	—	—	—	294	37,481
Deferred revenue	822	—	—	—	4,517	—	3,891	—	—	—	190	—
Notes payable, current portion	—	—	—	—	—	—	2,693	—	—	—	—	—
Commonwealth appropriation bonds, current portion	—	—	—	—	—	—	—	—	—	—	—	—
Bonds payable, current portion	—	—	—	—	—	—	10,458	—	—	—	—	114,210
Accrued compensated absences	131	228	1,065	176	285	—	5,450	—	—	10,618	868	—
Worker's compensation claims	—	—	—	—	—	—	—	—	—	—	—	—
Reserves for automobile accident benefit payments	—	—	—	—	—	—	—	—	—	—	—	—
Current portion of other long-term liabilities	—	6,191	—	—	—	—	92	—	—	3,416	—	—
Total current liabilities	1,905	27,404	10,477	1,860	197,012	556	164,518	101	4,131	157,966	35,920	495,960
Noncurrent liabilities:												
Due to:												
Primary government	—	—	—	—	—	—	—	—	—	—	—	—
Component units	—	—	—	—	—	—	3,917	—	—	—	19,151	—
Interest payable	—	—	—	—	—	—	—	—	—	—	—	—
Deferred revenue	—	—	—	—	6,400	—	11,921	—	—	—	—	—
Notes payable	—	—	—	—	—	—	65,626	—	—	—	—	—
Commonwealth appropriation bonds	—	—	—	—	—	—	—	—	—	—	—	—
Bonds payable	—	—	—	—	482,589	—	279,514	—	—	—	—	1,502,354
Accrued compensated absences	42	5,754	—	772	—	314	—	—	833	—	3,471	—
Other long-term liabilities	2,442	976	—	130	—	—	182	—	37,749	7,572	2,672	23,682
Total noncurrent liabilities	2,484	6,730	—	902	488,989	314	361,160	—	38,582	7,572	25,294	1,526,036
Total liabilities	4,389	34,134	10,477	2,762	686,001	870	525,678	101	42,713	165,538	61,214	2,021,996
Net assets:												
Invested in capital assets, net of related debt	592	231,628	160	21,793	18,656	407	357,626	—	29,010	39,755	67,602	—
Restricted for:												
Trust – nonexpendable	—	—	—	—	—	—	—	—	—	—	—	—
Capital projects	—	—	—	21,855	55,531	257	—	—	—	—	267	—
Debt service	—	—	—	—	30,716	—	112,380	—	—	—	—	41,273
Affordable housing and related loan insurance programs	—	—	—	—	—	—	—	—	—	—	—	—
Student loans and other educational purposes	—	—	—	832	—	7,351	—	—	—	—	—	—
Other specified purposes	—	—	61,070	—	—	1,034	—	—	442	3	—	—
Unrestricted	(1,542)	12,109	64,944	—	7,432	596	(56,018)	8,152	212,253	(88,022)	(48,689)	18,921
Total net assets	(950)	243,737	126,174	44,480	112,335	9,645	413,988	8,152	241,705	(48,264)	19,180	60,194
Total liabilities and net assets	\$ 3,439	277,871	136,651	47,242	798,336	10,515	939,666	8,253	284,418	117,274	80,394	2,082,190

See accompanying independent auditors' report.

COMMONWEALTH OF PUERTO RICO
Nonmajor Discretely Presented Component Units – Statement of Net Assets
June 30, 2006
(In thousands)

Liabilities and Net Assets	Puerto Rico Ports Authority	Puerto Rico Public Broadcasting Corporation	Puerto Rico School of Plastic Arts	Puerto Rico Solid Waste Authority	Puerto Rico Telephone Authority	Puerto Rico Tourism Company	Puerto Rico Trade and Export Company	Right to Employment Administration	Special Communities Perpetual Trust	State Insurance Fund Corporation	Total
Liabilities:											
Current liabilities:											
Accounts payable and accrued liabilities	\$ 113,809	2,340	50	18,386	278	41,548	6,091	1,077	42,591	140,097	847,037
Deposits and escrow liabilities	1,294	—	—	—	—	—	—	—	—	—	647,157
Due to:											
Primary government	—	—	—	—	—	17,993	—	—	—	—	92,487
Component units	15,871	—	—	18,500	—	—	—	—	—	—	385,518
Other governmental entities	—	—	—	—	—	—	—	2,198	—	—	37,485
Securities lending transactions and reverse repurchase agreements	—	—	—	—	—	—	—	—	—	114,131	277,844
Interest payable	2,295	—	—	—	—	—	6,076	—	22,717	—	107,468
Deferred revenue	441	4,180	—	—	—	—	—	3,925	—	34,866	98,758
Notes payable, current portion	122,464	—	—	—	—	—	—	—	—	1,956	129,234
Commonwealth appropriation bonds, current portion	—	—	—	—	—	489	—	—	—	—	1,207
Bonds payable, current portion	4,545	—	—	—	—	—	—	—	—	—	129,213
Accrued compensated absences	7,558	897	44	438	—	1,783	2,234	1,548	—	44,440	97,948
Worker's compensation claims	—	—	—	—	—	—	—	—	—	696,922	696,922
Reserves for automobile accident benefit payments	—	—	—	—	—	—	—	—	—	—	114,388
Current portion of other long-term liabilities	13,865	—	—	50	23,215	120	—	—	—	339	56,324
Total current liabilities	282,142	7,417	94	37,374	23,493	61,933	14,401	8,788	65,308	1,032,751	3,718,990
Noncurrent liabilities:											
Due to:											
Primary government	—	—	—	—	—	—	—	—	—	—	7,108
Component units	285,689	—	—	69,333	—	—	—	—	425,107	—	932,831
Interest payable	—	—	—	—	—	—	—	—	—	—	—
Deferred revenue	4,276	—	—	—	—	—	—	—	—	—	23,385
Notes payable	12,485	—	—	—	—	—	400,000	—	—	51,636	1,046,347
Commonwealth appropriation bonds	—	—	—	7,701	—	126,038	—	—	—	—	296,356
Bonds payable	61,659	—	—	—	—	—	—	—	—	—	2,326,116
Accrued compensated absences	—	1,403	334	542	—	6,241	—	1,584	—	—	24,040
Other long-term liabilities	421	—	—	6	—	800	3,910	—	—	71,983	154,824
Total noncurrent liabilities	364,530	1,403	334	77,582	—	133,079	403,910	1,584	425,107	123,619	4,811,007
Total liabilities	646,672	8,820	428	114,956	23,493	195,012	418,311	10,372	490,415	1,156,370	8,529,997
Net assets:											
Invested in capital assets, net of related debt	364,710	22,771	8,702	99,859	—	37,787	108,145	345	—	25,957	1,576,736
Restricted for:											
Trust – nonexpendable	—	—	—	—	—	—	—	—	—	—	—
Capital projects	(1,399)	—	—	2,166	—	—	—	—	—	—	80,616
Debt service	25,228	—	—	—	—	—	—	—	—	—	209,597
Affordable housing and related loan insurance programs	—	—	—	—	—	—	—	—	526,912	—	526,912
Student loans and other educational purposes	—	—	771	—	—	—	—	—	—	—	9,454
Other specified purposes	3,686	—	—	—	6,818	—	—	—	—	—	100,281
Unrestricted	(72,071)	950	447	4,083	185	(12,593)	22,363	(2,872)	(447,824)	687,926	154,966
Total net assets	320,154	23,721	9,920	106,108	7,003	25,194	130,508	(2,527)	79,088	713,883	2,658,562
Total liabilities and net assets	\$ 966,826	32,541	10,348	221,064	30,496	220,206	548,819	7,845	569,503	1,870,253	11,188,559

See accompanying independent auditors' report.

COMMONWEALTH OF PUERTO RICO
Nonmajor Discretely Presented Component Units - Statement of Activities
Year ended June 30, 2006
(In thousands)

Component units	Expenses	Program revenues			Net revenues (expenses) and changes in net assets	General revenue						Change in net assets	Net assets, beginning or restated	Net assets, end of year				
		Charges for services	Operating grants and contributions	Capital grants and contributions		Payments from primary government	Payments from (to) other component units	Contributions not restricted to specific programs	Taxes	Interest and investment earnings	Gain (loss) on sale of assets				Miscellaneous			
Agricultural Services and Development Administration	\$ 164,649	59,090	—	—	(105,559)	85,029	—	—	—	—	—	—	—	2,410	(18,120)	(89,554)	(107,674)	
Automobile Accident Compensation Administration	109,147	80,647	—	—	(28,500)	—	—	—	—	—	—	—	—	—	(14,964)	52,189	37,225	
Cardiovascular Center Corporation of Puerto Rico and the Caribbean	70,349	61,996	—	—	(8,413)	4,702	—	—	—	—	—	—	—	—	—	—	—	
Caribbean Basin Projects Financing Authority	7	—	—	—	(7)	—	—	—	—	—	—	—	—	—	—	(3,504)	(29,385)	(32,889)
Culebra Conservation and Development Authority	893	222	—	—	(671)	800	—	—	—	—	—	—	—	—	—	(4)	103	99
Economic Development Bank for Puerto Rico	57,971	58,453	—	—	482	—	—	—	—	—	—	—	—	—	—	129	1,058	1,187
Employment and Training Enterprise Corporation	5,488	3,560	277	—	(1,251)	723	—	—	—	—	—	—	—	—	—	5,808	113,092	118,900
Farm Insurance Corporation of Puerto Rico	8,652	9,799	2,107	—	3,254	—	—	—	—	—	—	—	—	—	—	98	(423)	(5,611)
Fine Arts Center Corporation	6,037	2,807	—	—	(3,230)	4,530	—	—	—	—	—	—	—	—	—	101	3,596	970
Governing Board of the 911 Service	16,767	22,285	—	—	5,518	—	—	—	—	—	—	—	—	—	—	159	1,459	19,605
Institutional Trust of the National Guard of Puerto Rico	8,120	18,543	—	—	10,423	—	—	—	—	—	—	—	—	—	—	159	7,083	29,087
Land Authority of Puerto Rico	28,875	32,668	—	—	3,793	3,893	—	—	—	—	—	—	—	—	—	1,835	12,258	55,174
Musical Arts Corporation and Subsidiaries	10,423	852	1,219	—	(8,354)	6,334	—	—	—	—	—	—	—	—	—	2,279	39	24,925
National Parks Company of Puerto Rico	46,086	11,972	—	—	(34,114)	19,960	—	—	—	—	—	—	—	—	—	466	—	1,159
Public Corporation for the Supervision and Deposit Insurance of Puerto Rico	6,743	12,654	1,307	—	7,218	—	—	—	—	—	—	—	—	—	—	1,692	1,065	(11,397)
Puerto Rico Conservatory of Music Corporation	7,472	2,455	301	36	(4,680)	19,396	—	—	—	—	—	—	—	—	—	8	—	5,425
Puerto Rico Convention Center District Authority	66,091	22,474	—	—	(43,617)	1,483	—	—	—	—	—	—	—	—	—	—	—	8
Puerto Rico Council on Higher Education	33,543	182	3,061	—	(30,300)	29,487	—	—	—	—	11,475	—	—	—	—	—	—	936
Puerto Rico Industrial Development Company	97,937	63,147	—	36	(34,754)	19,643	—	—	—	—	—	—	—	—	—	—	—	343
Puerto Rico Industrial, Tourist, Educational, Medical, and Environmental Control Facilities Financing Authority	231	420	—	—	189	—	—	—	—	—	—	—	—	—	—	—	—	6,112
Puerto Rico Land Administration	20,153	32,608	—	—	12,455	123	—	—	—	—	—	—	—	—	—	—	—	296
Puerto Rico Medical Services Administration	159,504	104,234	—	—	(55,270)	27,033	—	—	—	—	—	—	—	—	—	—	—	3,589
Puerto Rico Metropolitan Bus Authority	82,112	32,397	21,643	—	(28,072)	19,956	—	—	—	—	—	—	—	—	—	—	—	464
Puerto Rico Municipal Finance Agency	106,082	—	—	—	(106,082)	—	—	—	—	—	—	—	—	—	—	—	—	19,956
Puerto Rico Ports Authority	181,780	144,830	—	24,182	(12,768)	2,500	—	—	—	—	—	—	—	—	—	—	—	84
Puerto Rico Public Broadcasting Corporation	28,655	2,241	—	—	(26,414)	23,841	—	—	—	—	—	—	—	—	—	—	—	49,915
Puerto Rico School of Plastic Arts	5,732	1,413	701	—	(3,618)	2,996	—	—	—	—	—	—	—	—	—	—	—	1,692
Puerto Rico Solid Waste Authority	14,493	1,222	—	—	(13,271)	4,429	—	—	—	—	—	—	—	—	—	—	—	84
Puerto Rico Telephone Authority	3,942	—	—	—	(3,942)	—	—	—	—	—	—	—	—	—	—	—	—	—
Puerto Rico Tourism Company	293,932	318,406	—	—	24,474	11,869	(69,035)	—	—	—	—	—	—	—	—	—	—	761
Puerto Rico Trade and Export Company	41,300	16,328	—	—	(24,972)	15,143	—	—	—	—	—	—	—	—	—	—	—	302
Right to Employment Administration	28,967	—	7,126	—	(21,841)	19,683	—	—	—	—	—	—	—	—	—	—	—	6,352
Special Communities Perpetual Trust	156,365	—	—	—	(156,365)	—	—	—	—	—	—	—	—	—	—	—	—	—
State Insurance Fund Corporation	617,272	710,984	—	—	93,712	—	—	—	—	—	—	—	—	—	—	—	—	—
Total nonmajor	\$ 2,485,772	1,829,229	37,742	24,254	(594,547)	323,553	(68,783)	3,715	66,277	188,311	8,737	(8,231)	(80,968)	2,739,530	2,658,562			

See accompanying independent auditors' report.

STATISTICAL SECTION

STATISTICAL SECTION

This part of the Commonwealth of Puerto Rico's comprehensive annual financial report presents detailed information as a context for understanding what the information in the financial statements, note disclosures, and required supplementary information says about the Commonwealth's overall financial health.

Contents	Pages
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Financial Trends	1 – 4
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These schedules contain trend information to help the reader understand how the Commonwealth's financial performance and well-being have changed over time.

Revenue Capacity	5
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This schedule contains information to help the reader assess the Commonwealth's most significant local revenue sources.

Debt Capacity	6 – 7
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These schedules present information to help the reader assess the affordability of the Commonwealth's current levels of outstanding debt and the Commonwealth's ability to issue additional debt in the future.

Demographic and Economic Information	8 – 10
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These schedules offer demographic and economic indicators to help the reader understand the environment within which the Commonwealth's financial activities take place.

Operating Information	11
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This schedule contains service data to help the reader understand how the information in the Commonwealth's financial report relates to the services the government provides and the activities it performs.

Sources: Unless otherwise noted, the information in these schedules is derived from the comprehensive annual financial reports for the relevant year.

COMMONWEALTH OF PUERTO RICO

Statements of Changes in Net Assets

Last Four Fiscal Years

Accrual Basis of Accounting

(In thousands)

	<u>2006</u>	<u>2005</u>	<u>2004</u>	<u>2003</u>
Expenses:				
Governmental activities:				
General government	\$ 2,844,494	1,827,816	1,963,879	2,324,715
Public safety	2,217,294	2,580,951	1,950,635	1,606,272
Health	1,422,813	2,364,110	2,386,735	1,903,811
Public housing and welfare	3,287,559	3,443,886	2,919,315	3,239,366
Education	4,110,669	5,000,686	3,684,331	3,375,815
Economic development	564,447	1,006,945	896,925	451,945
Intergovernmental	440,390	—	591,237	466,762
Interest and other	882,163	845,556	778,700	671,228
Total governmental activities	<u>15,769,829</u>	<u>17,069,950</u>	<u>15,171,757</u>	<u>14,039,914</u>
Business-type activities:				
Lotteries	670,425	699,407	731,344	695,888
Unemployment	207,483	197,967	142,652	343,243
Other	25,043	32,437	26,763	22,385
Total business-type activities	<u>902,951</u>	<u>929,811</u>	<u>900,759</u>	<u>1,061,516</u>
Total primary government expenses	<u>16,672,780</u>	<u>17,999,761</u>	<u>16,072,516</u>	<u>15,101,430</u>
Program revenue:				
Governmental activities:				
Charges for services	828,993	702,691	769,207	757,116
Operating grants and contributions	4,365,711	4,096,204	1,038,776	3,830,639
Capital grants and contributions	100,990	121,083	2,592,055	173,644
Total governmental activities	<u>5,295,694</u>	<u>4,919,978</u>	<u>4,400,038</u>	<u>4,761,399</u>
Business activities:				
Charges for services	1,149,426	1,187,009	1,136,705	1,132,285
Operating grants and contributions	59,613	22,315	59,728	97,033
Total business-type activities	<u>1,209,039</u>	<u>1,209,324</u>	<u>1,196,433</u>	<u>1,229,318</u>
Net (expense) revenue:				
Governmental activities	(10,474,135)	(12,149,972)	(10,771,719)	(9,278,515)
Business-type activities	306,088	279,513	295,674	167,802
Total primary government net expense	<u>\$ (10,168,047)</u>	<u>(11,870,459)</u>	<u>(10,476,045)</u>	<u>(9,110,713)</u>
General revenue:				
Governmental activities:				
Taxes:				
Income	\$ 6,255,391	5,526,006	5,191,080	4,941,128
Excise	2,013,998	2,101,216	1,924,610	1,894,729
Other	15,145	7,128	19,211	3,055
Revenue from global settlement agreement	66,796	106,521	70,420	101,849
Unrestricted investment earnings	117,080	116,686	60,585	85,565
Revenue from component units	68,745	474,069	175,729	111,752
Grants and contributions not restricted to specific programs	196,721	102,691	5,706	103,423
Payment from agency fund	—	—	—	—
Special item	(2,485)	—	(35,646)	(203,514)
Gain on sale of assets	19,588	—	—	—
Transfers	242,642	492,796	203,258	279,060
Other	203,525	322,185	384,719	214,381
Total governmental activities	<u>9,197,146</u>	<u>9,249,298</u>	<u>7,999,672</u>	<u>7,531,428</u>
Business-type activities:				
Unrestricted investments earnings	33,165	32,284	23,831	77,362
Revenue from component units	—	—	—	1,038
Grants and contributions not restricted to specific programs	—	—	—	—
Transfers	(242,642)	(492,796)	(203,258)	(279,060)
Total business-type activities	<u>(209,477)</u>	<u>(460,512)</u>	<u>(179,427)</u>	<u>(200,660)</u>
Total primary government	<u>8,987,669</u>	<u>8,788,786</u>	<u>7,820,245</u>	<u>7,330,768</u>
Change in net assets:				
Governmental activities	(1,276,989)	(2,900,674)	(2,772,047)	(1,747,087)
Business-type activities	96,611	(180,999)	116,247	(32,858)
Total primary government	<u>\$ (1,180,378)</u>	<u>(3,081,673)</u>	<u>(2,655,800)</u>	<u>(1,779,945)</u>

COMMONWEALTH OF PUERTO RICO

Statements of Net Assets by Component

Last Four Fiscal Years

Accrual Basis of Accounting

(In thousands)

	<u>2006</u>	<u>2005</u>	<u>2004</u>	<u>2003</u>
Governmental activities:				
Invested in capital assets, net of related debt	\$ 3,485,882	3,774,098	3,133,230	1,969,864
Restricted	280,078	296,692	—	19,749
Unrestricted (deficit)	<u>(20,975,523)</u>	<u>(19,987,579)</u>	<u>(16,789,576)</u>	<u>(13,942,397)</u>
Total governmental activities net assets	<u>(17,209,563)</u>	<u>(15,916,789)</u>	<u>(13,656,346)</u>	<u>(11,952,784)</u>
Business-type activities:				
Invested in capital assets, net of related debt	1,008	847	1,672	1,895
Restricted	947,507	872,215	853,194	736,947
Unrestricted (deficit)	<u>(171,015)</u>	<u>(202,212)</u>	<u>(3,037)</u>	<u>(3,260)</u>
Total business-type activities net assets	<u>777,500</u>	<u>670,850</u>	<u>851,829</u>	<u>735,582</u>
Primary government:				
Invested in capital assets, net of related debt	3,486,890	3,774,945	3,134,902	1,971,759
Restricted	1,227,585	1,168,907	853,194	756,696
Unrestricted (deficit)	<u>(21,146,538)</u>	<u>(20,189,791)</u>	<u>(16,792,613)</u>	<u>(13,945,657)</u>
Total primary government net assets	\$ <u>(16,432,063)</u>	<u>(15,245,939)</u>	<u>(12,804,517)</u>	<u>(11,217,202)</u>

COMMONWEALTH OF PUERTO RICO
Statements of Changes in Fund Balances of Governmental Funds

All Governmental Fund Types

Last Ten Fiscal Years

(In thousands)

	2006	2005	2004	2003	2002	2001	2000	1999	1998	1997
Revenue:										
Taxes:										
Income	\$ 6,181,995	5,564,673	5,061,761	4,874,795	4,843,852	4,536,840	4,967,138	4,413,860	3,989,239	3,622,988
Excise	2,013,998	2,101,216	1,924,610	1,894,729	1,713,098	1,788,992	1,736,539	1,714,444	1,884,348	1,827,305
Other	15,145	7,128	19,211	3,055	1,963	92,024	87,523	78,926	73,426	64,910
Charges for services	828,993	702,691	750,978	780,905	535,423	645,806	617,020	457,454	569,096	464,034
Intergovernmental	4,663,422	4,319,977	3,654,766	4,107,706	3,634,358	3,807,049	2,971,528	3,417,647	3,009,169	3,077,042
Interest	117,080	116,686	58,914	85,565	90,940	67,020	91,525	97,880	116,030	110,777
Other	334,591	869,338	629,426	436,668	839,240	270,711	383,548	162,228	189,476	134,819
Total revenue all governmental fund types	14,155,224	13,681,709	12,099,666	12,183,423	11,658,874	11,208,442	10,854,821	10,342,439	9,830,784	9,301,875
Expenditures:										
General government	2,489,093	1,675,428	1,777,365	1,774,156	1,279,750	739,009	853,040	526,629	484,547	499,652
Public safety	2,108,152	2,409,668	1,765,199	1,424,846	1,659,280	1,623,362	1,310,322	1,103,606	1,241,762	1,188,814
Health	1,429,888	2,344,522	2,176,741	1,908,717	1,983,727	954,563	972,757	625,475	656,498	508,659
Public housing and welfare	3,130,373	3,320,849	2,738,016	2,953,189	2,726,129	2,315,899	2,102,410	2,485,092	1,902,902	2,086,828
Education	4,101,980	4,177,664	3,474,013	3,297,248	3,343,002	2,308,479	2,436,267	2,272,903	2,744,630	1,960,185
Economic development	516,444	706,066	868,926	428,621	637,794	170,937	337,255	314,897	186,296	333,290
Intergovernmental	409,727	—	528,829	465,699	466,169	222,721	373,016	318,664	55,739	496,844
Capital outlays	502,348	665,630	581,788	1,184,976	507,634	1,020,344	833,397	642,016	1,515,230	1,395,463
Debt service:										
Principal	446,281	391,554	526,572	330,346	2,062,059	466,467	416,369	351,722	620,866	359,851
Interest and other	822,234	733,931	737,502	1,158,749	614,347	545,001	444,595	442,614	595,053	556,835
Total expenditures all governmental fund types	15,956,520	16,425,312	15,174,951	14,926,547	15,279,891	10,366,782	10,079,628	9,083,618	10,003,523	9,386,421
Other financing sources (uses):										
Transfers in	1,423,240	1,745,992	1,034,090	1,664,278	966,935	756,229	1,026,581	992,667	1,116,455	1,255,621
Transfers out	(1,180,598)	(1,253,216)	(830,832)	(1,385,218)	(779,752)	(2,864,056)	(2,646,732)	(2,841,330)	(2,156,852)	(2,330,765)
Long-term debt issued	1,518,355	1,619,562	3,001,116	2,241,190	3,107,821	834,396	474,471	479,610	1,971,960	1,258,495
Discount on bonds issued	(323)	(6,078)	(23,061)	(36,204)	(16,075)	—	—	—	—	—
Capital leases	4,580	847	2,300	58,897	—	—	—	—	—	—
Refunding bonds issued	—	—	2,372,689	1,754,686	1,636,838	329,370	54,645	117,529	631,906	335,155
Payment to refunded bond escrow agent	—	—	(2,316,910)	(1,754,686)	(1,665,811)	(227,369)	(54,645)	(117,529)	(632,822)	(333,111)
Other	54,135	—	—	—	327,785	—	—	—	140,000	—
Total other financing sources (uses) all governmental fund types	1,819,389	2,107,107	3,239,392	2,542,943	3,577,741	(1,171,430)	(1,145,680)	(1,369,053)	1,070,647	185,395
Net change in fund balances (deficit)	\$ 18,093	(636,496)	164,107	(200,181)	(43,276)	(329,770)	(370,487)	(110,232)	897,908	100,849

The annual special tax of 1.03% of the assessed value of all real and personal property not exonerated from taxation, collected by the Municipal Revenue Collection Center on the Commonwealth's behalf, is presented as property tax from 2002 henceforth but as intergovernmental revenue in prior years.

In 2002, the Commonwealth adopted GASB No. 34. This statement requires that component units be included as expenditure by function. In prior years, such payments were reported as operating transfers-out to component units.

COMMONWEALTH OF PUERTO RICO

Fund Balances of Governmental Funds

Last Four Fiscal Years

Modified-Accrual Basis of Accounting

(In thousands)

	<u>2006</u>	<u>2005</u>	<u>2004</u>	<u>2003</u>
General fund:				
Reserved	\$ 770,628	810,314	1,102,232	262,758
Unreserved (deficit)	<u>(1,154,383)</u>	<u>(1,321,585)</u>	<u>(1,468,182)</u>	<u>(342,941)</u>
Total general fund	<u>\$ (383,755)</u>	<u>(511,271)</u>	<u>(365,950)</u>	<u>(80,183)</u>
All other governmental funds:				
Reserved	\$ 73,346	45,546	72,455	33,047
Unreserved reported in:				
Debt service funds	143,732	156,564	119,830	168,928
Special revenue funds	358,452	256,949	449,455	506,252
Capital project funds	<u>219,163</u>	<u>437,923</u>	<u>744,577</u>	<u>228,215</u>
Total all other governmental funds	<u>\$ 794,693</u>	<u>896,982</u>	<u>1,386,317</u>	<u>936,442</u>

Commonwealth of Puerto Rico
General Fund Net Revenue
For the last ten fiscal years
(In thousands)

	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
Total	5,600,748	5,902,506	6,550,043	6,943,613	6,962,134	7,454,399	7,841,742	7,985,388	8,305,669	8,541,238
From internal revenue	5,335,879	5,630,040	6,271,392	6,647,632	6,632,090	6,865,454	7,505,866	7,622,201	7,937,772	8,185,413
Tax revenue	5,095,218	5,358,805	5,982,504	6,344,398	6,204,639	6,428,083	6,910,345	7,091,198	7,374,589	7,735,669
Property taxes	8,286	5,673	2,214	1,131	287	-	-	-	3,949	1,106
Income taxes, total	3,610,016	3,972,869	4,433,804	4,856,011	4,778,590	4,878,418	5,170,294	5,297,931	5,485,950	5,989,906
Individuals	1,825,337	2,026,612	2,244,376	2,352,066	2,259,090	2,449,982	2,767,678	2,720,920	2,885,903	3,087,748
Corporations	1,440,691	1,527,415	1,653,762	1,781,862	1,696,766	1,706,137	1,776,985	1,831,027	1,870,937	1,872,458
Partnerships	2,120	4,404	2,087	2,339	3,026	2,670	2,101	3,005	3,245	2,787
Withholding to nonresidents	88,603	192,463	369,384	557,276	696,835	583,256	517,141	631,100	612,005	921,260
Tollgate tax (regular)	83,640	65,285	49,249	57,203	23,664	44,213	35,576	24,411	17,611	19,570
Tollgate tax (prepayment)	126,605	105,668	65,284	53,927	25,847	15,302	9,745	7,168	5,362	7,826
Interest subject to 17%	7,582	11,406	10,666	11,674	14,782	14,310	11,278	10,108	10,489	11,536
Taxes on dividends	35,438	39,616	38,996	39,664	58,580	62,548	49,790	70,192	80,398	66,721
Inheritance and gift taxes	4,028	1,380	1,811	3,109	7,475	1,962	2,825	15,691	7,129	9,466
Excise taxes, total	1,419,353	1,312,716	1,473,827	1,410,346	1,341,949	1,465,128	1,651,350	1,693,345	1,792,345	1,643,881
Alcoholic beverages, total	229,043	238,118	243,464	236,374	237,512	249,705	299,582	296,302	298,235	292,180
Distilled spirits	51,855	48,034	47,519	49,425	46,963	51,734	58,389	61,306	56,641	54,056
Beer	167,321	178,465	181,348	170,065	177,448	179,737	223,309	217,568	221,902	219,379
Other beverages	9,867	11,619	14,597	16,884	13,101	18,234	17,884	17,428	19,692	18,745
General taxes, total	1,190,310	1,074,598	1,230,363	1,173,972	1,104,437	1,215,423	1,351,768	1,397,043	1,494,110	1,351,701
Cigarettes	120,287	111,094	119,105	115,157	119,135	116,055	149,487	144,733	146,527	135,267
Petroleum products	22,095	6,172	5,562	4,689	7,046	5,095	5,860	4,934	5,143	5,146
Motor vehicle	365,820	350,004	411,573	389,995	406,252	418,024	499,252	551,181	606,662	533,957
Horse races	29,138	27,401	21,405	26,351	18,893	22,033	28,872	28,865	31,463	30,786
Insurance premiums	19,430	19,364	20,368	21,564	22,845	24,290	26,771	27,217	28,324	43,055
Cement	2,234	1,702	2,417	2,531	2,707	3,426	3,279	3,432	3,228	2,919
Slot machines	-	12,230	26,330	30,869	-	36,953	90,018	76,966	85,513	23,167
Crude oil and derived products	158,739	51,636	70,056	24,786	1,901	38,619	12,925	-	-	-
5% general excise tax	446,500	468,425	520,351	525,561	508,972	486,302	505,709	535,381	557,323	551,723
Hotel rooms	12,139	13,299	15,923	17,275	-	-	9,056	-	-	-
Others	13,928	13,271	17,273	15,194	16,686	64,626	20,539	24,334	29,927	25,681
Licenses	53,535	66,167	70,848	73,801	76,338	82,575	85,876	84,231	85,216	91,310
Motor vehicles	42,354	46,268	46,781	49,133	49,834	54,896	58,426	55,638	55,669	59,525
Entertainment machines	-	7,327	9,235	10,545	11,322	12,874	13,932	14,393	15,019	16,981
Alcoholic beverages and others	11,181	12,572	14,832	14,123	15,182	14,805	13,518	14,200	14,528	14,804
Non-tax revenue	240,661	271,235	288,888	303,234	427,451	437,371	595,521	531,003	563,183	449,744
Traditional lottery	52,829	57,986	59,206	63,779	57,482	61,358	67,621	65,387	64,638	62,729
Electronic lottery	47,994	54,681	53,013	70,209	70,211	57,897	89,443	86,115	68,011	55,212
Transfer in from non-budgeted funds	-	-	-	-	89,093	80,000	123,600	-	-	-
Miscellaneous	139,838	158,568	176,669	169,246	210,665	238,116	314,857	379,501	430,534	331,803
From non-internal revenue	264,869	272,466	278,651	295,981	330,044	344,848	335,876	363,187	367,897	355,825
Custom duties	61,114	72,206	61,355	50,231	43,154	30,595	25,918	34,266	26,731	9,553
Excises on off-shore shipments	\$ 203,755	200,260	217,296	245,750	286,890	314,253	309,958	328,921	341,166	346,272
Administrative measures						244,097				

Note: The net revenue presented above includes certain revenue and operating transfers-in from other funds presented in the combined statement of revenue and expenditures- budget and actual- budget basis.
Source: Puerto Rico Treasury Department.

COMMONWEALTH OF PUERTO RICO

Legal Debt Margin Information

Last Ten Fiscal Years

(In thousands)

	<u>2006</u>	<u>2005</u>	<u>2004</u>	<u>2003</u>	<u>2002</u>	<u>2001</u>	<u>2000</u>	<u>1999</u>	<u>1998</u>	<u>1997</u>
Internal revenue average for two years	\$ 8,061,593	7,779,987	7,564,034	7,185,660	6,748,772	6,639,861	6,459,512	5,950,716	5,482,960	5,155,399
Legal debt limit – 15% of internal revenue average for two years	1,209,239	1,166,998	1,134,605	1,077,849	1,012,316	995,979	968,927	892,607	822,444	773,310
Maximum debt service requirement	680,742	630,685	598,547	599,611	521,035	588,359	561,918	532,324	533,241	479,017
Additional legal debt service requirement margin		536,313	536,058	478,238	491,281	40,762	407,009	360,283	289,203	294,293
Total maximum debt service requirement as a percentage of internal revenue average for two years	<u>8.44%</u>	<u>8.11%</u>	<u>7.91%</u>	<u>8.34%</u>	<u>7.72%</u>	<u>8.86%</u>	<u>8.70%</u>	<u>8.95%</u>	<u>9.73%</u>	<u>9.29%</u>

Legal Debt Margin Calculation for Fiscal Year 2006

Internal revenue for the year ended June 30, 2005	\$ 7,937,772
Internal revenue for the year ended June 30, 2006	<u>8,185,413</u>
Total internal revenue for the years ended June 30, 2005 and 2006	<u>\$ 16,123,185</u>
Internal revenue average for the two years	\$ 8,061,593
Legal debt limit – 15% of internal revenue average for the two years	\$ 1,209,239
Maximum debt service requirement	<u>680,742</u>
Additional legal debt service requirement margin	<u>\$ 528,497</u>
Total maximum debt service requirement as a percentage of internal revenue average for two years	

Sources: Governmental Development Bank for Puerto Rico General obligation debt service may not exceed 15% of the average of the internal revenues for the last two fiscal years.

COMMONWEALTH OF PUERTO RICO

**Ratio of Annual Debt Service for General
Bonded Debt to Total General Expenditures**

Last Ten Fiscal Years

(In thousands)

Fiscal year:	Total debt service	General governmental expenditures	Ratio (%)
2006	\$ 565,137	15,849,707	3.6%
2005	491,394	16,425,312	3.0
2004	459,336	15,174,951	3.0
2003	362,136	14,926,547	2.4
2002	608,674	15,279,891	4.0
2001	538,436	10,366,782	5.2
2000	507,336	10,079,628	5.0
1999	468,970	9,083,618	5.2
1998	435,894	10,003,523	4.4
1997	430,153	9,386,421	4.6

COMMONWEALTH OF PUERTO RICO

Demographic and Economic Statistics

Last Ten Fiscal Years

	<u>Population *</u>	<u>Per capita income</u>	<u>Median age</u>	<u>Life expectancy</u>	<u>School enrollment</u>	<u>Labor force**</u>	<u>Unemployment rate (%)</u>	<u>Gross product (current prices)***</u>	<u>Real gross product (2000 prices)***</u>
Fiscal year:									
2006	3,928	\$ 12,997 (p)	34.4	76.8	770,831	1,420	11.7	\$ 56,688 (p)	45,111 (p)
2005	3,912	12,365	34.4	76.8	757,450	1,385	10.6	53,601	44,813
2004	3,895	11,724	33.8	76.8	764,861	1,360	11.4	50,709	43,967
2003	3,879	11,429	33.3	76.8	776,095	1,352	12.1	47,479	42,795
2002	3,859	10,921	32.9	75.2	792,284	1,309	12.1	45,071	41,901
2001	3,840	10,732	32.6	74.0	799,933	1,278	10.5	44,047	42,044
2000	3,816	10,204	32.2	74.0	748,769	1,292	11.0	41,419	41,419
1999	3,800	9,659	31.8	75.0	752,448	1,306	12.5	38,281	40,225
1998	3,781	9,108	31.4	73.0	752,171	1,318	13.7	35,111	38,658
1997	3,759	8,729	31.0	73.5	765,767	1,298	13.1	32,343	37,442

Source: Puerto Rico Planning Board, Department of Education, Department of Labor and Human Resources, and General Council of Education of the Commonwealth. The enrollment in private schools is an estimate.

* Population as of July 1st (In thousands)

** amounts expressed in thousands

*** amounts expressed in millions

(p) Preliminary figures.

COMMONWEALTH OF PUERTO RICO

Average Employment by Sector

Last Ten Fiscal Years

(In thousands)

Sector	2006	2005	2004	2003	2002	2001	2000	1999	1998	1997
Agriculture	22	26	25	24	23	21	24	27	31	31
Manufacturing	136	138	136	134	137	157	158	159	161	162
Construction	87	87	88	82	84	84	84	78	69	64
Trade	271	261	253	252	236	239	237	228	236	228
Finance, insurance, and real estate	47	43	41	42	42	39	42	42	40	37
Transportation, communications, and public utilities	59	59	56	57	62	56	55	59	59	59
Services	354	349	340	328	311	298	304	306	297	285
Government (1)	278	274	268	269	257	248	247	245	245	261
Total (2)	1,253	1,238	1,205	1,188	1,152	1,144	1,150	1,143	1,139	1,127

(1) Includes the Commonwealth, its municipalities, and federal government, and excludes public corporations.
Sources: Puerto Rico Department of Labor and Human Resources, Household Survey.

(2) Totals may not add due to rounding.

COMMONWEALTH OF PUERTO RICO

Tourism Indicators

Last Ten Fiscal Years

	<u>2006 (p)</u>	<u>2005</u>	<u>2004</u>	<u>2003</u>	<u>2002</u>	<u>2001</u>	<u>2000</u>	<u>1999</u>	<u>1998</u>	<u>1997</u>
All hotels and hostelry registration	2,152,472	2,097,606	2,008,730	1,964,963	1,821,274	1,836,377	1,674,092	1,637,620	1,570,683	1,461,567
Occupancy rates	67.9%	67.7%	68.9%	64.9%	67.8%	66.7%	70.7%	71.9%	67.3%	69.8%
Number of rooms	13,577	13,459	12,864	12,788	12,768	12,353	11,928	11,102	11,848	10,869
Visitors expenditures*	\$ 3,369	3,239	3,024	2,677	2,486	2,728	2,388	2,139	2,233	2,046

*Amounts expressed in millions of dollars.

(p) Preliminary figures.

Sources: Puerto Rico Tourism Company and Puerto Rico Planning Board.

COMMONWEALTH OF PUERTO RICO

Operating Indicators by Function

Last Ten Fiscal Years

Function	2006	2005	2004	2003	2002	2001	2000	1999	1998	1997
Fire protection:										
Number of stations	94	94	98	93	93	92	96	92	91	91
Fire personnel and officers	2,233	2,233	1,851	1,894	1,867	1,852	1,818	2,004	2,004	1,791
Calls answered	10,435	11,514	10,716	12,340	13,256	14,271	31,681	28,575	23,299	37,698
Building inspections conducted	73,360	71,610	56,093	53,750	41,415	31,693	44,396	14,621	30,139	32,402
Police protection:										
Number of stations	238	234	231	228	235	239	238	236	234	448
Police personnel and officers	20,552	20,806	21,185	21,079	20,468	20,800	20,822	20,305	19,934	17,650
Calls answered	7,146	7,178	6,907	5,538	4,673	4,957	5,059	4,545	4,748	5,000
Water system:										
Customers	1,285,732	1,251,699	1,256,981	1,238,461	1,209,834	1,195,038	1,179,109	1,163,673	1,148,284	1,141,648
Water consumption (millions of cubic meters)	365	356	359	350	349	348	350	348	343	364
Electric distribution system:										
Customers	1,450,227	1,438,699	1,419,602	1,401,301	1,383,888	1,365,668	1,344,907	1,326,055	1,309,954	1,291,633
Electricity consumption (millions of kilowatt)	20,620	20,507	20,260	19,887	19,130	18,723	18,144	16,989	17,457	16,118
Electricity production (millions of kilowatt)	24,870	24,500	24,100	23,717	22,514	22,132	21,461	20,140	20,725	19,143
Education:										
Enrollment in public schools:										
Kindergarden to sixth grade	306,073	323,270	321,653	326,606	334,929	341,467	341,470	350,714	354,098	354,226
Seventh to ninth grade	135,166	137,717	142,305	146,896	146,837	145,858	145,908	144,157	143,382	145,591
Tenth to twelfth grade	122,251	118,491	116,829	118,519	117,072	119,162	118,498	114,684	111,798	117,340
Enrollment in private schools:										
Kindergarden to sixth grade	128,645	110,283	117,622	117,622	119,648	119,648	91,321	91,321	91,321	91,284
Seventh to ninth grade	41,888	36,448	37,226	37,226	41,256	41,256	28,908	28,908	28,908	31,244
Tenth to twelfth grade	36,808	31,241	29,226	29,226	32,542	32,542	22,664	22,664	22,664	26,082
Enrollment in universities and colleges:										
Public	68,813	71,044	74,056	74,801	73,974	73,846	73,846	72,010	70,765	68,838
Private	140,734	136,650	132,735	125,041	117,578	100,704	100,704	103,623	101,020	106,552

Source: Various agencies and component units of the Commonwealth. The enrollment in private schools is an estimate.

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FORM OF OPINION OF BOND COUNSEL

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

_____, 2007

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

Dear Sir:

We have served as bond counsel in connection with the issuance by the Commonwealth of Puerto Rico of its \$91,200,000 principal amount of Public Improvement Bonds of 2007, Series B (the "Bonds"). The Bonds are dated, mature on July 1 of the years and in such principal amounts and bear interest at the rates, all as set forth in the Resolution referred to hereinbelow. The Bonds are issuable as fully registered Bonds without coupons, in authorized denominations of \$5,000 and integral multiples thereof, in the manner and in accordance with the terms and conditions of the Resolution.

In our capacity as bond counsel, we have examined the transcript of the proceedings (the "Transcript") of the Commonwealth of Puerto Rico relating to the issuance of the Bonds, including, without limitation, Act No. 74 of the Legislature of Puerto Rico (the "Legislature"), approved on July 23, 2007, as amended by Act No. 115 of the Legislature approved on August 31, 2007, and as supplemented by Joint Resolution No. 116 of the Legislature, approved on July 23, 2007 and Joint Resolution No. 117 of the Legislature, approved on July 23, 2007 (collectively, the "Act"), and a resolution adopted on September 19, 2007 by the Acting Secretary of the Treasury of Puerto Rico and approved by the Governor of Puerto Rico (the "Resolution"), and such other documents as we have deemed necessary to render this opinion.

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

From such examination, we are of the opinion that:

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

As bond counsel, we express no opinion as to any federal, state, Commonwealth of Puerto Rico or local tax consequences regarding the Bonds. We understand that you are relying on the opinion of Quiñones & Sánchez PSC, special tax counsel, as to certain tax consequences regarding the Bonds.

In rendering the opinions set forth herein, we have assumed the accuracy and truthfulness of all public records and of all certifications, documents and other proceedings examined by us that have been executed or certified by public officials acting within the scope of their official capacities and have not verified the accuracy or truthfulness thereof. We have also assumed the genuineness of the signatures appearing upon such public records, certifications, documents and proceedings. As to questions of fact material to our opinion, we have relied on representations of the Commonwealth of Puerto Rico furnished to us, without undertaking to verify such representations by independent investigation.

It is to be understood that the rights of the holders of the Bonds and the enforceability of the Resolution and the Bonds may be subject to judicial discretion and valid bankruptcy, insolvency, reorganization, moratorium and other laws affecting creditors' rights generally, and subject to general principles of equity (regardless of whether considered in a proceeding in equity or at law).

Respectfully submitted,

[To be signed "Squire, Sanders & Dempsey L.L.P."]

FORM OF OPINION OF SPECIAL TAX COUNSEL

Upon delivery of the Bonds, Quiñones & Sánchez PSC is prepared to render its final opinion with respect to the Bonds in substantially the following form:

_____, 2007

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

Dear Sir:

We have acted as Special Tax Counsel in connection with the issuance by the Commonwealth of Puerto Rico (the "Commonwealth") of its \$91,200,000 Public Improvement Bonds of 2007, Series B (the "Bonds"). As such counsel we have examined Act No. 74 of the Legislature of Puerto Rico (the "Legislature"), approved on July 23, 2007, as amended by Act No. 115 of the Legislature approved on August 31, 2007, and as supplemented by Joint Resolution No. 116 of the Legislature, approved on July 23, 2007 and Joint Resolution No. 117 of the Legislature, approved on July 23, 2007 (collectively, the "Act"), and pursuant to a resolution authorizing the issuance of the Bonds adopted in accordance with the Act by the Secretary of the Treasury of the Commonwealth of Puerto Rico and approved by the Governor of Puerto Rico, and other proofs submitted relative to the issuance and sale of the Bonds.

We have also examined the United States Internal Revenue Code of 1986, as amended, and regulations promulgated thereunder (the "U.S. Code"), the Puerto Rico Internal Revenue Code of 1994, as amended, and regulations promulgated thereunder (the "P.R. Code"), and such other laws as we have deemed relevant for the purpose of rendering this opinion

In connection with matters opined herein under the U.S. Code, please be advised that in accordance with the requirements of IRS Circular 230: (i) such opinions are not intended or written to be used and cannot be used by any person for purposes of avoiding penalties that may be imposed on such person, (ii) such opinions are issued to support the promotion or marketing of the Bonds, and (iii) any person investing in the Bonds should seek advice based on such person's particular circumstances from an independent tax advisor.

From such examination, we are of the opinion that, based on the provisions of Commonwealth law now in force:

1. Interest of the Bonds is exempt from Puerto Rico income and withholding taxes, including the alternative minimum tax imposed by Section 1017 of the P.R. Code.
2. The Bonds are exempt from property taxes imposed by the Municipal Property Tax Act of 1991, as amended, and interest thereon is exempt from the municipal license tax imposed by the Municipal License Tax Act of 1974, as amended.

3. The transfer of the Bonds by (i) gift will not be subject to gift tax under the P.R. Code in the case of donors who are residents of the Commonwealth at the time the gift is made and (ii) death will not be subject to estate tax under the P.R. Code in the case of a decedent who at the time of death was (x) residents of Puerto Rico and (y) a United States citizen who acquired such citizenship solely by reason of birth or residence in Puerto Rico.

4. Gain realized from the sale, exchange or redemption of a Bond by an individual that is a resident of the Commonwealth (as determined under the P.R. Code) or a corporation or partnership organized under the laws of the Commonwealth will be subject to income tax under the P.R. Code.

Gain realized from the sale, exchange or redemption of the Bonds by an individual that is a citizen of the United States and not a resident of Puerto Rico during the taxable year in which such gain is realized will not be subject to income tax under the P.R. Code, provided such gain does not constitute income from sources within Puerto Rico.

Gain realized from the sale, exchange or redemption of the Bonds by an individual that is an alien and not a resident of the Commonwealth or by a foreign corporation or partnership will not be subject to income tax under the P.R. Code, provided such gain does not constitute income from sources within the Commonwealth and is not effectively connected with the conduct of a trade or business within the United States.

5. The Bonds will be considered an obligation qualifying for (i) the non-recognition of gain rules of Section 1112(f)(2)(A) of the P.R. Code applicable to certain involuntary conversions and (ii) the exemption from the surtax imposed by Section 1102 of the P.R. Code available in obligations of the Commonwealth and certain other investments.

6. Interest of the Bonds constitutes "industrial development income" under Section 2(j) of the Puerto Rico Industrial Incentives Act of 1963, the Puerto Rico Industrial Incentives Act of 1978, the Puerto Rico Tax Incentives Act of 1987, and the Puerto Rico Tax Incentives Act of 1998, all as amended (collectively, the "Incentives Acts"), when received by a holder of a grant of tax exemption issued under any of the Incentives Acts that acquired the Bonds with "eligible funds," as such term is defined in the Incentives Acts.

The P.R. Code does not provide rules with respect to the treatment of the excess of the amount due at maturity of a Bond with an initial offering price to the public lower than the amount due at maturity over such initial offering price (the "Discount Amount"). Under the current administrative practice followed by the Department of the Treasury of the Commonwealth, the Discount Amount is treated as interest.

Prospective owners of the Bonds, including but not limited to financial institutions, should be aware that ownership of the Bonds may result in having a portion of their interest and other expenses attributable to interest on the Bonds disallowed as deductions for purposes of computing the regular tax and the alternative minimum tax for Puerto Rico income tax purposes.

From such examination, we are further of the opinion that, based on the provisions of the U.S. Code now in force:

1. Interest on the Bonds received by, or "original issue discount" (within the meaning of Sections 1272 and 1273 of the U.S. Code) accrued to, a corporation (i) organized under the laws of the Commonwealth and subject to income tax under the U.S. Code as a corporation, or (ii) otherwise constituting a foreign corporation that is subject to income tax under the U.S. Code as a corporation, is not, in the hands of such corporation, subject to income taxation under the U.S. Code provided such interest or "original issue discount" is not effectively connected, or treated as effectively connected, with or attributable to the conduct of a trade or business within the United States by such corporation;

2. Interest on the Bonds received by, or "original issue discount" (within the meaning of Sections 1272 and 1273 of the U.S. Code) accrued to, an individual who is a *bona fide* resident of the Commonwealth (within the meaning of Sections 933 and 937(a) of the U.S. Code and the regulations issued thereunder) during the entire taxable year in which such interest is received or "original issue discount" is accrued will constitute gross income from sources within the Commonwealth and, therefore, is excludable from gross income pursuant to Section 933(1) of the U.S. Code, provided such interest and original issue discount are not effectively connected with the conduct of a trade or business within the United States by such individual.

3. Interest on the Bonds and any original issue discount accrued or received thereon is not excludable from the gross income of the recipient thereof for United States federal income tax purposes under Section 103(a) of the U.S. Code.

4. Pursuant to Notice 89-40 issued by the United States Internal Revenue Services on March 27, 1989, gain on the sale, or exchange or redemption of the Bonds by an individual who is a *bona fide* resident of the Commonwealth (within the meaning of Sections 933 and 937(a) of the U.S. Code and the regulations issued thereunder) during the entire taxable year will constitute income from sources within the Commonwealth and, therefore, qualify for the exclusion from gross income provided in Section 933(1) of the U.S. Code, provided such Bonds do not constitute inventory in the hands of such individual and at the time that the Bonds were acquired by such individual, such individual was a *bona fide* resident of the Commonwealth (within the meaning of Sections 933 and 937(a) of the U.S. Code and the regulations issued thereunder).

5. The Transfer of the Bonds by death or gift will not be subject to estate or gift tax under the U.S. Code in the case of decedents or donors who, at the time of death or gift, are (i) residents of the Commonwealth and (ii) United States citizens that acquired such citizenship solely by reason of birth or residence in the Commonwealth.

Prospective owners of the Bonds should also be aware that the U.S. Code provides special rules for the taxation of shareholders of foreign corporations that qualify as "controlled foreign corporations," "personal holding companies," or "passive foreign investment companies," as such terms are defined by the U.S. Code.

Other than as described herein, we have not addressed, and we are not opining upon, the federal or Commonwealth tax consequences to any investor arising from the ownership of, receipt or accrual of interest on, or disposition of the Bonds.

Very truly yours,

[To be signed "Quiñones & Sánchez PSC"]

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COMMONWEALTH OF PUERTO RICO • PUBLIC IMPROVEMENT BONDS OF 2007, SERIES B (GENERAL OBLIGATION BONDS)

