NEW ISSUE - BOOK-ENTRY ONLY

# $1,206,130,000
# Puerto Rico Public Finance Corporation
# 2004 Series A Bonds
# (Commonwealth Appropriation Bonds)

Puerto Rico Public Finance Corporation (the "Corporation") is issuing its 2004 Series A Bonds for the purpose of refunding a portion of certain of its outstanding bonds. The 2004 Series A Bonds and the Corporation's 2004 Series B Bonds, which are being offered solely in the Commonwealth of Puerto Rico under a separate Official Statement (collectively referred to as the "Series 2004 Bonds"), will be issued under a new trust agreement between the Corporation and U.S. Bank Trust National Association. The Series 2004 Bonds are limited obligations of the Corporation payable solely from payments of principal of and interest on certain promissory notes (the "Series 2004 Notes") issued by certain departments, agencies, instrumentalities and public corporations of the Commonwealth of Puerto Rico (the "Authorized Debtors"). The Series 2004 Notes are payable solely from budgetary appropriations to be made by the Legislature of the Commonwealth pursuant to legislation adopted by the Legislature of the Commonwealth (the "Appropriation Acts"). The Appropriation Acts require the Office of Management and Budget of the Commonwealth to include in the annual operating budget of the Commonwealth amounts required to pay debt service on the Series 2004 Notes and certain other notes of the Authorized Debtors. If these budgetary appropriations are made on a timely basis by the Legislature of the Commonwealth, payments required to be made under the Series 2004 Notes will at all times be sufficient to pay the principal of and interest on the Series 2004 Bonds as they become due. The Legislature of Puerto Rico is not legally bound to appropriate funds for such payments. The 2004 Series A Bonds will have the following characteristics:

- Interest on the 2004 Series A Bonds will accrue from their date of issuance and will be payable semiannually on the first day of August and February, commencing on August 1, 2004, through the Mandatory Tender Date (as defined below).

- The 2004 Series A Bonds will bear interest through February 1, 2012 (the "Mandatory Tender Date") at the rates shown on the inside cover. On the Mandatory Tender Date, the 2004 Series A Bonds must be tendered for remarketing by the holders of such bonds. The purchase price of such 2004 Series A Bonds is equal to the principal amount thereof, plus accrued interest, if any, to the Mandatory Tender Date, and is payable as to principal solely from the proceeds of such remarketing. Any 2004 Series A Bonds not purchased on the Mandatory Tender Date will be returned to their holders, remain outstanding, and bear interest at the rate of 8% per annum until such 2004 Series A Bonds are successfully remarketed.

- The maturity schedules and prices of the 2004 Series A Bonds are presented on the inside cover page.

- The scheduled payment of principal of and interest on some of the 2004 Series A Bonds will be insured by CDC IXIS Financial Guaranty North America, Inc., MBIA Insurance Corporation, Ambac Assurance Corporation or Financial Guaranty Insurance Company, as indicated on the inside cover of this Official Statement.

- In the opinion of Bond Counsel, under existing law and assuming compliance with the tax covenants described herein, and the accuracy of certain representations and certifications made by the Corporation, the Authorized Debtors described herein and certain other entities, interest on the 2004 Series A Bonds is excluded from gross income for federal income tax purposes under Section 103 of the Internal Revenue Code of 1986, as amended (the "Code"). Bond Counsel is also of the opinion that such interest is not treated as a preference item in calculating the alternative minimum tax imposed under the Code with respect to individuals and corporations. Interest on the 2004 Series A Bonds is, however, included in the adjusted current earnings of certain corporations for purposes of computing the alternative minimum tax imposed on such corporations. Bond Counsel is further of the opinion that the 2004 Series A Bonds and the interest thereon are exempt from state, Commonwealth and local income taxation. See "Tax Matters" herein regarding certain other tax considerations.

The Corporation expects to deliver the 2004 Series A Bonds on or about June 28, 2004.

**The 2004 Series A Bonds will not constitute an obligation of the Commonwealth of Puerto Rico or any of its political subdivisions or public instrumentalities (other than the Corporation), and neither the Commonwealth of Puerto Rico nor any of its political subdivisions or public instrumentalities (other than the Corporation) will be liable thereon. The Corporation has no taxing power.**

**Lehman Brothers** **JP Morgan** **Morgan Stanley**
**Banc of America Securities LLC** **Citigroup** **Goldman, Sachs & Co.**
**Merrill Lynch & Co.** **Raymond James & Associates, Inc.**
**Samuel A. Ramírez & Co., Inc.** **UBS Financial Services Inc.**
**Wachovia Bank, National Association**

June 11, 2004

**$1,206,130,000**
**Puerto Rico Public Finance Corporation**
**2004 Series A Bonds**
**(Commonwealth Appropriation Bonds)**

| | | | |
|---|---|---|---|
| **$489,480,000** | **5.75%*** | **Term Bonds due August 1, 2027** | **– Yield 4.48%**** |
| **$24,850,000†** | **5.00%*** | **Term Bonds due August 1, 2027** | **– Yield 4.18%**** |
| **$252,765,000‡** | **5.25%*** | **Term Bonds due August 1, 2029** | **– Yield 4.10%**** |
| **$39,035,000‡** | **4.10%*** | **Term Bonds due August 1, 2029** | **– Yield 4.10%**** |
| **$250,000,000±** | **5.25%*** | **Term Bonds due August 1, 2030** | **– Yield 4.10%**** |
| **$150,000,000±±** | **5.25%*** | **Term Bonds due August 1, 2031** | **– Yield 4.10%**** |

* Initial rate.
** Yield to February 1, 2012 (the Mandatory Tender Date).
† Insured by CDC IXIS Financial Guaranty North America, Inc.
‡ Insured by MBIA Insurance Corporation.
± Insured by AMBAC Assurance Corporation.
±± Insured by Financial Guaranty Insurance Company.

No dealer, broker, sales representative or other person has been authorized by the Corporation or the Underwriters to give any information or to make any representations other than those contained herein and, if given or made, such other information or representations must not be relied upon as having been authorized by the Corporation or the Underwriters. 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 2004 Series A Bonds by any person in any jurisdiction in which it is unlawful for such person to make such an offer, solicitation or sale. The delivery of this Official Statement at any time does not imply that the information contained herein is correct as of any time subsequent to its date. The information set forth herein has been obtained from the Corporation, 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 Corporation or the Commonwealth since the date hereof. The Underwriters have provided the following three sentences 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 THIS OFFERING, THE UNDERWRITERS MAY EFFECT TRANSACTIONS WHICH STABILIZE OR MAINTAIN THE MARKET PRICES OF THE 2004 SERIES A BONDS OFFERED HEREBY AT LEVELS ABOVE THOSE WHICH MIGHT OTHERWISE PREVAIL IN THE OPEN MARKET. SUCH STABILIZING, IF COMMENCED, MAY BE DISCONTINUED AT ANY TIME.**

**Other than with respect to the information concerning CDC IXIS Financial Guaranty North America, Inc., ("CIFGNA"), MBIA Insurance Corporation ("MBIA"), Ambac Assurance Corporation ("Ambac"), and Financial Guaranty Insurance Company ("FGIC") contained under the caption "Bond Insurance" of this Official Statement, none of the information in this Official Statement has been supplied or verified by CIFGNA, MBIA, Ambac or FGIC. CIFGNA, MBIA, Ambac and FGIC make no representation or warranty, express or implied, as to (i) the accuracy or completeness of such information, (ii) the validity of the 2004 Series A Bonds, or (iii) the tax exempt status of the interest on the 2004 Series A Bonds.**

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## INTRODUCTORY STATEMENT

This Official Statement of Puerto Rico Public Finance Corporation, a subsidiary of Government Development Bank for Puerto Rico ("Government Development Bank"), provides certain information in connection with the sale by the Corporation of its 2004 Series A Bonds, which together with the 2004 Series B Bonds hereinafter mentioned, are collectively referred to as the "Series 2004 Bonds."

This Official Statement includes as Appendix I the Commonwealth of Puerto Rico Financial Information and Operating Data Report dated April 1, 2004 (the "Commonwealth Report"). This Official Statement incorporates by reference the Comprehensive Annual Financial Report of the Commonwealth for the fiscal year ended June 30, 2002, prepared by the Department of the Treasury of the Commonwealth (the "Commonwealth's Annual Financial Report"), which report includes the basic financial statements of the Commonwealth as of and for the fiscal year ended June 30, 2002. The Commonwealth expects that the Commonwealth's Annual Financial Report for the fiscal year ended June 30, 2003 will be available during the second calendar quarter of 2004. Upon completion thereof, the Commonwealth will file such Comprehensive Annual Financial Report with each nationally recognized municipal securities information repository ("NRMSIR") and will make such report available to any person to whom this Official Statement is delivered upon request in the manner specified below.

The Commonwealth Report includes important information about the Commonwealth, including information about the economy, historical revenues and expenditures of the Commonwealth's General Fund, the approved budget for fiscal year 2004, the proposed budget for fiscal year 2005, and the debt of the Commonwealth's public sector, and should be read in its entirety.

The Commonwealth's Annual Financial Report includes the basic financial statements of the Commonwealth for the fiscal year ended June 30, 2002, together with the independent auditor's report thereon, dated April 30, 2003, of KPMG LLP, certified public accountants. The Commonwealth's Annual Financial Report has been filed by the Commonwealth with each NRMSIR. KPMG LLP did not audit the financial statements of the Public Buildings Authority's capital project fund (a major fund), and certain activities, funds and component units separately identified in their report. Those financial statements were audited by other auditors whose reports have been furnished to KPMG LLP, and their 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 KPMG LLP report also contains an emphasis paragraph for the implementation of a new reporting model as required by GASB Statement No. 34, Basic Financial Statements - and Management's Discussion and Analysis - for State and Local Governments, GASB Statement No. 35, Basic Financial Statements - and Management's Discussion and Analysis - for Public Colleges and Universities, GASB Statement No. 37, Basic Financial Statements - and Management's Discussion and Analysis - for State and Local Governments: Omnibus, GASB Statement No. 38, Certain Financial Statement Note Disclosures, and GASB Interpretation No. 6, Recognition and Measurement of Certain Liabilities and Expenditures in Governmental Fund Financial Statements as of July 1, 2001.

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's 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 2004 Series A 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.

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, 140 Broadway, 38th Floor, New York, New York 10005, 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 Undertaking" below.

## PLAN OF FINANCING

The 2004 Series A Bonds are being issued under a trust agreement (the "Trust Agreement"), dated as of June 1, 2004, between the Corporation and U.S. Bank Trust National Association, as trustee (the "Trustee"), for the purpose of refunding certain bonds of the Corporation, which refunded bonds are listed in Appendix V hereto, and refunding interest (but not principal) accrued during the fiscal year ending June 30, 2005 on certain other bonds of the Corporation. Simultaneously with the issuance of the 2004 Series A Bonds, the Corporation expects to issue $146,895,000 of its 2004 Series B Bonds, which will be offered solely in the Commonwealth of Puerto Rico and under a separate Official Statement for the purpose of refunding certain other bonds issued by the Corporation (all such bonds being refunded by the Series 2004 Bonds are collectively referred to as the "Refunded Bonds"). Pursuant to certain Escrow Agreements between the Corporation and U.S. Bank Trust National Association (the "Escrow Agent"), the Corporation will irrevocably deposit cash and securities in trust with the Escrow Agent. The securities will bear interest at such rates and will mature at such times and in such amounts so that, together with any uninvested cash held by the Escrow Agent, sufficient moneys will be available to make full and timely payments of the maturing principal and redemption premium, if any, and interest on, the Refunded Bonds to their respective maturity or redemption dates. Upon such irrevocable deposits, the Refunded Bonds will no longer be deemed to be outstanding and will no longer be entitled to the benefit of the pledge and lien established by the trust agreements under which such bonds were issued or to payment from the budgetary appropriations described below. The Corporation will direct the Escrow Agent to redeem the Refunded Bonds on the dates and at the redemption prices set forth in Appendix V hereto.

The Refunded Bonds, and certain other bonds of the Corporation that were issued under the same trust agreements as the Refunded Bonds but are not being refunded and that will remain outstanding after the issuance of the Series 2004 Bonds (the "Parity Bonds" and, together with the Refunded Bonds, the "Prior Bonds"), were issued for the purpose of providing the Corporation with the necessary funds to purchase from Government Development Bank several promissory notes (the "Existing Notes") issued in connection with the restructuring and refinancing of certain loans made by Government Development Bank to the Authorized Debtors pursuant to the terms of the Appropriation Acts. The Prior Bonds were issued under several different trust agreements relating to several different Appropriation Acts. In connection with the refunding of the Refunded Bonds, certain of the Existing Notes will be amended to permit the execution and delivery of the Series 2004 Notes, and the Series 2004 Notes will be issued. The Existing Notes, as so amended, together with all other notes of the Authorized Debtors securing the Parity Bonds, are referred to as the "Parity Notes." The Series 2004 Bonds are payable solely from payments of principal and interest on the Series 2004 Notes. The Parity Bonds are payable solely from payments of principal and interest on the Parity Notes. The Series 2004 Notes and the Parity Notes are payable on a parity basis solely from budgetary appropriations made by the Legislature of Puerto Rico pursuant to the Appropriation Acts. The Series 2004 Notes and the Parity Notes are of equal rank.

The Series 2004 Bonds and any additional bonds issued in the future under the Trust Agreement are herein collectively referred to as the "Bonds." Additional Bonds may be issued under the Trust Agreement only to (i) refund any Bonds outstanding under the Trust Agreement or any other bonds payable from budgetary appropriations made under the Appropriation Acts, (ii) fund a Reserve Account, if applicable, (iii) pay capitalized interest with respect to any such additional Bonds, and (iv) pay the cost of issuance of such additional Bonds. The Corporation may not issue additional Bonds under the Trust Agreement unless the amount of principal and interest payable under the Series 2004 Notes, the Parity Notes and any other promissory notes of Authorized Debtors issued in connection with such additional Bonds (such other promissory notes, together with the Series 2004 Notes, are collectively referred to as the "Notes"), are sufficient to pay the principal of and interest on all Bonds and Parity Bonds outstanding after the issuance of such additional Bonds. See "Source of Payment and Security for the 2004 Series A Bonds - Limitation on Additional Bonds."

The Series 2004 Bonds are limited obligations of the Corporation payable solely from Pledged Revenues (as defined in the Trust Agreement), consisting of payments of principal of and interest on the Series 2004 Notes and other amounts deposited to the credit of the Puerto Rico Public Finance Corporation Restructuring Sinking Fund (the "Sinking Fund") established under the Trust Agreement, including the investment earnings thereon. Payments of principal and interest under the Series 2004 Notes will be made solely from budgetary appropriations made by the Legislature of the Commonwealth pursuant to the Appropriation Acts (such budgetary appropriations which relate to the Series 2004 Notes are referred to as the "Legislative Appropriations"). The Appropriation Acts require the Office of Management and Budget to include in the operating budget of the Commonwealth submitted annually to the Legislature of the Commonwealth the amounts necessary, up to certain specified maximums in some cases, to pay the principal of and interest on the Notes as they become due. If the Legislative Appropriations are made on a timely basis each year and in the required amounts, payments of principal and interest required to be made under the Series 2004 Notes will at all times be sufficient to pay the principal of and interest on the Series 2004 Bonds as they become due and payable. The Legislature of Puerto Rico is not legally bound to appropriate funds for such payments. See "Source of Payment and Security for the 2004 Series A Bonds."

Payment of the principal of and interest on the 2004 Series A Bonds maturing on August 1, 2027 and bearing interest initially at a rate of 5.00% per annum (the "CIFGNA Insured Bonds") when due will be insured by a financial guaranty insurance policy to be issued by CDC IXIS Financial Guaranty North America, Inc. ("CIFGNA"), simultaneously with the delivery of CIFGNA Insured Bonds.

Payment of the principal of and interest on the 2004 Series A Bonds maturing on August 1, 2029 (the "MBIA Insured Bonds") when due will be insured by a financial guaranty insurance policy to be issued by MBIA Insurance Corporation ("MBIA"), simultaneously with the delivery of the MBIA Insured Bonds.

Payment of the principal of and interest on the 2004 Series A Bonds maturing on August 1, 2030 (the "Ambac Insured Bonds") when due will be insured by a financial guaranty insurance policy to be issued by Ambac Assurance Corporation ("Ambac"), simultaneously with the delivery of the Ambac Insured Bonds.

Payment of the principal of and interest on the 2004 Series A Bonds maturing on August 1, 2031 (the "FGIC Insured Bonds") when due will be insured by a financial guaranty insurance policy to be issued by Financial Guaranty Insurance Company ("FGIC"), simultaneously with the delivery of the FGIC Insured Bonds.

This Official Statement, including information incorporated in this Official Statement by reference, contains certain "forward-looking statements" concerning the Commonwealth's operations and financial condition. 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. The words "may," "would," "could," "will," "expect," "anticipate," "believe," "intend," "plan," "estimate" and similar expressions are meant to identify these forward-looking statements. Actual results may differ materially from those expressed or implied by these forward-looking statements.

Descriptions of the Corporation, the Commonwealth, the 2004 Series A Bonds, the Trust Agreement, the Notes, the Parity Notes, the Parity Bonds and certain other documents are included in this Official Statement. Such descriptions do not purport to be comprehensive or definitive. All references herein to the Trust Agreement and other documents are qualified in their entirety by reference to each such document. References herein to the 2004 Series A Bonds are qualified in their entirety by reference to the form thereof. The resolution of the Corporation authorizing the issuance of the 2004 Series A Bonds (the "Resolution") and each of the aforesaid documents are available for inspection at the offices of the Corporation, located at Minillas Government Center, De Diego Avenue, San Juan, Puerto Rico 00940.

Capitalized terms not otherwise defined herein are defined in the Trust Agreement. See Appendix II – “Summary of the Trust Agreement.”

## SOURCES AND USES OF FUNDS

The sources and uses of bond proceeds are set forth below.

**Sources:**

| | |
|---|---|
| Principal amount of the 2004 Series A Bonds | $1,206,130,000.00 |
| Net original issue premium | 89,441,569.55 |
| Funds available from trust accounts relating to Refunded Bonds | 3,655,769.66 |
| Total Sources | $1,299,227,339.21 |

**Uses:**

| | |
|---|---|
| Refunding of the Refunded Bonds | $1,253,416,511.92 |
| Underwriting discount, bond insurance premiums, legal, printing and other costs of issuance of the 2004 Series A Bonds | 45,810,827.29 |
| Total Uses | $1,299,227,339.21 |

## PUERTO RICO PUBLIC FINANCE CORPORATION

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

The Board of Directors of the Corporation consists of the same members of the Board of Directors of Government Development Bank, who are the following:

| Member | Occupation | Expiration Date of Term |
|---|---|---|
| Juan Agosto Alicea, Chairman | Chairman, Board of Directors of Puerto Rico Aqueduct and Sewer Authority | September 22, 2004 |
| Melba Acosta Febo | Director, Office of Management and Budget | September 22, 2006 |
| Milton Segarra Pancorbo | Secretary of Economic Development and Commerce | September 22, 2006 |
| Juan A. Flores Galarza | Secretary of the Treasury | September 22, 2004 |
| Samuel H. Jové Fontán | President, BMJ Foods of Puerto Rico, Inc. | September 22, 2007 |
| Fermín Contreras Bordallo | Private investor | September 22, 2007 |
| Angel Blanco Bottey | Private investor | September 21, 2004 |

The following individuals are currently officers of the Corporation:

*Antonio Faría-Soto,* President of the Corporation, is also President of Government Development Bank for Puerto Rico. Mr. Faría-Soto was appointed President of Government Development Bank in November 2003. At the time of his appointment, he was President of the Economic Development Bank for Puerto Rico. Prior to his appointment as President of the Economic Development Bank for Puerto Rico, he served as Commissioner of Financial Institutions for the Commonwealth. Mr. Faría-Soto has over 30 years of experience in the commercial and investment banking industry, having worked at PaineWebber, Banco Santander, Banco Central Hispano and Citibank N.A. He obtained a master's degree in Business Administration from the InterAmerican University of Puerto Rico and a bachelor's degree in Business Administration from Catholic University of Puerto Rico.

*Carlos M. Piñeiro*, Executive Vice President of the Corporation, is also Executive Vice President of Government Development Bank for Puerto Rico, a position he assumed in 2002. Prior to joining Government Development Bank, Mr. Piñeiro held various positions in investment banking in Chicago, Illinois, and was Executive Vice President of a Puerto Rico health care institution. Mr. Piñeiro received a Bachelor's of Science Degree in Industrial Engineering from Lehigh University, and a Master in Business Administration from the University of Michigan Business School.

*María de Lourdes Rodríguez*, General Counsel of the Corporation, is also General Counsel of Government Development Bank for Puerto Rico, a position she assumed in 2003. Prior to joining Government Development Bank, Ms. Rodríguez worked as an attorney in private practice in the corporate and environmental law areas. Ms. Rodríguez received a Bachelor's Degree from the Catholic University of America in Washington D.C., and a law degree from the University of Puerto Rico Law School.

*Olga Ortiz*, Secretary of the Board of Directors of the Corporation, is also Secretary of the Board of Directors of Government Development Bank.

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

As of December 31, 2003, the Corporation had bonds or notes outstanding in the aggregate principal amount of $4.2 billion. All such bonds and notes, other than the Bonds, are payable from revenues other than the Pledged Revenues. Except for Bonds which may be issued in the future to refund the Bonds, to refund other bonds payable from budgetary appropriations made under the Appropriation Acts, to fund a Reserve Account for one or more series of Bonds, to pay capitalized interest with respect to any such additional Bonds or to fund the costs of issuance of Bonds, the Corporation may not issue additional bonds payable from Pledged Revenues. The Corporation may from time to time issue additional bonds and notes, which would be authorized and issued pursuant to trust indentures or authorizing resolutions separate from and unrelated to the Resolution and the Trust Agreement and would be secured with revenues other than the Pledged Revenues. See Appendix II – "Summary of the Trust Agreement - Additional Bonds - Refunding Bonds."

## THE 2004 SERIES A BONDS

### General

The 2004 Series A Bonds are being issued as registered bonds without coupons and will be initially registered only in the name of Cede & Co., as nominee of The Depository Trust Company ("DTC"), New York, New York, which will act as securities depository for the 2004 Series A Bonds. The 2004 Series A Bonds will be available to purchasers in denominations of $5,000 or any integral multiple thereof only under the book-entry system maintained by DTC through brokers and dealers who are, or act through, DTC Participants (as defined herein). Purchasers will not receive physical delivery of the 2004 Series A Bonds. So long as any purchaser is the Beneficial Owner (as defined herein) of a 2004 Series A Bond, such purchaser must maintain an account with a broker or dealer who is, or acts through, a DTC Participant to receive payment of principal of and interest on such 2004 Series A Bonds. See "Book-Entry Only System" below.

The 2004 Series A Bonds are being issued pursuant to the Resolution and the Trust Agreement. The 2004 Series A Bonds will be issued in such aggregate principal amounts and will be stated to mature as set forth on the inside cover page of this Official Statement.

**Interest**

The 2004 Series A Bonds will bear interest at the rates set forth on the inside cover page hereof until February 1, 2012 (the "Mandatory Tender Date"). Interest will accrue from the date of issue of the 2004 Series A Bonds, and will be payable semiannually during that period on the first day of August and February, commencing on August 1, 2004. Interest will be calculated on the basis of a 360-day year of twelve 30-day months.

**No Optional Tender**

The 2004 Series A Bonds will not be subject to tender at the option of the holders of such Bonds prior to the Mandatory Tender Date.

**Mandatory Tender**

The 2004 Series A Bonds are subject to mandatory tender to Lehman Brothers Inc., as the remarketing agent (the "Remarketing Agent") on the Mandatory Tender Date for remarketing to prospective investors. Therefore, on the Mandatory Tender Date, the 2004 Series A Bonds must be tendered for remarketing by the Holders thereof to the Trustee as tender agent. The Remarketing Agent will use its best efforts to remarket the 2004 Series A Bonds on the Mandatory Tender Date.

On the Mandatory Tender Date, if the 2004 Series A Bonds are successfully remarketed, the Holders thereof will be paid, solely from the proceeds of the remarketing (in the case of principal), the purchase price of such Bonds, equal to the principal amount thereof, plus accrued interest to the Mandatory Tender Date (the "Tender Purchase Price"), and such Holders will have no right to retain the 2004 Series A Bonds. No funds of the Corporation are available to pay the Tender Purchase Price of the 2004 Series A Bonds on the Mandatory Tender Date. The Corporation has not obtained, and will not obtain, a liquidity facility to pay the Tender Purchase Price of the 2004 Series A Bonds on the Mandatory Tender Date.

If the 2004 Series A Bonds are not successfully remarketed on the Mandatory Tender Date, the Holders thereof will retain ownership of such Bonds and the 2004 Series A Bonds will continue to be Outstanding under the Trust Agreement and will bear interest at the rate of 8.00% per annum from the Mandatory Tender Date until such Bonds are successfully remarketed (the "Stepped Rate Period"). On any date during the Stepped Rate Period, the 2004 Series A Bonds will be subject to redemption at the option of the Corporation or mandatory tender to the Remarketing Agent.

Notice of the mandatory tender for remarketing of the 2004 Series A Bonds will be given not less than 30 days prior to the Mandatory Tender Date by first-class mail, postage prepaid, to DTC (or if the book-entry only system has been discontinued as described above, to the registered owners of the 2004 Series A Bonds, at their addresses appearing upon the registration books maintained by the Trustee). Failure to mail such notice to the registered owner of any 2004 Series A Bond will not affect the tender or remarketing of such Bond.

In connection with their remarketing, the 2004 Series A Bonds may be converted to a different interest rate mode, but this conversion will only be effective after the 2004 Series A Bonds have been sold in the remarketing. This interest rate mode will be the "flexible rate mode" in which the Remarketing Agent determines both the length of the interest rate period (which must be an integral multiple of 30 days) and the applicable interest rate after taking into consideration certain limitations contained in the Appropriation Acts and in the laws applicable to all Commonwealth bonds which may place restrictions on the maximum interest rate applicable to the 2004 Series A Bonds after their remarketing. The Corporation may also cause the 2004 Series A Bonds to be remarketed in another interest rate mode authorized by the Resolution (a daily rate, a weekly rate, a commercial paper rate, a term rate or a fixed rate), but only if (i) the Corporation is able to obtain an opinion of Bond Counsel to the effect that such action will not cause interest on the 2004 Series A Bonds to be includable in the gross income of the owners thereof for purposes of federal income taxation, or (ii) the 2004 Series B Bonds are sold as bonds the interest on which is not excludable from gross income for federal income tax purposes.

**Optional Redemption**

At the option of the Corporation and upon at least 30 days' notice, the 2004 Series A Bonds are subject to redemption, from any moneys that may be available for that purpose, either in whole or in part, and if in part, in such order of maturity as directed by the Corporation, on the Mandatory Tender Date and on any date thereafter during the Stepped Rate Period until such Bonds are successfully remarketed, at a price equal to the principal amount of the 2004 Series A Bonds to be redeemed, without premium, together with the interest accrued thereon to the date of redemption.

Any redemption of the 2004 Series A Bonds, either in whole or in part, shall be made upon at least 30 days' notice by mail to DTC or, if the book-entry only system as described below has been discontinued, by first class mail, postage prepaid, to all registered owners in the manner and under the terms and conditions provided in the Trust Agreement. On the date designated for redemption, notice having been given as provided in the Trust Agreement and moneys for payment of the principal of and redemption premium, if any, and the interest on the 2004 Series A Bonds or portions thereof so called for redemption being held by the Trustee, interest on the 2004 Series A Bonds or portions thereof so called for redemption shall cease to accrue. Subject to certain provisions of the Trust Agreement, 2004 Series A Bonds and portions thereof which have been duly called for redemption under the provisions of the Trust Agreement, or with respect to which irrevocable instructions to call for redemption or to pay at maturity have been given, and for which sufficient moneys or investments permitted by the Trust Agreement are held in a separate account for the payment of the principal of and redemption premium, if any, and the interest on the 2004 Series A Bonds or portions thereof to be paid or redeemed, such 2004 Series A Bonds shall not be deemed to be Outstanding under the Trust Agreement, and the registered owners thereof shall have no rights with respect thereto, except to receive payment of the principal thereof and redemption premium, if any, and the interest thereon from such separate account.

Each notice of redemption shall contain, among other things, the CUSIP identification number of the 2004 Series A Bonds (or portions thereof) being called for redemption, the redemption date and price and the address at which such 2004 Series A Bonds are to be surrendered for payment of the redemption price. Any defect in such notice or the failure to mail any such notice to DTC will not affect the validity of the proceedings for the redemption of any other 2004 Series A Bond.

If less than all the 2004 Series A Bonds of any maturity are called for redemption, the particular 2004 Series A Bonds so called for redemption shall be selected by the Trustee by such method as it deems fair and appropriate, except that so long as the book-entry only system remains in effect, in the event of any such partial redemption, DTC shall reduce the credit balances of the applicable DTC Participants with respect to the 2004 Series A Bonds and such DTC Participants shall in turn select those Beneficial Owners (as defined herein) whose ownership interests are to be extinguished by such partial redemption, each by such method as DTC or such DTC Participant, as the case may be, in its sole discretion, deems fair and appropriate.

**Book-Entry Only System**

The following information concerning DTC and DTC's book-entry system has been obtained from DTC. The Corporation, the Trustee and the Underwriters assume no responsibility for the accuracy thereof.

DTC will act as securities depository for the 2004 Series A Bonds. The 2004 Series A Bonds will be issued as fully registered bonds registered in the name of Cede & Co. (DTC's partnership nominee) or such other name as may be requested by an authorized representative of DTC. One fully registered bond will be issued for each maturity of the 2004 Series A 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. DTC holds and provides asset servicing for over two million issues of U.S. and non-U.S. equity, corporate, and municipal debt issues, and money market instruments from over 85 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 in 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 its Direct Participants, by members of the National Securities Clearing Corporation, the Government Securities Clearing Corporation, the MBS Clearing Corporation and the Emerging Markets Clearing Corporation (all subsidiaries of DTCC), 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 (the "Indirect Participants" and, together with the Direct Participants, the "Participants"). DTC has Standard & Poor's highest rating: AAA. The DTC rules applicable to DTC and its Participants are on file with the Securities and Exchange Commission. More information about DTC can be found at www.dtcc.com.

Purchases of the 2004 Series A Bonds under the DTC system must be made by or through Direct Participants, which will receive a credit for the 2004 Series A Bonds in DTC's records. The ownership interest of each actual purchaser of a 2004 Series A Bond (a "Beneficial Owner") will in turn be recorded in 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 the transaction, as well as periodic statements of their holdings, from the Direct or Indirect Participant through which the Beneficial Owner entered into the transaction. Transfers of ownership interests in the 2004 Series A Bonds will be accomplished by entries made in the books of Participants acting on behalf of the Beneficial Owners. Beneficial Owners will not receive certificates representing their ownership interests in the 2004 Series A Bonds, except in the event that use of the book-entry system for the 2004 Series A Bonds is discontinued.

To facilitate subsequent transfers, all 2004 Series A Bonds deposited by Direct Participants with DTC are registered in the name of DTC's partnership nominee, Cede & Co. or such other name as may be requested by an authorized representative of DTC. The deposit of 2004 Series A 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 2004 Series A Bonds; DTC's records reflect only the identity of the Direct Participants to whose accounts such 2004 Series A Bonds are credited, which may or may not be the Beneficial Owners. The Participants will remain responsible for keeping account of their holdings on behalf of their customers.

Conveyance of notices and other communications by DTC to Direct Participants, by Direct Participants to Indirect Participants, and by Direct Participants and Indirect Participants to Beneficial Owners will be governed by arrangements among them, subject to any statutory or regulatory requirements as may be in effect from time to time. Beneficial Owners of 2004 Series A Bonds may wish to take certain steps to augment transmission to them of notices of significant events with respect to the 2004 Series A Bonds, such as redemptions, tenders, defaults and proposed amendments to the documents governing the 2004 Series A Bonds. For example, Beneficial Owners of 2004 Series A Bonds may wish to ascertain that the nominee holding the 2004 Series A Bonds for their benefit has agreed to obtain and transmit notices to Beneficial Owners. In the alternative, Beneficial Owners may wish to provide their names and addresses to the Trustee and request that copies of the notices be provided directly to them.

Redemption notices will be sent to DTC. If less than all of the 2004 Series A Bonds within a maturity are being redeemed, DTC's practice is to determine by lot the amount of the interest of each Direct Participant in the 2004 Series A Bonds of that maturity to be redeemed.

Neither DTC nor Cede & Co. (nor any other DTC nominee) will consent or vote with respect to the 2004 Series A Bonds unless authorized by a Direct Participant in accordance with DTC's procedures. Under its usual procedures, DTC mails an Omnibus Proxy to the Corporation as soon as possible after the record date. The Omnibus Proxy assigns Cede & Co.'s consenting or voting rights to those Direct Participants to whose accounts the 2004 Series A Bonds are credited on the record date (identified in a listing attached to the Omnibus Proxy).

Principal, redemption premium, if any, and interest payments on the 2004 Series A Bonds will be made to Cede & Co. or such other nominee as may be requested by an authorized representative of DTC. DTC's practice is to credit Direct Participants' accounts upon DTC's receipt of funds and corresponding detail information from the Corporation or the Trustee on 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, the Corporation or the Trustee, subject to any statutory or regulatory requirements as may be in effect from time to time. Payment of the 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 Corporation or the Trustee. Disbursement of such payments to Direct Participants will be the responsibility of DTC, and disbursement of such payments to the Beneficial Owners will be the responsibility of Direct and Indirect Participants.

A Beneficial Owner shall effect delivery of its 2004 Series A Bonds in connection with their mandatory tender by causing the Direct Participant to transfer the Participant's interest in the 2004 Series A Bonds, on DTC's records, to the Remarketing Agent. The requirement for physical delivery of 2004 Series A Bonds in connection with a mandatory tender will be deemed satisfied when the ownership rights in the 2004 Series A Bonds are transferred by Direct Participants on DTC's records and followed by a book-entry credit of tendered 2004 Series A Bonds to the Remarketing Agent's DTC account.

Each person for which a DTC Participant acquires an interest in the 2004 Series A Bonds, as nominee, may desire to make arrangements with such DTC Participant to receive a credit balance in the records of such DTC Participant, to have all communications to DTC which may affect such persons forwarded in writing by such DTC Participant, and to have notification made of all interest payments.

**The Corporation, the Trustee, and the Underwriters will have no responsibility or obligation to DTC Participants, Beneficial Owners or other nominees of such Beneficial Owners for: (i) sending transaction statements; (ii) maintaining, supervising or reviewing the accuracy of any records maintained by DTC or any DTC Participant or other nominees of such Beneficial Owners; (iii) payment or the timeliness of payment by DTC to any DTC Participant, or by any DTC Participant or other nominees of Beneficial Owners to any Beneficial Owner, of any amount due with respect to the principal of or interest on 2004 Series A Bonds; (iv) delivery or timely delivery by DTC to any DTC Participant, or by any DTC Participant or other nominees of Beneficial Owners to any Beneficial Owners, of any notice or other communication which is required or permitted under the terms of the Trust Agreement to be given to the registered owners of 2004 Series A Bonds; or (v) any consent given or any action taken by DTC or its nominee as the registered owner of the 2004 Series A Bonds.**

**Discontinuance of the Book-Entry Only System**

DTC may discontinue providing its services as securities depository with respect to the 2004 Series A Bonds at any time by giving reasonable notice to the Corporation or the Trustee. Under such circumstances, in the event that a successor securities depository is not obtained, definitive 2004 Series A Bonds will be printed and delivered.

The Corporation, in its sole discretion and without the consent of any other person, may terminate the services of DTC as securities depository with respect to the 2004 Series A Bonds. In such event, definitive 2004 Series A Bonds will be printed and delivered.

In the event that such book-entry only system is discontinued or the Corporation terminates the services of DTC as securities depository, the following provisions will apply: (i) payments of the principal of and the interest on the 2004 Series A Bonds will be made in lawful money of the United States of America; (ii) payments of principal will be made at the principal corporate trust office of the Trustee in New York, New York; (iii) interest on the 2004 Series A Bonds will be paid by check mailed to the respective addresses of the registered owners thereof as of the fifteenth day of the month immediately preceding the interest payment date as shown on the registration books of the Corporation maintained by the Trustee; (iv) the 2004 Series A Bonds will be issued only as registered bonds without coupons in denominations of $5,000 or any multiple thereof; and (v) the transfer of the 2004 Series A Bonds will be registrable and the 2004 Series A Bonds may be exchanged at the principal corporate trust office of the Trustee in New York, New York, upon the payment of any taxes or other governmental charges required to be paid with respect to such transfer or exchange.

## BOND INSURANCE

### The CIFGNA Bond Insurance Policy

The following information has been furnished by CIFGNA for use in this Official Statement. Reference is made to Appendix VI for a specimen of CIFGNA's policy.

*The Insurer and the Financial Guaranty Insurance Policy*. Concurrently with the issuance of the CIFGNA Insured Bonds, CIFGNA will issue the CIFGNA Financial Guaranty Insurance Policy for the CIFGNA Insured Bonds. CIFGNA is a monoline financial guaranty insurance company incorporated under the laws of the State of New York, with its principal place of business in New York City.

The claims-paying ability (also referred to as its financial strength) of CIFGNA is rated "AAA" by Fitch Ratings ("Fitch"), "Aaa" by Moody's, and "AAA" by Standard and Poor's, the highest rating assigned by each such rating agency. Each rating of CIFGNA should be evaluated independently. The ratings reflect the respective rating agency's current assessment of the creditworthiness of CIFGNA and its ability to pay claims on its policies of insurance based upon, among other factors, the adequacy of the net worth maintenance and reinsurance agreements provided by CIFG described below under "Capitalization." Any further explanation as to the significance of the above ratings may be obtained only from the applicable rating agency. The above ratings are not recommendations to buy, sell or hold the CIFGNA Insured Bonds, and such ratings may be subject to revision or withdrawal at any time by the rating agencies. Any downward revision or withdrawal of any of the above ratings may have an adverse effect on the market price of the CIFGNA Insured Bonds. CIFGNA does not guarantee the market price of the CIFGNA Insured Bonds nor does it guarantee that the ratings on the CIFGNA Insured Bonds will not be revised or withdrawn.

CIFGNA is licensed and subject to regulation as a financial guaranty insurance corporation under the laws of the State of New York, its state of domicile, and is licensed to do business in over 40 jurisdictions. CIFGNA is subject to Article 69 of the New York Insurance Law which, among other things, limits the business of such insurers to financial guaranty insurance and related lines, requires that each such insurer maintain a minimum surplus to policyholders, establishes contingency, loss and unearned premium reserve requirements for each such insurer, and limits the size of individual transactions ("single risks") and the volume of transactions ("aggregate risks") that may be underwritten by such insurers. Other provisions of the New York Insurance Law applicable to non-life insurance companies such as CIFGNA regulate, among other things, permitted investments, payment of dividends, transactions with affiliates, mergers, consolidations, acquisitions or sales of assets and incurrence of liabilities for borrowings. CIFGNA is required to file quarterly and annual statutory financial statements with the New York State Insurance Department ("NYSID"), and is subject to statutory restrictions concerning the types and quality of its investments and the filing and use of policy forms and premium rates. Additionally, CIFGNA's accounts and operations are subject to periodic examination by the NYSID.

THE INSURANCE PROVIDED BY THE CIFGNA FINANCIAL GUARANTY INSURANCE POLICY IS NOT COVERED BY THE PROPERTY/CASUALTY INSURANCE SECURITY FUND SPECIFIED BY THE INSURANCE LAWS OF THE STATE OF NEW YORK.

*Capitalization*. In addition to its capital and surplus as set forth below, CIFGNA is supported by a net worth maintenance agreement from its indirect parent, CDC IXIS Financial Guaranty, a French reinsurance corporation ("CIFG"). The net worth maintenance agreement provides that CIFG will maintain CIFGNA's U.S. statutory capital and surplus at no less than $80 million. In addition, through a facultative reinsurance agreement, CIFGNA may cede up to 90% of its exposure on each transaction to CIFG; however, the facultative reinsurance agreement does not require that CIFG reinsure its exposure under any transaction. CIFG's claims paying ability is rated "Aaa" by Moody's, "AAA" by Standard & Poor's and "AAA" by Fitch, the highest rating assigned by each such rating agency. Notwithstanding these net worth maintenance and reinsurance agreements, the holders of the CIFGNA Insured Bonds will have direct recourse against CIFGNA only, and neither CIFG nor any other affiliate of CIFGNA will be directly liable to the holders of the CIFGNA Insured Bonds.

The following table sets forth the capitalization of CIFGNA as of March 31, 2004, on the basis of accounting principles prescribed or permitted by the NYSID (in thousands):

| | |
|---|---|
| Common capital stock | $ 19,700 |
| Gross paid in and contributed surplus | 110,925 |
| Unassigned funds (retained deficit) | ( 33,942) |
| Surplus as regards policyholders | $ 96,683 |

There has been no material adverse change in the capitalization of CIFGNA from March 31, 2004 to the date of this Official Statement.

Audited financial statements of CIFGNA as of December 31, 2003, prepared in accordance with statutory accounting principles applicable to insurance companies, may be obtained by writing to CIFGNA at 825 Third Avenue, 6th Floor, New York, New York 10022, Attention: Finance Department. The toll-free telephone number of CIFGNA is (866) CIFG 212.

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

**The MBIA Bond Insurance Policy**

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

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

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

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

*MBIA*. MBIA is the principal operating subsidiary of MBIA Inc., a New York Stock Exchange listed company (the "Company"). The Company is not obligated to pay the debts of or claims against MBIA. MBIA is domiciled in the State of New York and licensed to do business in and subject to regulation under the laws of all 50 states, the District of Columbia, the Commonwealth of Puerto Rico, the Commonwealth of the Northern Mariana Islands, the Virgin Islands of the United States and the Territory of Guam. MBIA has three branches, one in the Republic of France, one in the Republic of Singapore and one in the Kingdom of Spain. New York has laws prescribing minimum capital requirements, limiting classes and concentrations of investments and requiring the approval of policy rates and forms. State laws also regulate the amount of both the aggregate and individual risks that may be insured, the payment of dividends by MBIA, changes in control and transactions among affiliates. Additionally, MBIA is required to maintain contingency reserves on its liabilities in certain amounts and for certain periods of time.

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

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

*MBIA Information*. The following documents filed by the Company with the Securities and Exchange Commission (the "SEC") are incorporated herein by reference:

(1) the Company's Annual Report on Form 10-K for the year ended December 31, 2003; and
(2) the Company's Quarterly Report on Form 10-Q for the quarter ended March 31, 2004.

Any documents filed by the Company pursuant to Sections 13(a), 13(c), 14 or 15(d) of the Securities Exchange Act of 1934, as amended, after the date of this Official Statement and prior to the termination of the offering of the MBIA Insured Bonds offered hereby shall be deemed to be incorporated by reference in this Official Statement and to be a part hereof. Any statement contained in a document incorporated or deemed to be incorporated by reference herein, or contained in this Official Statement, shall be deemed to be modified or superseded for purposes of this Official Statement to the extent that a statement contained herein or in any other subsequently filed document which also is or is deemed to be incorporated by reference herein modifies or supersedes such statement. Any such statement so modified or superseded shall not be deemed, except as so modified or superseded, to constitute a part of this Official Statement.

The Company files annual, quarterly and special reports, information statements and other information with the Securities and Exchange Commission ("SEC") under File No. 1-9583. Copies of the SEC filings (including (1) the Company's Annual Report on Form 10-K for the year ended December 31, 2003, and (2) the Company's Quarterly Report on Form 10-Q for the quarter ended March 31, 2004) are available (i) over the Internet at the SEC's web site at http://www.sec.gov; (ii) at the SEC's public reference room in Washington D.C.; (iii) over the Internet at the Company's web site at http://www.mbia.com; and (iv) at no cost, upon request to MBIA Insurance Corporation, 113 King Street, Armonk, New York 10504. The telephone number of MBIA is (914) 273-4545.

As of December 31, 2003, MBIA had admitted assets of $9.9 billion (audited), total liabilities of $6.2 billion (audited), and total capital and surplus of $3.7 billion (audited) determined in accordance with statutory accounting practices prescribed or permitted by insurance regulatory authorities. As of March 31, 2004 MBIA had admitted assets of $10.3 billion (unaudited), total liabilities of $6.5 billion (unaudited), and total capital and surplus of $3.8 billion (unaudited) determined in accordance with statutory accounting practices prescribed or permitted by insurance regulatory authorities.

*Financial Strength Ratings of MBIA*. Moody's rates the financial strength of MBIA "Aaa." Standard & Poor's rates the financial strength of MBIA "AAA." Fitch rates the financial strength of MBIA "AAA."

Each rating of MBIA should be evaluated independently. The ratings reflect the respective rating agency's current assessment of the creditworthiness of MBIA and its ability to pay claims on its policies of insurance. Any further explanation as to the significance of the above ratings may be obtained only from the applicable rating agency.

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

**The Ambac Bond Insurance Policy**

The following information has been furnished by Ambac for use in this Official Statement. Reference is made to Appendix VIII for a specimen of Ambac's policy.

*Payment Pursuant to Financial Guaranty Insurance Policy*. Ambac has made a commitment to issue a financial guaranty insurance policy (the "Ambac Financial Guaranty Insurance Policy") relating to the Ambac Insured Bonds effective as of the date of issuance of the Ambac Insured Bonds. Under the terms of the Ambac Financial Guaranty Insurance Policy, Ambac will pay to The Bank of New York, in New York, New York or any successor thereto (the "Insurance Trustee") that portion of the principal of and interest on the Ambac Insured Bonds which shall become Due for Payment but shall be unpaid by reason of Nonpayment by the Corporation (as such terms are defined in the Ambac Financial Guaranty Insurance Policy). Ambac will make such payments to the Insurance Trustee on the later of the date on which such principal and interest becomes Due for Payment or within one business day following the date on which Ambac shall have received notice of Nonpayment from the Trustee. The insurance will extend for the term of the Ambac Insured Bonds and, once issued, cannot be canceled by Ambac.

The Ambac Financial Guaranty Insurance Policy will insure payment only on stated maturity dates and on mandatory sinking fund installment dates, in the case of principal, and on stated dates for payment, in the case of interest. If the Ambac Insured Bonds become subject to mandatory redemption and insufficient funds are available for redemption of all outstanding Ambac Insured Bonds, Ambac will remain obligated to pay principal of and interest on outstanding Ambac Insured Bonds on the originally scheduled interest and principal payment dates including mandatory sinking fund redemption dates. In the event of any acceleration of the principal of the Ambac Insured Bonds, the insured payments will be made at such times and in such amounts as would have been made had there not been an acceleration.

In the event the Trustee has notice that any payment of principal of or interest on an Ambac Insured Bond which has become Due for Payment and which is made to a Holder by or on behalf of the Corporation has been deemed a preferential transfer and theretofore recovered from its registered owner pursuant to the United States

Bankruptcy Code in accordance with a final, nonappealable order of a court of competent jurisdiction, such registered owner will be entitled to payment from Ambac to the extent of such recovery if sufficient funds are not otherwise available.

The Ambac Financial Guaranty Insurance Policy does not insure any risk other than Nonpayment, as defined in the Policy. Specifically, the Ambac Financial Guaranty Insurance Policy does not cover:

1. payment on acceleration, as a result of a call for redemption (other than mandatory sinking fund redemption) or as a result of any other advancement of maturity;

2. payment of any redemption, prepayment or acceleration premium;

3. nonpayment of principal or interest caused by the insolvency or negligence of any trustee, paying agent or bond registrar, if any.

If it becomes necessary to call upon the Ambac Financial Guaranty Insurance Policy, payment of principal requires surrender of the relevant Ambac Insured Bonds to the Insurance Trustee together with an appropriate instrument of assignment so as to permit ownership of such Ambac Insured Bond to be registered in the name of Ambac to the extent of the payment under the Ambac Financial Guaranty Insurance Policy. Payment of interest pursuant to the Ambac Financial Guaranty Insurance Policy requires proof of Holder entitlement to interest payments and an appropriate assignment of the Holder's right to payment to Ambac.

Upon payment of the insurance benefits, Ambac will become the owner of the Ambac Insured Bond, appurtenant coupon, if any, or right to payment of principal or interest on such Ambac Insured Bond and will be fully subrogated to the surrendering Holder's rights to payment.

The Ambac Financial Guaranty Insurance Policy does not insure against loss relating to payments of the purchase price of any Ambac Insured Bond upon tender by a registered owner thereof or any preferential transfer relating to payments of the purchase price of any Ambac Insured Bond upon tender by a registered owner thereof.

*Ambac Assurance Corporation*. Ambac is a Wisconsin-domiciled stock insurance corporation regulated by the Office of the Commissioner of Insurance of the State of Wisconsin and licensed to do business in the 50 states, the District of Columbia, the Territory of Guam, the Commonwealth of Puerto Rico and the U.S. Virgin Islands, with admitted assets of approximately $7,670,000,000 (unaudited) and statutory capital of approximately $4,683,000,000 (unaudited) as of March 31, 2004. Statutory capital consists of Ambac's policyholders' surplus and statutory contingency reserve. Standard & Poor's, Moody's and Fitch have each assigned a triple-A financial strength rating to Ambac.

Ambac has obtained a ruling from the Internal Revenue Service to the effect that the insuring of a bond by Ambac will not affect the treatment for federal income tax purposes of interest on such bond and that insurance proceeds representing maturing interest paid by Ambac under policy provisions substantially identical to those contained in its financial guaranty insurance policy shall be treated for federal income tax purposes in the same manner as if such payments were made by the obligor of the bond.

Ambac makes no representation regarding the Ambac Insured Bonds or the advisability of investing in the Ambac Insured Bonds and makes no representation regarding, nor has it participated in the preparation of, the Official Statement other than the information supplied by Ambac and presented under the heading "Bond Insurance -The Ambac Bond Insurance Policy".

*Available Information*. The parent company of Ambac, Ambac Financial Group, Inc. (the "Company"), is subject to the informational requirements of the Securities Exchange Act of 1934, as amended, and in accordance therewith files reports, proxy statements and other information with the SEC. These reports, proxy statements and other information can be read and copied at the SEC's public reference room at 450 Fifth Street, N.W., Washington, D.C. 20549. Please call the SEC at 1-800-SEC-0330 for further information on the public reference room. The SEC maintains an internet site at http://www.sec.gov that contains reports, proxy and information statements and other information regarding companies that file electronically with the SEC, including the Company. These reports, proxy statements and other information can also be read at the offices of the New York Stock Exchange, Inc. (the "NYSE"), 20 Broad Street, New York, New York 10005.

Copies of Ambac's financial statements prepared in accordance with statutory accounting standards are available from Ambac. The address of Ambac's administrative offices and its telephone number are One State Street Plaza, 19th Floor, New York, New York 10004 and (212) 668-0340.

*Incorporation of Certain Documents by Reference*. The following documents filed by the Company with the SEC (File No. 1-10777) are incorporated by reference in this Official Statement:

1. The Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2003 and filed on March 15, 2004;

2. The Company's Current Report on Form 8-K dated April 21, 2004 and filed on April 22, 2004; and

3. The Company's Quarterly Report on Form 10-Q for the fiscal quarterly period ended March 31, 2004 and filed on May 10, 2004.

All documents subsequently filed by the Company pursuant to the requirements of the Securities Exchange Act after the date of this Official Statement will be available for inspection in the same manner as described above in "Available Information."

**The FGIC Bond Insurance Policy**

The following information has been supplied by FGIC for inclusion in this Official Statement. No representation is made by the Corporation or the Underwriters as to the accuracy or completeness of this information. Reference is made to Appendix IX for a specimen of FGIC's policy.

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

Once issued, the Policy is non-cancelable by FGIC. The Policy covers failure to pay principal (or accreted value, if applicable) of the FGIC Insured Bonds on their stated maturity dates and their mandatory sinking fund redemption dates, and not on any other date on which the FGIC Insured Bonds may have been otherwise called for redemption, accelerate or advanced in maturity. The Policy also covers the failure to pay interest on the stated date for its payment. If the FGIC Insured Bonds are accelerated or become subject to mandatory redemption, FGIC will be obligated to pay principal (or accreted value, if applicable) and interest on the originally scheduled principal (including mandatory sinking fund redemption) and interest payment dates. Upon such payment, FGIC will become the owner of the FGIC Insured Bond, appurtenant coupon or right to payment of principal or interest on such FGIC Insured Bond and will be fully subrogated to all of the Bondholder's rights thereunder.

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

As a condition of its commitment to insure FGIC Insured Bonds, FGIC may be granted certain rights under the Trust Agreement. The specific rights, if any, granted to FGIC in connection with its insurance of the FGIC Insured Bonds may be set forth in the description of the principal legal documents appearing elsewhere in this Official Statement, and reference is made thereto.

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

*Financial Guaranty Insurance Company*. FGIC, a New York stock insurance corporation, is a direct, wholly-owned subsidiary of FGIC Corporation, and provides financial guaranty insurance for public finance and structured finance obligations. FGIC is licensed to engage in financial guaranty insurance in all 50 states, the District of Columbia and the Commonwealth of Puerto Rico and, through a branch, in the United Kingdom. FGIC is a wholly-owned subsidiary of FGIC Corporation, a Delaware corporation.

On December 18, 2003, an investor group consisting of The PMI Group, Inc. ("PMI"), affiliates of The Blackstone Group L.P. ("Blackstone"), affiliates of The Cypress Group L.L.C. ("Cypress") and affiliates of CIVC Partners L.P. ("CIVC") acquired FGIC Corporation (the "FGIC Acquisition") from a subsidiary of General Electric Capital Corporation ("GE Capital"). PMI, Blackstone, Cypress and CIVC acquired approximately 42%, 23%, 23% and 7%, respectively, of FGIC Corporation's common stock. GE Capital retained approximately $234.6 million in liquidation preference of FGIC Corporation's convertible participating preferred stock and approximately 5% of FGIC Corporation's common stock. Neither FGIC Corporation nor any of its shareholders is obligated to pay any debts of FGIC or any claims under any insurance policy, including the Policy, issued by FGIC.

FGIC is subject to the insurance laws and regulations of the State of New York, where it is domiciled, including Article 69 of the New York Insurance Law ("Article 69"), a comprehensive financial guaranty insurance statute. FGIC is also subject to the insurance laws and regulations of all other jurisdictions in which it is licensed to transact insurance business. The insurance laws and regulations, as well as the level of supervisory authority that may be exercised by the various insurance regulators, vary by jurisdiction, but generally require insurance companies to maintain minimum standards of business conduct and solvency, to meet certain financial tests, to comply with requirements concerning permitted investments and the use of policy forms and premium rates and to file quarterly and annual financial statements on the basis of statutory accounting principles ("SAP") and other reports. In addition, Article 69, among other things, limits the business of each financial guaranty insurer, including FGIC, to financial guaranty insurance and certain related lines.

For the three months ended March 31, 2004, and the years ended December 31, 2003 and December 31, 2002, FGIC had written directly or assumed through reinsurance, guaranties of approximately $11.3 billion, $42.4 billion and $47.9 billion par value of securities, respectively (of which approximately 50%, 79% and 81%, respectively, constituted guaranties of municipal bonds), for which it had collected gross premiums of approximately $56.4 million, $260.3 million and $232.6 million, respectively. For the three months ended March 31, 2004, FGIC had reinsured, through facultative arrangements, approximately 0.3% of the risks it had written.

As of March 31, 2004, FGIC had net admitted assets of approximately $2.864 billion, total liabilities of approximately $1.728 billion, and total capital and policyholders' surplus of approximately $1.136 billion, determined in accordance with statutory accounting practices prescribed or permitted by insurance regulatory authorities.

The audited financial statements of FGIC as of March 31, 2004, December 31, 2003 and December 31, 2002, which have been filed with the NRMSIRs, are hereby included by specific reference in this Official

Statement. Any statement contained herein under the heading "*Bond Insurance-The FGIC Bond Insurance Policy*" or in any documents included by specific reference herein, shall be modified or superseded to the extent required by any statement in any document subsequently filed by FGIC with such NRMSIRs, and shall not be deemed, except as so modified or superseded, to constitute a part of this Official Statement**.** All financial statements of FGIC (if any) included in documents filed by the Corporation with the NRMSIRs subsequent to the date of this Official Statement and prior to the termination of the offering of the Bonds shall be deemed to be included by specific reference into this Official Statement and to be a part hereof from the respective dates of filing of such documents.

FGIC also prepares quarterly and annual financial statements on the basis of generally accepted accounting principles. Copies of FGIC's most recent GAAP and SAP financial statements are available upon request to: Financial Guaranty Insurance Company, 125 Park Avenue, New York, NY 10017, Attention: Corporate Communications Department. FGIC's telephone number is (212) 312-3000.

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

**Neither FGIC nor any of its affiliates accepts any responsibility for the accuracy or completeness of the Official Statement or any information or disclosure that is provided to potential purchasers of the FGIC Insured Bonds, or omitted from such disclosure, other than with respect to the accuracy of information with respect to FGIC or the Policy under the heading "*Bond Insurance-The FGIC Bond Insurance Policy*." In addition, FGIC makes no representation regarding the FGIC Insured Bonds or the advisability of investing in the FGIC Insured Bonds.**

**Certain Rights of the Bond Insurers**

As long as the provider of any of the municipal bond insurance policies insuring certain of the 2004 Series A Bonds shall not be in default on its obligations under the municipal bond insurance policy issued by it, the provider shall have certain rights with respect to the 2004 Series A Bonds insured by it, including (1) the right to take remedial actions under the Trust Agreement upon a default by the Corporation and (2) the right to approve amendments or supplements to the Trust Agreement that require Bondholder consent.

## SOURCE OF PAYMENT AND SECURITY FOR THE 2004 SERIES A BONDS

### General

Under the Trust Agreement, the Corporation will pledge the Series 2004 Notes (and any other Notes that may in the future be delivered to the Corporation to secure the Bonds) to the Trustee and create a first lien on the Pledged Revenues (as defined in the Trust Agreement) for the benefit of the holders of the Bonds.

The Bonds are payable solely from and are secured by the Pledged Revenues, consisting of payments of principal of and interest on the Notes required to be deposited to the credit of the Bond Service Account and Redemption Account established under the Trust Agreement, any other moneys deposited to the credit of those Accounts, including investment earnings thereon, and the moneys on deposit in the Surplus Account established under the Trust Agreement, including investment earnings thereon. See Appendix II - "Summary of the Trust Agreement - Sinking Fund and Accounts."

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

### The Appropriation Acts and the Notes

Each of the Appropriation Acts provides that the Commonwealth, through budgetary appropriations during a number of fiscal years specified in such Appropriation Act, will pay the principal of and interest on the Notes and the Parity Notes covered thereunder. Some of the Appropriation Acts provide that such budgetary appropriations shall not exceed specified dollar amounts per Commonwealth fiscal year. The aggregate principal and interest installments required to be paid under the Notes and the Parity Notes is sufficient to cover the aggregate principal amount of and the aggregate annual amount of interest payable on the Series 2004 Bonds and the Parity Bonds, together with fees, expenses and other amounts payable by the Corporation or the relevant trustee with respect to the Series 2004 Bonds and the Parity Bonds. The Series 2004 Notes and the Parity Notes are a combination of the Act 164 Notes, the Act 85 Notes, the Joint Resolution 523 Notes and the Act 113 Notes described below. A brief summary of each of the Appropriation Acts follows.

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

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

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

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

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

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

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

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

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

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

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

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

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

**Letter of Credit**

Under the Commonwealth's Constitution, if the annual budget of capital expenditures and operating expenses of the Commonwealth for a fiscal year has not been adopted by the last day of the preceding fiscal year (June 30), the budget for such preceding fiscal year is automatically renewed for the ensuing fiscal year, until a new budget for such succeeding fiscal year is approved by the Legislature of Puerto Rico and the Governor. This means that if the debt service on the Notes for any fiscal year and, therefore, the annual budgetary appropriation for such fiscal year is less than the debt service on the Notes in the immediately succeeding fiscal year, then in the case of a delay in the approval of the budget for such succeeding fiscal year, pending approval of the new budget, the budgetary appropriation that would carry over and be available to meet debt service on the Notes for such succeeding fiscal year would be insufficient to meet the debt service on the Notes, and consequently on the 2004 Series A Bonds. See "Budgetary Process and Payment of Commonwealth Obligations" below.

To cover the risk that in any year until the Mandatory Tender Date the budget is not adopted prior to June 30 and the Legislative Appropriation that automatically carries over from the prior fiscal year may be insufficient to cover fully the debt service payments on the 2004 Series A Bonds during the ensuing Bond Year, on the date of delivery of the 2004 Series A Bonds Government Development Bank will issue an irrevocable, transferable standby letter of credit (the "Letter of Credit") in favor of the Trustee solely for the benefit of the owners of the 2004 Series A Bonds. The Letter of Credit will be in a stated amount at any time equal to the estimated maximum increase from each fiscal year thereafter to the next fiscal year, until the Mandatory Tender Date, in the aggregate debt service on the 2004 Series A Bonds. The Letter of Credit enables the Trustee to draw up to the full amount thereof unless: (i) on or prior to the third Business Day immediately preceding August 1 of each fiscal year until the Mandatory Tender Date it receives written notice from the Corporation to the effect that the operating budget of the Commonwealth for such fiscal year has been adopted, or (ii) the Trustee has otherwise received funds representing the full amount of the principal and interest due with respect to the 2004 Series A Bonds for the Bond Year commencing within such fiscal year.

The Letter of Credit will expire on April 1, 2012. After the remarketing of the 2004 Series A Bonds on the Mandatory Tender Date, or, if the 2004 Series A Bonds cannot be remarketed, after the interest rate on the 2004 Series A Bonds has increased to 8%, the Government Development Bank has agreed to issue a new Letter of Credit in an amount sufficient to cover the maximum increase in the aggregate debt service on the 2004 Series A Bonds from each fiscal year thereafter to the next fiscal year.

The stated amount of the Letter of Credit will be reduced by the amount of any drawing thereunder. The amount of any such drawing will be reinstated upon receipt by Government Development Bank of reimbursement of the full amount due to it with respect to such drawing. Such reimbursement would occur if the Legislature of the Commonwealth subsequently appropriates the full amount required to pay debt service on the Notes. If such appropriation is not made, the Corporation would not have sufficient funds to reimburse Government Development Bank, and the amount of the drawing under the Letter of Credit would not be reinstated. In such event, holders of the 2004 Series A Bonds would no longer have the protection intended to be afforded by the Letter of Credit. The Letter of Credit is not intended to and does not cover the risk that no appropriation is made by the Legislature of Puerto Rico under any Appropriation Act for any particular fiscal year, or that an appropriation is made in an amount lower than the amount of debt service on the Notes due with respect to any fiscal year. If the budget for any fiscal year is adopted but no appropriation for the payment of the Notes is included in such budget, or an appropriation is made in an amount lower than the amount of debt service on the Notes, the Trustee may not make a drawing under the Letter of Credit.

Appendix IV sets forth certain information with respect to Government Development Bank, issuer of the Letter of Credit.

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

The Government Development Bank will also issue an irrevocable, transferable standby letter of credit solely for the benefit of the 2004 Series B Bonds.

**Flow of Funds**

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

Any Legislative Appropriation (or funds received in substitution therefor or with respect to the Series 2004 Notes, including any moneys received pursuant to a draw under the Letter of Credit) and other funds received by the Trustee, including any Hedge Counterparty Swap Payments (other than moneys received from draws made under any Credit Facility or Liquidity Facility, other than the Letter of Credit, which moneys will be deposited in special subaccounts as provided in the Trust Agreement) for the payment of principal of and interest on the Bonds shall be deposited in the Sinking Fund in the following order:

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

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

**No Acceleration of the Bonds**

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

**Limitation on Additional Bonds**

No additional Bonds may be issued under the Trust Agreement except (i) to refund any Bonds issued under the Trust Agreement or any other bonds of the Corporation payable from the budgetary appropriations made under the Appropriation Acts, (ii) to fund a Reserve Account, if applicable, (iii) to pay capitalized interest with respect to such additional Bonds, or (iv) to pay the costs of issuance of such additional Bonds. All such additional Bonds will be issued on a parity with the Series 2004 Bonds and will be entitled to the same benefit and security under the Trust Agreement.

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

**Budgetary Process and Payment of Commonwealth Obligations**

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

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

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

During any fiscal year in which the resources available to the Commonwealth are insufficient to cover the appropriations approved for such year, the Governor may take administrative measures necessary to balance the budget, or make recommendations to the Legislature of Puerto Rico for new taxes, or take any other necessary action to meet the estimated deficiency, or authorize borrowings under provisions of existing legislation, or take action which involves a combination of such steps. Any such proposed adjustments shall give effect to the "priority norms" established by law for the disbursement of public funds in the following order of priority: first, the payment of the interest on, and amortization requirements for, public debt (Commonwealth general obligation and guaranteed debt); second, the fulfillment of obligations arising out of legally binding contracts, court decisions on eminent domain and certain commitments to protect the name, credit and good faith of the Commonwealth government; third, current expenditures in the areas of health, protection of persons and property, education, welfare and retirement systems; and fourth, all other purposes.

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

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

## PUBLIC SECTOR DEBT OF THE COMMONWEALTH

The following table presents a summary of public sector debt as of December 31, 2003. Excluded from the table is debt not primarily payable from Commonwealth or municipal taxes, Commonwealth appropriations or rates charged by public corporations for services or products. Also excluded from the table is debt the inclusion of which would reflect double counting, including, but not limited to, \$1.323 billion of outstanding bonds issued by the Municipal Finance Agency to finance its purchase of bonds of Puerto Rico municipalities, and \$1.026 billion of obligations of Government Development Bank issued to purchase certain Commonwealth public sector debt and for other purposes, of which \$267 million is guaranteed by the Commonwealth. The table should be read in conjunction with the information set forth under "Debt" in the Commonwealth Report.

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

| | December 31, 2003 |
|---|---|
| Puerto Rico direct debt (1) | $ 8,515,633 |
| Municipal debt | 1,935,028 |
| Public corporations debt | |
| Puerto Rico guaranteed debt | 643,295 |
| Debt supported by Puerto Rico appropriations or taxes | 13,527,718 |
| Other non-guaranteed debt | 7,694,201 |
| Total public corporations debt | $21,865,214 |
| Total public sector debt | $32,315,875 |

* For a complete recital of all notes to this table, see "Public Sector Debt" under "Debt" in the Commonwealth Report.
(1) This amount excludes any Commonwealth general obligation bonds that have been refunded with proceeds that were invested in non-eligible investments, even though such bonds will be considered outstanding under their respective authorizing resolutions and for purposes of calculating the Commonwealth's constitutional debt limitation.

*Source:* Government Development Bank

## TAX MATTERS

### Federal Income Taxes

The Internal Revenue Code of 1986, as amended (the "Code"), imposes certain requirements that must be met subsequent to the issuance and delivery of the 2004 Series A Bonds for interest thereon to be and remain excluded from gross income for federal income tax purposes. Noncompliance with such requirements could cause the interest on the 2004 Series A Bonds to be included in gross income for federal income tax purposes retroactive to the date of issue of the 2004 Series A Bonds. The Corporation, Government Development Bank, the Authorized Debtors and certain other entities have each covenanted to comply with the applicable requirements of the Code in order to maintain the exclusion of the interest on the 2004 Series A Bonds from gross income for federal income tax purposes pursuant to Section 103 of the Code.

In the opinion of Nixon Peabody LLP, Bond Counsel, under existing law and assuming compliance with the aforementioned covenant, interest on the 2004 Series A Bonds is excluded from gross income for federal income tax purposes under Section 103 of the Code. Bond Counsel is also of the opinion that such interest is not treated as a preference item in calculating the alternative minimum tax imposed under the Code with respect to individuals and corporations. Interest on the 2004 Series A Bonds is, however, included in the adjusted current earnings of certain corporations for purposes of computing the alternative minimum tax imposed on such corporations.

### Commonwealth Taxes

Bond Counsel is also of the opinion that the 2004 Series A Bonds and the interest thereon are exempt from state, Commonwealth and local income taxation.

### Original Issue Premium

The 2004 Series A Bonds, other than the 2004 Series A Bonds maturing on August 1 2029, bearing interest initially at the rate of 4.1% per annum, are referred to as "Premium Bonds." The Premium Bonds are being offered at prices in excess of their principal amounts. Bond Counsel is of the opinion that an initial purchaser with an initial adjusted basis in a Premium Bond in excess of its principal amount will have amortizable bond premium which is not deductible from gross income for federal income tax purposes. The amount of amortizable bond premium for a taxable year is determined actuarially on a constant interest rate basis over the term of each Premium Bond based on the purchaser's yield to maturity (or, in the case of Premium Bonds callable prior to their maturity, over the period to the call date, based on the purchaser's yield to the call date and giving effect to any call premium). For purposes of determining gain or loss on the sale or other disposition of a Premium Bond, an initial purchaser who acquires such obligation with an amortizable bond premium is required to decrease such purchaser's adjusted basis in such Premium Bond annually by the amount of amortizable bond premium for the taxable year. The amortization of bond premium may be taken into account as a reduction in the amount of tax-exempt income for purposes of determining various other tax consequences of owning such 2004 Series A Bonds. Owners of the Premium Bonds are advised that they should consult with their own advisors with respect to the state and local tax consequences of owning such Premium Bonds.

### Certain Federal Tax Information

General. The following is a discussion of certain additional tax matters under existing statutes. It does not purport to deal with all aspects of federal taxation that may be relevant to particular investors. Prospective investors, particularly those who may be subject to special rules, are advised to consult their own tax advisors regarding the federal tax consequences of owning and disposing of the 2004 Series A Bonds, as well as any tax consequences arising under the laws of any state or other taxing jurisdiction.

Social Security and Railroad Retirement Payments. The Code provides that interest on tax-exempt obligations is included in the calculation of modified adjusted gross income in determining whether a portion of Social Security or railroad retirement benefits received are to be included in taxable income.

Branch Profits Tax. The Code provides that interest on tax-exempt obligations is included in effectively connected earnings and profits for purposes of computing the branch profits tax on certain foreign corporations doing business in the United States.

Borrowed Funds. The Code provides that interest paid (or deemed paid) on borrowed funds used during a tax year to purchase or carry tax-exempt obligations is not deductible. In addition, under rules used by the Internal Revenue Service for determining when borrowed funds are considered used for the purpose of purchasing or carrying particular assets, the purchase of obligations may be considered to have been made with borrowed funds even though the borrowed funds are not directly traceable to the purchase of such obligations.

Property and Casualty Insurance Companies. The Code contains provisions relating to property and casualty insurance companies whereunder the amount of certain loss deductions otherwise allowed is reduced (in certain cases below zero) by a specified percentage of, among other things, interest on tax-exempt obligations acquired after August 7, 1986.

Financial Institutions. The Code provides that commercial banks, thrift institutions and other financial institutions may not deduct the portion of their interest expense allocable to tax-exempt obligations acquired after August 7, 1986, other than certain "qualified" obligations. The 2004 Series A Bonds are not "qualified" obligations for this purpose.

S Corporations. The Code imposes a tax on excess net passive income of certain S corporations that have subchapter C earnings and profits. Interest on tax-exempt obligations must be included in passive investment income for purposes of this tax.

Earned Income Credit. For any taxable year beginning after December 31, 1995, the Code denies the earned income credit to persons otherwise eligible for it if the aggregate amount of disqualified income of the taxpayer for the taxable year exceeds $2,200, subject to adjustment for inflation for taxable years beginning after December 31, 1996. Interest on the 2004 Series A Bonds will constitute disqualified income for this purpose.

Changes in Federal Tax Law and Post Issuance Events. From time to time proposals are introduced in Congress that, if enacted into law, could have an adverse impact on the potential benefits of the exclusion from gross income for federal income tax purposes of the interest on the 2004 Series A Bonds, and thus on the economic value of the 2004 Series A Bonds. This could result from reductions in federal income tax rates, changes in the structure of the federal income tax rates, changes in the structure of the federal income tax or its replacement with another type of tax, repeal of the exclusion of the interest on the 2004 Series A Bonds from gross income for such purposes, or otherwise. It is not possible to predict whether any legislation having an adverse impact on the tax treatment of holders of the 2004 Series A Bonds may be proposed or enacted. Bond Counsel has not undertaken to advise in the future whether any events after the date of issuance and delivery of the 2004 Series A Bonds may affect the tax status of interest on the 2004 Series A Bonds. Bond Counsel expresses no opinion as to any federal, state, Commonwealth of Puerto Rico or local tax law consequences with respect to the 2004 Series A Bonds, or the interest thereon, if any action is taken with respect to the 2004 Series A Bonds or the proceeds thereof upon the advice or approval of other counsel.

## CONTINUING DISCLOSURE UNDERTAKING

In accordance with the requirements of Rule l5c2-12, as amended (the "Rule"), promulgated by the Securities and Exchange Commission, the Corporation and the Commonwealth, as specifically stated below, have agreed in a continuing disclosure agreement for the benefit of the Beneficial Owners to provide or cause to provide the following:

1. The Commonwealth will file with each NRMSIR and with any Commonwealth state information depository ("SID") core financial information and operating data for each fiscal year, including (i) its 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 information as to revenues, expenditures, financial operations and indebtedness of the Commonwealth, generally consistent with the information contained in the Commonwealth Report. Such information is expected to be filed within 305 days after the end of each fiscal year.

2. The Corporation will file, in a timely manner, with each NRMSIR or with the Municipal Securities Rulemaking Board and with any SID, notice of the failure by the Commonwealth to comply with paragraph 1 above

and notice of the occurrence of any of the following events with respect to the 2004 Series A Bonds if, in the judgment of the Corporation or its agent, such event is 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 2004 Series A Bonds;
g. modifications to rights of the holders (including beneficial owners) of the 2004 Series A Bonds;
h. bond calls;
i. defeasances;
j. release, substitution, or sale of property securing repayment of the 2004 Series A Bonds; and
k. rating changes.

The Corporation 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 Corporation, such other event is material with respect to the 2004 Series A Bonds, but the Corporation does not undertake to provide any such notice of the occurrence of any material event except those events listed above.

Event (c) is included pursuant to a letter from the SEC staff to the National Association of Bond Lawyers, dated September 19, 1995. However, event (c) may not be applicable since the terms of the 2004 Series A Bonds do not provide for "debt service reserves." In addition, with respect to the following events:

Events (d) and (e). The Corporation does not undertake to provide any notice with respect to credit enhancement added after the primary offering of the 2004 Series A Bonds, unless the Corporation applies for or participates in obtaining the enhancement.

Event (f). For information on the tax status of the 2004 Series A Bonds, see "Tax Matters."

Event (h). The Corporation does not undertake to provide the above-described event notice of a mandatory scheduled redemption, not otherwise contingent upon the occurrence of an event, if (i) the terms, dates and amounts of redemption are set forth in detail in this Official Statement, (ii) the only open issue is which 2004 Series A Bonds will be redeemed in the case of a partial redemption, (iii) notice of redemption is given to the Bondholders as required under the terms of the 2004 Series A Bonds, and (iv) public notice of the redemption is given pursuant to Securities Exchange Act of 1934 Release No. 34-23856 of the SEC, even if the originally scheduled amounts are reduced by prior optional redemptions or 2004 Series A Bond purchases.

The Commonwealth expects to provide the information described in paragraph 1(ii) 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 its Financial Information and Operating Data Report containing the information described in paragraph 1(ii) above by such deadline.

The Corporation and the Commonwealth have made similar continuing disclosure covenants in connection with prior bond issuances, and have complied with all such covenants, except as hereinafter noted. The Commonwealth's audited financial statements for the fiscal year ended June 30, 2002 and the Commonwealth's audited financial statements for the fiscal year ended June 30, 2003 were filed after the Commonwealth's filing deadline of May 1, 2003, and April 30, 2004, respectively, because of delays in finalizing such financial statements resulting from the implementation of Governmental Accounting Standards Board Statement No. 34 ("GASB 34"). The Commonwealth expects that its financial statement for the fiscal year ended June 30, 2003, will be available and filed during the second calendar quarter of 2004.

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 and the Corporation acknowledge that their undertaking pursuant to the Rule described under this heading is intended to be for the benefit of the holders of the 2004 Series A Bonds, including Beneficial Owners, and shall be enforceable by any such holders or Beneficial Owners; provided that the right to enforce the provisions of this undertaking shall be limited to a right to obtain specific enforcement of the Corporation's or the Commonwealth's obligations hereunder, and any failure by the Corporation or the Commonwealth to comply with the provisions of this undertaking shall not be an event of default with respect to the 2004 Series A Bonds under the Trust Agreement.

No bondholder or Beneficial Owner may institute any suit, action or proceeding at law or in equity ("Proceeding") for the enforcement of the foregoing covenants (the "Covenants") or for any remedy for breach thereof, unless such bondholder or Beneficial Owner shall have filed with the Corporation and the Commonwealth written notice of any request to cure such breach, and the Corporation or the Commonwealth, as applicable, shall have refused to comply within a reasonable time. All Proceedings shall be instituted only in a Commonwealth court located in the Municipality of San Juan for the equal benefit of all bondholders or Beneficial Owners of the Outstanding 2004 Series A Bonds benefited by the Covenants, and no remedy shall be sought or granted other than specific performance of any of the Covenants at issue. Notwithstanding the foregoing, no challenge to the adequacy of the information provided in accordance with the filings mentioned above may be prosecuted by any bondholder or Beneficial Owner except in compliance with the remedial and enforcement provisions contained in the Trust Agreement. Moreover, Proceedings filed by bondholders or Beneficial Owners against the Commonwealth may be subject to the sovereign immunity provisions of Article 2 of Law No. 104 of the Legislature of Puerto Rico, approved June 29, 1955, as amended (32 L.P.R.A. Section 3077), which governs the scope of legal actions against the Commonwealth and substantially limits the amount of monetary damages that may be granted against the Commonwealth.

The Covenants may only be amended if:

a) the amendment is made in connection with a change in circumstances that arises from a change in legal requirements, change in law, or change in the identity, nature, or status of the Corporation or the Commonwealth, or type of business conducted; the Covenants, as amended, would have complied with the requirements of the Rule at the time of award of the 2004 Series A Bonds, after taking into account any amendments or change in circumstances; and the amendment does not materially impair the interests of bondholders or Beneficial Owners, as determined by parties unaffiliated with the Corporation or the Commonwealth; or

b) all or any part of the Rule, as interpreted by the staff of the Securities and Exchange Commission at the date of the adoption of such Rule, ceases to be in effect for any reason, and the Corporation or the Commonwealth, as applicable, elects that the Covenants shall be deemed amended accordingly.

The 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.

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

## UNDERWRITING

The Underwriters have jointly and severally agreed, subject to certain conditions, to purchase the 2004 Series A Bonds from the Corporation at an aggregate discount of $7,019,327.37 from the initial public offering prices of the 2004 Series A Bonds set forth or derived from information set forth on the inside cover page hereof. The obligations of the Underwriters are subject to certain conditions precedent, and the Underwriters will be obligated to purchase all the 2004 Series A Bonds, if any 2004 Series A Bonds are purchased. The Underwriters may offer to sell the 2004 Series A Bonds to certain dealers and others at prices lower than the initial public offering prices, and such offering prices may be changed, from time to time, by the Underwriters.

Lehman Brothers Inc. has entered into a written agreement with Santander Securities Corporation pursuant to which Santander Securities has agreed to provide investment banking services to Lehman Brothers in connection with Lehman Brothers' provision of underwriting and investment banking services to the Corporation with respect to the 2004 Series A Bonds. Pursuant to this agreement, the existence of which has been disclosed to the Corporation and Government Development Bank, Santander Securities will be entitled to receive a portion of Lehman Brothers' actual net profits, if any, in connection with the underwriting of the 2004 Series A Bonds. Other similar agreements with respect to the sharing of underwriting net profits have been entered into and disclosed to the Corporation and Government Development Bank by the following Underwriters: Goldman, Sachs & Co. and FirstBank Puerto Rico; J.P. Morgan and R-G Investments; Merrill Lynch & Co. and BBVA Capital Markets; Banc of America Securities LLC and Oriental Financial Services Corp.; Morgan Stanley & Co. Incorporated and Popular Securities, Inc.; and Wachovia Bank, National Association and Doral Securities Inc.

## LEGAL MATTERS

The proposed form of opinion of Nixon Peabody LLP, Bond Counsel, is attached as Appendix III to this Official Statement. Certain legal matters will be passed upon for the Underwriters by O'Neill & Borges, San Juan, Puerto Rico.

## LEGAL INVESTMENT

The 2004 Series A Bonds will be eligible for deposit by banks in Puerto Rico to secure public funds and will be approved investments for domestic insurance companies.

## VERIFICATION OF MATHEMATICAL COMPUTATIONS

Samuel Klein & Company, Certified Public Accountants (the "Verification Agent"), will verify, from the information provided to them, the mathematical accuracy as of the date of the closing of the Series 2004 Bonds of the computations contained in the provided schedules to determine that (i) the anticipated receipts from the securities listed in such schedules, to be held in escrow, will be sufficient to pay, when due, the principal, interest and call premium payment requirements of the Refunded Bonds; and (ii) the anticipated budgetary appropriations will be sufficient to pay, when due, the principal and interest requirements of the Series 2004 Bonds and the Parity Bonds. The Verification Agent will express no opinion on the assumptions provided to them.

## GOVERNMENT DEVELOPMENT BANK FOR PUERTO RICO

As required by Act No. 272 of the Legislature of Puerto Rico, approved May 15, 1945, as amended, Government Development Bank has acted as financial advisor to the Corporation in connection with the 2004 Series A Bonds offered hereby. As financial advisor, Government Development Bank participated in the selection of the Underwriters of the 2004 Series A Bonds. Certain of the Underwriters have been selected by Government Development Bank to serve from time to time as underwriters of its obligations and the obligations of the Commonwealth, its instrumentalities and public corporations. Certain of the Underwriters or their affiliates participate in other financial transactions with Government Development Bank.

## RATINGS

Moody's and Standard & Poor's have assigned the 2004 Series A Bonds ratings of "Baa2" and "BBB+," respectively. These ratings do not reflect the municipal bond insurance policies that cover certain 2004 Series A Bonds identified in the inside cover page of this Official Statement. Moody's and Standard & Poor are expected to give ratings of "Aaa" and "AAA," respectively, to the CIFGNA Insured Bonds, the MBIA Insured Bonds, the AMBAC Insured Bonds and the FGIC Insured Bonds. These ratings reflect only the respective views of the rating agencies and an explanation of the significance of each rating may be obtained only from the respective rating agency. There is no assurance that such ratings will remain in effect for any given period of time or that they will not be revised downward or withdrawn entirely by either or both of such rating agencies, if in the judgment of either or both, circumstances so warrant. Any such downward revision or withdrawal of either of such ratings may have an adverse effect on the market prices of the 2004 Series A Bonds.

Such rating agencies were provided with materials relating to the Commonwealth and the 2004 Series A Bonds and other relevant information, and no application has been made to any other rating agency for the purpose of obtaining a rating on the 2004 Series A Bonds.

## MISCELLANEOUS

The foregoing summaries of or references to the various acts, the 2004 Series A Bonds, the Trust Agreement, the Resolution, the Notes, the Parity Notes, the Parity Bonds, the Letter of Credit, the Appropriation Acts and the summaries of or references to the various acts contained in the Commonwealth Report are made subject to all the detailed provisions thereof to which reference is hereby made for further information and do not purport to be complete statements of any or all of such provisions.

Appended to and constituting a part of this Official Statement are (i) the Commonwealth Report (Appendix I), (ii) a summary of the provisions of the Trust Agreement (Appendix II), (iii) the proposed form of opinion of Bond Counsel (Appendix III), (iv) information relating to Government Development Bank (Appendix IV), (v) the table of Refunded Bonds (Appendix V), (vi) the specimen of CIFGNA Insurance Policy (Appendix VI), (vii) the specimen of MBIA Insurance Policy (Appendix VII), (viii) the specimen of Ambac Insurance Policy (Appendix VIII), and (ix) the specimen of FGIC Insurance Policy (Appendix IX).

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

The information set forth in this Official Statement was supplied by certain officials of Government Development Bank, the Corporation and the Commonwealth or certain of its agencies or instrumentalities, in their respective official capacities, or was obtained from publications of the Commonwealth or certain of its agencies or instrumentalities and is included in this Official Statement on the authority of such officials or the authority of such publications as public official documents.

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

**PUERTO RICO PUBLIC FINANCE CORPORATION**

By: /s/ Antonio Faría-Soto
President

**APPENDIX I**

COMMONWEALTH OF PUERTO RICO
Financial Information and Operating Data Report
April 1, 2004

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**COMMONWEALTH OF PUERTO RICO**

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# 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, 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 fifty 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 Legislature 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.

Sila M. Calderón was sworn in as Governor of Puerto Rico on January 2, 2001. She obtained a Bachelor's degree in Political Science from Manhattanville College in New York and undertook graduate studies at the School of Public Administration of the University of Puerto Rico. Since 1973, she has worked in the public sector as Executive Assistant to the Secretary of Labor, Special Assistant to the Governor of Puerto Rico, Chief of Staff of the Governor of Puerto Rico and Secretary of State. In the private sector, she was an executive in charge of Business Development for Citibank, N.A., President of Commonwealth Investment Company Inc., and a member of the Board of Directors of BanPonce, Banco Popular de Puerto Rico and Pueblo International, Inc. From 1997 until taking office as Governor, she served as elected Mayor of the municipality of San Juan.

Juan A. Flores Galarza, Secretary of the Treasury, took office on January 2, 2001. He is a certified public accountant and a graduate of the University of Puerto Rico, Mayagüez Campus, where he obtained a Bachelor's degree in Business Administration. Prior to his appointment as Secretary of the Treasury, he worked in a manufacturing company and as an auditor for a large accounting firm.

Melba Acosta, Director of the Office of Management and Budget, took office on January 2, 2001. She is a graduate of the University of Puerto Rico, where she obtained a Bachelor's degree in Business Administration and a Juris Doctor degree. She obtained a Master's degree in Business Administration from the Harvard Graduate School of Business. She is a certified public accountant and has six years of experience as a tax consultant and corporate attorney in the private sector. Prior to her appointment as head of the Office of Management and Budget, she served for four years in the public sector as Chief of Staff of the Municipality of San Juan.

Antonio Faría-Soto was appointed President of Government Development Bank in November 2003. He obtained a Bachelor's degree in Business Administration from Catholic University of Puerto Rico and a Master's degree in Business Administration from InterAmerican University. At the time of his appointment, he was President of the Economic Development Bank for Puerto Rico. Prior to his appointment as President of the Economic Development Bank for Puerto Rico, he served as Commissioner of Financial Institutions for the Commonwealth. Mr. Faría has over 30 years of experience in the commercial and investment banking industry, having worked at PaineWebber, Banco Santander, Banco Central Hispano, Banco Central y Economías and Citibank, N.A.

**Political Trends**

For many years there have been two major views in Puerto Rico with respect to the island'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 vote received by the gubernatorial candidates of the various parties in the last five elections by voter preference with respect to commonwealth status, statehood, and independence. While the electoral choices of Puerto Rico's voters are not based solely on preferences regarding the island'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.

| | 1984 | 1988 | 1992 | 1996 | 2000 |
|---|---|---|---|---|---|
| Popular Democratic Party | 48.5% | 48.7% | 45.9% | 44.5% | 48.6% |
| New Progressive Party | 45.5 | 45.8 | 49.9 | 51.1 | 45.7 |
| Puerto Rico Independence Party | 3.9 | 5.4 | 4.2 | 3.8 | 5.2 |
| Others | 2.1 | 0.1 | -- | 0.6 | 0.5 |

With the results of the 2000 election, control of the executive and legislative branches is now under the Popular Democratic Party. The composition of the Senate and House of Representatives by political party is as follows:

| | Senate | House |
|---|---|---|
| Popular Democratic Party | 20 | 29 |
| New Progressive Party | 8 | 21 |
| Puerto Rico Independence Party | 1 | 1 |
| | 29 | 51 |

The next general election (gubernatorial, municipal, and legislative) in Puerto Rico will be held in November 2004. Voter participation in Puerto Rico is substantially higher than in the United States, averaging 83% 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 island's population.

Puerto Rico has enjoyed two decades of almost continuous economic expansion. Almost every sector of the economy has participated in this expansion, and record levels of employment have been achieved. Factors contributing to this expansion included government-sponsored economic development programs, increases in the level of federal transfer payments, a significant expansion in construction investment driven by infrastructure projects and private investment, primarily in housing, the relatively low cost of borrowing, and low oil prices in many years during this period.

Personal income, both aggregate and per capita, has increased consistently each fiscal year from 1985 to 2003. In fiscal year 2003, aggregate personal income was $43.6 billion ($41.7 billion in 2000 prices) and personal income per capita was $11,279 ($10,784 in 2000 prices).* Personal income includes transfer payments to individuals in Puerto Rico under various social programs. Total federal payments to Puerto Rico, which include transfers to 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

*Different price deflators are used for gross 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.

Puerto Rico than in any state of the United States. Transfer payments to individuals in fiscal year 2003 were $9.6 billion, of which $7.4 billion, or 76.6%, represented entitlements to individuals who had previously performed services or made contributions under programs such as Social Security, Veterans' Benefits, Medicare and U.S. Civil Service retirement pensions.

Total average employment (as measured by the Department of Labor and Human Resources Household Employment Survey) has also increased. For example, from fiscal year 1999 to fiscal year 2003, average employment increased from 1,146,700 to 1,210,800.

The dominant sectors of the Puerto Rico economy 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, electronics, 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 only to manufacturing in contribution to the gross domestic product and leads all sectors in providing employment.

The following table shows the gross product for the five fiscal years ended June 30, 2003.

**Commonwealth of Puerto Rico**
**Gross Product**

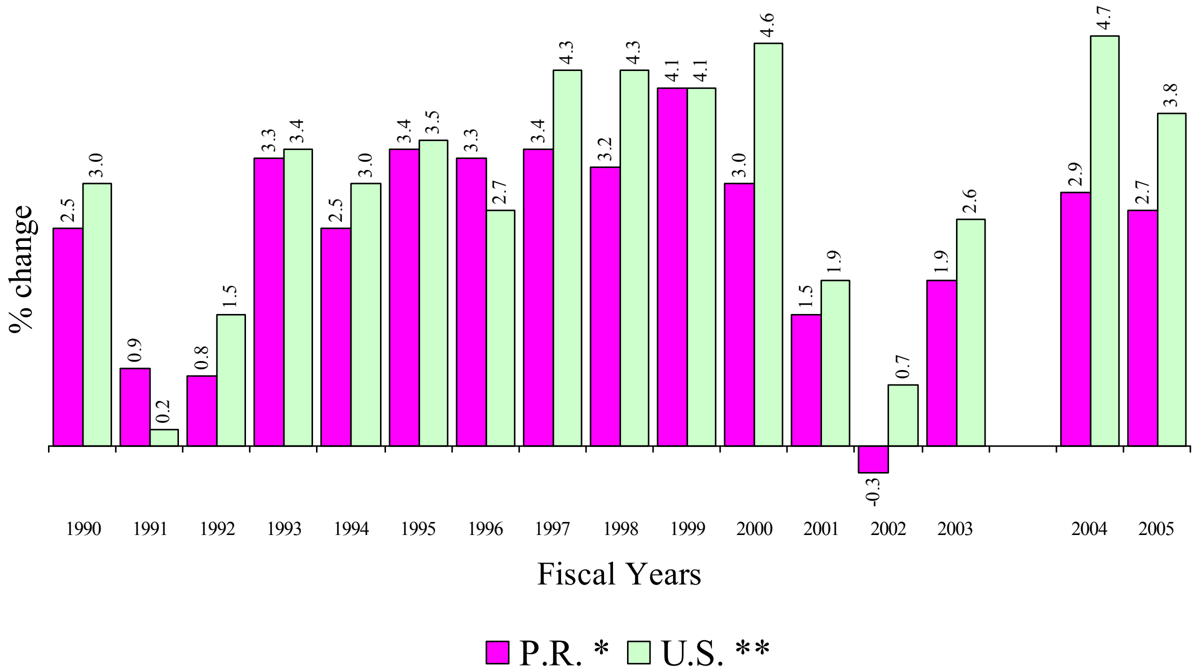
| | Fiscal Years Ended June 30 | | | | |
|---|---|---|---|---|---|
| | **1999** | **2000** | **2001** | **2002** | **2003**(1) |
| Gross product - $ millions(2) | $ 38,281 | $ 41,419 | $ 44,047 | $ 45,008 | $ 47,354 |
| Real gross product - $ millions (2000 prices) | 40,225 | 41,419 | 42,044 | 41,910 | 42,689 |
| Annual percentage increase in real gross product (2000 prices) | 4.1% | 3.0% | 1.5% | (0.3%) | 1.9% |
| U.S. annual percentage increase in real gross product (2000 prices) | 4.1% | 4.6% | 1.9% | 0.7% | 2.6% |

(1) Preliminary.
(2) In current dollars.

*Sources:* P.R. Planning Board and Global Insight Inc.

The economy of Puerto Rico is closely linked to the United States economy. Factors affecting the United States economy usually have a significant impact on the performance of the Puerto Rico economy. These include exports, direct investment, the amount of federal transfer payments, the level of interest rates, the level of oil prices, the rate of inflation, and tourist expenditures. Consequently, the economic slowdown in the United States in 2001 and 2002 and the subsequent recovery in 2003, which continues in 2004, have also been reflected in the Puerto Rico economy. During fiscal year 2003 (July 2002 through June 2003), approximately 86% of Puerto Rico's exports went to the United States mainland, which was also the source of approximately 49% of Puerto Rico's imports. In fiscal year 2003, Puerto Rico experienced a $21.4 billion positive merchandise trade balance. The graph on the following page compares the growth rate of real gross national product for the Puerto Rico and United States economies since fiscal 1990, and the projection of the growth rate for fiscal years 2004 and 2005.

# Real GNP Growth Rate




* P.R. Planning Board

** Global Insight 04/04.

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. In contrast with the BEA, which computes the economic accounts on a quarterly basis, the Planning Board computes the economic accounts on an annual basis. Like the BEA, the Planning Board revises the macroeconomic numbers on a regular basis. The Planning Board has always classified the latest annual numbers as preliminary until they are revised and made final in conjunction with the release of new data each year. At present, all macroeconomic accounts for fiscal year 2003 are preliminary until the revised figures are released.

*Fiscal Year 2003*

The Planning Board's preliminary reports of the performance of the Puerto Rico economy during fiscal year 2003 indicate that the economy registered an increase of 1.9% in real gross product. Gross product was $47.4 billion in fiscal year 2003 ($42.7 billion in 2000 prices) compared to $45.0 billion in fiscal year 2002 ($41.9 billion in 2000 prices). This represents an increase in nominal gross product of 5.2%. Aggregate personal income increased from $42.2 billion in fiscal year 2002 ($40.8 billion in 2000 prices) to $43.6 billion in fiscal year 2003 ($41.7 billion in 2000 prices), and personal income per capita increased from $10,969 in fiscal year 2002 ($10,603 in 2000 prices) to $11,279 in fiscal year 2003 ($10,784 in 2000 prices). According to the Department of Labor and Human Resources Household Employment Survey (the "Household Survey"), total monthly employment averaged 1,210,800 in fiscal year 2003 compared to 1,169,600 in fiscal year 2002, an increase of 3.5%. Notwithstanding this increase in average monthly employment, the unemployment rate increased from 12.0% during fiscal year 2002 to

12.1% during fiscal year 2003 due to a higher labor participation rate and a significant increase in the civilian population aged 16 years and over.

*Fiscal Year 2004*

The Planning Board's current real gross product forecast for fiscal years 2004 and 2005, released in February 2004, projects an increase of 2.9% and 2.7%, respectively. According to the Household Survey, total monthly seasonally adjusted employment for the period from July 2003 to March 2004 averaged 1,232,100, an increase of 2.3% compared to 1,204,700 for the same period during fiscal year 2003. The seasonally adjusted unemployment rate for the first nine months of fiscal year 2004 was 11.2%, a decrease from 12.1% for the same period in fiscal year 2003. As in the past, the economy of Puerto Rico is expected to follow the performance of the United States economy. Construction activity is expected to be a driving force for economic growth in the short and medium-term. The Planning Board's forecast for construction investment, both public and private, for fiscal year 2004 is $6.7 billion, in nominal terms, which represents a real growth of 4.6% when compared to fiscal year 2003.

**Economic Development Program for the Private Sector**

During the past three years, the Commonwealth's economic development program for the private sector has focused on initiatives which it believes will lead to sustainable economic development. The principal initiatives have been: (i) the enactment of laws in Puerto Rico providing tax benefits that will promote foreign and local investment and increased economic activity; (ii) the acceleration and simplification of the local permitting process; (iii) the reduction of the costs of doing business in Puerto Rico; and (iv) the promotion of new federal income tax benefits that enhance the attractiveness of establishing operations in Puerto Rico. Recognizing a shift in its post-industrial economy, the Commonwealth recently formulated a strategic plan to enhance its competitiveness in knowledge-based economic sectors, such as research and development of science and technology products. Two major components of this strategic plan are: (i) to build on the strong presence in Puerto Rico of multinational companies in the science and technology sectors and Puerto Rico's skilled workforce to promote the expansion of research and development facilities by companies currently operating in Puerto Rico and to attract new leaders in such sectors, and (ii) to provide incentives for companies and entrepreneurs to engage in the process of innovation and commercialization of new products and establish research and development facilities in Puerto Rico. The latter initiative includes the proposed creation of a government-sponsored trust to provide grants and financing to companies and entrepreneurs that engage in these activities. Legislation for the creation of the trust is expected to be submitted to the Legislature during the second quarter of 2004.

*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) and individuals residing in Puerto Rico generally are not subject to federal income taxes. This enables the Commonwealth to utilize local tax legislation as a tool for stimulating economic development in Puerto Rico. See "Tax Incentives" below.

In this regard, the Commonwealth has enacted legislation extending certain benefits of its most recent tax incentive 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 the Puerto Rico income tax liability of 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 the 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 facilities and the purchase of machinery and equipment. The amount of the credit is equal to 50% of the cash invested for such purposes.

The Commonwealth has also enacted legislation which (i) reduces the capital gains tax from 20% to 10% in the case of individuals and estates and trusts, and from 25% to 12.5% in the case of corporations and partnerships organized under the laws of the Commonwealth or engaged in trade or business in the Commonwealth, for gains from the sale of eligible Commonwealth investments; and (ii) allows income tax credits for extraordinary investment in housing infrastructure. In addition, legislation was recently enacted that reduces the tax payable on interest on certain qualifying debt obligations issued by Puerto Rico corporations and certain qualifying foreign corporations and paid to resident individuals, trusts and estates to 10% under certain circumstances.

In addition, legislation has been enacted: (i) amending the 1998 Tax Incentives Act to provide special income tax rates ranging from 0% to 2% to companies that establish operations in Puerto Rico in "core pioneer industries" which utilize innovative technology not previously used in Puerto Rico; (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) reducing to 7% the capital gains rate applicable to gains realized on the sale of the stock of Puerto Rico corporations sold in an initial public offering made prior to December 31, 2007, or acquired in public offerings made prior to December 31, 2007; (iv) granting income tax exemption to the fees and interest income received by financial institutions in connection with loans or guarantees of loans made to finance tourism development projects; (v) granting an exemption to qualified associations administering timesharing rights or vacation clubs and to owners' associations of areas designated as tourism enhancement districts; (vi) granting income tax exemption to financial institutions for charges collected on obligations issued for the financing of tourism projects; (vii) granting tax exemption for investments in infrastructure made by housing developers; (viii) granting tax credits to Puerto Rico businesses that acquire products manufactured in Puerto Rico for exportation; and (ix) 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.

*Acceleration and Simplification of Local Permitting Process*

Another government initiative to promote sustainable economic activity involves the simplification of the permitting process. As part of this initiative, the Commonwealth established a multi-agency center that handles, in a coordinated manner, the permitting process. Furthermore, the government developed a procedure that will allow agencies to conduct simultaneous public hearings in those instances when two or more agencies require them.

*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. As part of this initiative, Puerto Rico Industrial Development Company ("PRIDCO") is conducting a thorough evaluation of the cost of doing business in Puerto Rico in order to develop new proposals to reduce those costs.

One of the costs of doing business in Puerto Rico that is high, particularly for the manufacturing industry, relative to competing jurisdictions, is the cost of electricity. Puerto Rico is heavily dependent on oil imports for the production of electricity. As a result of the construction of two cogeneration plants, however, 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 Electric Power Authority now estimates that these plants could provide up to 33% of its electric energy requirements.

*Federal Tax Incentives*

In order to enhance the attractiveness for United States 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 United States 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 (see "Tax Incentives – Incentives Under the Code" below), 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, as discussed below, most U.S.-based companies operating under Sections 30A and 936 of the Code have converted from United States corporations to Puerto Rico or foreign corporations, which has lessened the impact of the phase-out of those sections.

## Employment and Unemployment

The number of persons employed in Puerto Rico during fiscal year 2003 averaged 1,210,800. Unemployment, although at relatively low historical levels, remains above the United States average. The average unemployment rate decreased from 12.5% in fiscal year 1999 to 12.1% in fiscal year 2003, and to 11.2% in March 2004.

The following table presents annual statistics of employment and unemployment for fiscal year 1999 through fiscal year 2003 and monthly statistics for July 2003 to March 2004. 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 15% of civilian employment in Puerto Rico, more than double the level in the United States.

**Commonwealth of Puerto Rico**
**Employment and Unemployment (1)**

| Fiscal Years Ended June 30 | Labor Force | Employed | Unemployed | Unemployment Rate(2) |
|---|---|---|---|---|
| | | (Annual Average) | | |
| 1999 | 1,310 | 1,147 | 163 | 12.5% |
| 2000 | 1,303 | 1,159 | 143 | 11.0 |
| 2001 | 1,293 | 1,158 | 135 | 10.5 |
| 2002 | 1,330 | 1,170 | 160 | 12.0 |
| 2003 | 1,378 | 1,211 | 167 | 12.1 |
| **Fiscal Year 2004** | | (Seasonally Adjusted) | | |
| July | 1,408 | 1,231 | 176 | 12.5% |
| August | 1,390 | 1,233 | 158 | 11.4 |
| September | 1,376 | 1,213 | 162 | 11.8 |
| October | 1,391 | 1,234 | 157 | 11.3 |
| November | 1,390 | 1,213 | 177 | 12.7 |
| December | 1,400 | 1,238 | 162 | 11.6 |
| January | 1,382 | 1,222 | 160 | 11.6 |
| February | 1,373 | 1,234 | 138 | 10.1 |
| March | 1,431 | 1,271 | 160 | 11.2 |

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

During the period between fiscal year 1999 and 2003, 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 product for the five fiscal years ended June 30, 2003.

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

| | Fiscal Years Ended June 30 | | | | |
|---|---|---|---|---|---|
| | **1999** | **2000** | **2001** | **2002** | **2003**[(1)] |
| Manufacturing | $23,312 | $24,079 | $29,037 | $30,527 | $31,297 |
| Services[(2)] | 22,435 | 24,920 | 26,615 | 27,168 | 28,745 |
| Government[(3)] | 5,530 | 5,478 | 5,992 | 6,303 | 7,147 |
| Transportation, communication and public utilities | 4,032 | 4,237 | 4,698 | 4,934 | 5,145 |
| Agriculture, forestry and fisheries | 336 | 529 | 348 | 228 | 203 |
| Construction[(4)] | 1,668 | 1,875 | 1,802 | 1,814 | 1,760 |
| Statistical discrepancy | 529 | 585 | 717 | 333 | 66 |
| Total gross domestic product[(5)] | $57,841 | $61,702 | $69,208 | $71,306 | $74,363 |
| Less: net payment abroad | (19,560) | (20,283) | (25,162) | (26,298) | (27,009) |
| Total gross product[(5)] | $38,281 | $41,419 | $44,047 | $45,008 | $47,354 |

(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.
(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, is 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 1999 - 2003.

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

| | Fiscal Years Ended June 30 | | | | |
|---|---|---|---|---|---|
| | **1999** | **2000** | **2001** | **2002** | **2003[(2)]** |
| Natural Resources and Mining | 1,408 | 1,425 | 1,455 | 1,292 | 1,173 |
| Construction | 67,325 | 73,492 | 73,729 | 69,208 | 68,701 |
| Manufacturing | | | | | |
| Durable Goods | 56,917 | 57,383 | 56,249 | 49,348 | 47,534 |
| Non-Durable Goods | 88,783 | 85,550 | 82,236 | 72,595 | 69,319 |
| Sub Total | 145,700 | 142,933 | 138,485 | 121,943 | 116,854 |
| Trade, Transportation, Warehouse & Utilities | | | | | |
| Wholesale Trade | 30,342 | 32,000 | 32,327 | 31,489 | 31,218 |
| Retail Trade | 126,067 | 131,817 | 133,821 | 127,716 | 128,189 |
| Transportation, Warehouse & Utilities | 18,765 | 19,458 | 19,285 | 17,603 | 17,124 |
| Sub Total | 175,084 | 183,275 | 185,433 | 176,808 | 176,530 |
| Information | 20,683 | 21,108 | 20,597 | 21,943 | 21,216 |
| Finance | 44,575 | 45,583 | 44,974 | 43,963 | 42,128 |
| Professional & Business | 91,008 | 96,750 | 97,164 | 95,223 | 96,938 |
| Educational & Health | 75,350 | 80,692 | 84,202 | 84,452 | 87,590 |
| Leisure & Hospitality | 61,333 | 65,942 | 66,435 | 64,273 | 66,200 |
| Other Services | 17,208 | 17,408 | 17,330 | 16,602 | 16,338 |
| Government | 302,183 | 286,133 | 282,723 | 288,679 | 298,751 |
| Total Non-Farm[(3)] | 1,001,858 | 1,014,742 | 1,012,528 | 984,385 | 992,418 |

(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. In Puerto Rico, self-employment represents around 15% of total employment, while representing approximately 7% of total employment in the United States.
(2) Preliminary.
(3) Totals may not add due to rounding.

*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 estimates that in fiscal year 2003 manufacturing generated $31.3 billion, or 42.1%, of gross domestic product. During fiscal year 2003, payroll employment for the manufacturing sector was 116,854, a decrease of 4.2% compared with fiscal year 2002, 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 February 2004, the average hourly manufacturing wage rate in Puerto Rico was 66.2% 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 the large investment over the last decade in the pharmaceutical, scientific instruments, computers and electrical products industries in Puerto Rico. One of the factors assisting 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 Internal Revenue Code of 1986, as amended, phases out the federal tax incentives during a ten-year period. See "Tax Incentives - Incentives Under the Code" under *The Economy*.

The following table sets forth gross domestic product by manufacturing sector for the five fiscal years ended June 30, 2003.

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

| | Fiscal Years Ended June 30 | | | | |
|---|---|---|---|---|---|
| | **1999** | **2000** | **2001** | **2002** | **2003(1)** |
| Pharmaceuticals | $12,913 | $13,580 | $16,620 | $17,958 | $19,239 |
| Machinery and metal products: | | | | | |
| Machinery, except electrical | 1,847 | 2,031 | 3,376 | 3,751 | 3,607 |
| Electrical machinery | 1,410 | 1,525 | 1,874 | 1,759 | 1,629 |
| Professional and scientific instruments | 1,697 | 1,758 | 2,100 | 2,276 | 2,306 |
| Other machinery and metal products | 377 | 341 | 316 | 323 | 372 |
| Food products | 1,910 | 1,912 | 1,974 | 2,080 | 2,051 |
| Other chemical and allied products | 898 | 777 | 765 | 619 | 591 |
| Apparel | 609 | 610 | 569 | 521 | 367 |
| Other(2) | 1,651 | 1,543 | 1,444 | 1,239 | 1,136 |
| Total gross domestic product of manufacturing sector(3) | $23,312 | $24,079 | $29,037 | $30,527 | $31,297 |

(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 1999 to 2003.

**Commonwealth of Puerto Rico**
**Non-Farm Payroll Manufacturing Employment by Industry Group[1]**
**(persons age 16 years and over)**

| Industry Group | Fiscal Years Ended June 30 | | | | |
|---|---|---|---|---|---|
| | 1999 | 2000 | 2001 | 2002 | 2003[2] |
| **Durable Goods** | | | | | |
| Nonmetallic Mineral Products Manufacturing | 4,275 | 4,833 | 4,726 | 4,447 | 4,255 |
| Cement and Concrete Products Manufacturing | 3,217 | 3,700 | 3,723 | 3,494 | 3,373 |
| Fabricated Metal Product | 6,817 | 7,267 | 7,218 | 6,403 | 6,054 |
| Computer and Electronic | 15,983 | 14,958 | 14,316 | 11,471 | 11,549 |
| Navigational, Measuring | 4,808 | 4,617 | 4,330 | 4,661 | 4,186 |
| Electrical Equipment | 8,725 | 8,917 | 8,225 | 7,064 | 6,927 |
| Electrical Equipment Manufacturing | 4,767 | 4,992 | 4,564 | 4,030 | 3,630 |
| Miscellaneous Manufacturing | 11,708 | 11,725 | 12,046 | 11,299 | 12,147 |
| Medical Equipment and Supplies Manufacturing | 10,258 | 10,300 | 10,784 | 10,110 | 11,187 |
| Other Durable Goods Manufacturing | 9,409 | 9,683 | 9,718 | 8,255 | 6,602 |
| Total – Durable Goods | 56,917 | 57,383 | 56,249 | 49,348 | 47,534 |
| **Non-Durable Goods** | | | | | |
| Food Manufacturing | 18,733 | 17,417 | 17,109 | 14,469 | 13,213 |
| Beverage and Tobacco Products Manufacturing | 3,658 | 3,425 | 3,571 | 3,423 | 3,352 |
| Apparel Manufacturing | 19,275 | 17,517 | 16,265 | 11,872 | 8,935 |
| Cut and Sew Apparel Manufacturing | 17,392 | 16,358 | 15,162 | 11,174 | 8,914 |
| Chemical Manufacturing | 28,625 | 29,450 | 29,124 | 30,265 | 31,621 |
| Pharmaceutical and Medicine Manufacturing | 23,425 | 24,300 | 24,275 | 25,707 | 27,337 |
| Plastics and Rubber Products | 4,308 | 4,108 | 3,820 | 3,399 | 3,154 |
| Plastics Product Manufacturing | 3,783 | 3,675 | 3,412 | 3,105 | 2,875 |
| Other Non-Durable Goods Manufacturing | 14,184 | 13,633 | 12,347 | 9,206 | 9,044 |
| Total – Non-Durable Goods | 88,783 | 85,550 | 82,236 | 72,595 | 69,319 |
| Total Manufacturing Employment | 145,700 | 142,933 | 138,485 | 121,943 | 116,853 |

(1) Totals may not add due to rounding.
(2) Preliminary.

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

While total employment in the manufacturing sector decreased by 28,847 from fiscal year 1999 to fiscal year 2003, other indicators of the manufacturing sector suggest that manufacturing production increased. Average weekly hours worked increased from 40.6 in the first eight months of fiscal year 1999 to 41.3 for the same period in fiscal year 2004. The reduction in manufacturing employment occurred during a period of significant expansion in real manufacturing output, as reflected in the growth of exports. This trend suggests a significant increase in manufacturing investment and productivity. Most of the decrease in employment has been concentrated in labor intensive industries, particularly apparel, textiles, tuna canning, and leather products.

## Leading United States and Foreign Companies with Manufacturing Operations in Puerto Rico [1]

| Employment 2,500 and over | Product |
|---|---|
| Baxter International, Inc. | Surgical Instruments |
| Eaton Corporation | Electronic Instruments |
| Johnson and Johnson | Pharmaceuticals |
| Pfizer Inc. | Pharmaceuticals |
| Sara Lee Corp. | Apparel |
| Wyeth | Pharmaceuticals |

| Employment 1,000 to 2,499 | Product |
|---|---|
| Abbott Laboratories Inc. | Pharmaceuticals |
| Bristol-Myers Squibb Company | Pharmaceuticals |
| Edwards Lifesciences LLC | Surgical Instruments |
| Eli Lilly and Company | Pharmaceuticals |
| GE Power Systems | Electrical Instruments |
| Hewlett-Packard Co. | Computers |
| Hubell Incorporated | Electrical Instruments |
| MacAndrews & Forbes Holdings | Tobacco Products |
| Medtronics, Inc. | Surgical Instruments |
| Merck & Co., Inc. | Pharmaceuticals |
| Nypro Inc. | Medical Devices |
| Pharmacia | Pharmaceuticals |
| Propper International Co. | Apparel |
| Schering Plough Corporation | Pharmaceuticals |
| Solectron Corp. | Electronic Instruments |
| Tyco Int. | Communications |
| Unilever PLC | Consumer Products |

| Employment 500 to 999 | Product |
|---|---|
| Advanced Medical Optics | Ophthalmic Products |
| Amgen Manufacturing | Pharmaceuticals |
| Astra Zeneca PLC | Pharmaceuticals |
| B. Braun Medical | Medical Equipment |
| Becton-Dickinson & Co. | Scientific Instruments |
| Bumble Bee Seafoods | Food |
| Cardinal Health, Inc. | Pharmaceuticals |
| Consolidated Container Co. | Packaging Products |
| Garguilo Inc. | Transportation |
| Guidant Corp. | Medical Instruments |
| Hamilton Sundstrand | Electrical Instruments |
| Ingersoll-Rand Co. | Electrical Instruments |
| Ivax Pharmaceutical | Pharmaceuticals |
| Novartis-Holding AG | Ophthalmic Products |
| Ocular Science | Ophthalmic Products |
| Pall Corporation | Filters |
| Pharmacia Up-John Co. | Pharmaceuticals |
| Pilgrim Pride Co. | Food |

| Employment 200 to 499 | Product |
|---|---|
| Agropecuaria Krisma C.A. | Food |
| Bacardí | Food |
| Bard Shannon LTD. | Scientific Instruments |
| Biovail Laboratories | Pharmaceuticals |
| Carolina Underwear Co. | Apparel |
| Checkpoint Systems Inc. | Electronic Instruments |
| Coca Cola Company | Food |
| Colgate-Palmolive Company | Consumer Products |
| Curtis Instruments Inc. | Electrical Instruments |
| E.I. DuPont de Nemours & Co. | Chemicals |
| Eastern Canvas Products | Textile Products |
| Emerson Electric Co. | Electronic Instruments |
| Espace Europee de Lenterprise | Pharmaceuticals |
| Essilor International | Ophthalmic Products |
| Hershey Foods | Food |
| ICN Pharmaceuticals Inc. | Pharmaceuticals |
| Lawson Mardon Wheaton | Glass and Plastics |
| Loctite Corporation | Chemicals |
| Lutron Electronics Co. Inc. | Electronic Instruments |
| Micro Technology | Electronic Instruments |
| Millipore Corporation | Surgical Instruments |
| Molex Inc. | Electrical Instruments |
| Mylan Laboratories | Chemicals |
| Northrop Grumman | Electrical Instruments |
| Owens Illinois Inc. | Glass and Plastics |
| Packaging Coordinators Inc. | Packaging Products |
| PepsiCo | Food |
| Procter & Gamble Co. | Pharmaceuticals |
| Rocky Shoes & Boots | Footwear |
| Siemens AG | Electrical Instruments |
| Standard Motor Products Inc. | Motor Vehicle Parts |
| Storage Technology Corp. | Electronics |
| Surgical Specialties Corp. | Surgical Instruments |
| Symmetricom Inc. | Electronic Equipment |
| Thomas & Betts | Electrical Instruments |
| Timberland Company | Leather |
| Watson Phamaceutical, Inc. | Pharmaceuticals |
| Wellco Enterprises, Inc. | Leather |

(1) Based on the last employment figures reported by each company to PRIDCO.

*Source:* PRIDCO, Office of Economic Research

*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 1999 and 2003, the gross domestic product in this sector, in nominal terms, increased at an average annual rate of 6.4%, while payroll employment in this sector increased at an average annual rate of 1.1%. It should also be noted that in the Puerto Rico labor market self-employment, which is not accounted for in the Payroll Survey, represents approximately 15% of total employment according to the Household Survey. Most of the self employment is concentrated in the service and construction sectors. For example, in fiscal year 2003, the number of self-employed individuals was 180,464, out of which 46.0% were in the service sector and 10.5% 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.

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 2003, services generated $28.7 billion of gross domestic product, or 38.7%, of the total. Services employment grew from 485,241 in fiscal year 1999 to 506,941 in fiscal year 2003 (representing 51.1% of total employment). This represents a cumulative increase of 4.5%. Wholesale and retail trade, finance, insurance and real estate experienced significant growth in fiscal years 1999 to 2003, as measured by gross domestic product. From fiscal year 1999 to 2003, gross domestic product increased in wholesale and retail trade from $8.1 billion to $8.6 billion and in finance, insurance, and real estate from $8.2 billion to $12.7 billion. There are sixteen commercial banks and trust companies currently operating in Puerto Rico. Total assets of these institutions as of December 31, 2003 were $61.0 billion. As of December 31, 2003, there were thirty-five international banking entities operating in Puerto Rico licensed to conduct offshore banking transactions with total assets of $56.5 billion.

The following tables set forth gross domestic product and employment for the services sector for the five fiscal years ended June 30, 2003.

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

| | Fiscal Years Ended June 30 | | | | |
|---|---|---|---|---|---|
| | **1999** | **2000** | **2001** | **2002** | **2003[1]** |
| Wholesale and retail trade | $ 8,112 | $ 8,340 | $ 8,338 | $ 8,409 | $ 8,623 |
| Finance, insurance and real estate | 8,183 | 9,977 | 11,294 | 11,590 | 12,732 |
| Other services[2] | 6,140 | 6,603 | 6,982 | 7,169 | 7,391 |
| Total[3] | $22,435 | $24,920 | $26,615 | $27,168 | $28,745 |

(1) Preliminary.
(2) Includes tourism.
(3) Totals may not add due to rounding.

*Source:* Planning Board

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

| | Fiscal Years Ended June 30 | | | | |
|---|---|---|---|---|---|
| | **1999** | **2000** | **2001** | **2002** | **2003[1]** |
| Trade, Transportation, Warehouse & Utilities | 175,084 | 183,275 | 185,433 | 176,808 | 176,531 |
| Wholesale Trade | 30,342 | 32,000 | 32,327 | 31,489 | 31,218 |
| Retail Trade | 126,067 | 131,817 | 133,821 | 127,716 | 128,189 |
| Transportation, Warehouse & Utilities | 18,675 | 19,458 | 19,285 | 17,603 | 17,124 |
| Information | 20,683 | 21,108 | 20,597 | 21,943 | 21,216 |
| Finance | 44,575 | 45,583 | 44,974 | 43,963 | 42,128 |
| Professional and Business | 91,008 | 96,750 | 97,164 | 95,223 | 96,938 |
| Educational & Health | 75,350 | 80,692 | 84,202 | 84,452 | 87,590 |
| Leisure & Hospitality | 61,333 | 65,942 | 66,435 | 64,273 | 66,200 |
| Other Services | 17,208 | 17,408 | 17,330 | 16,602 | 16,338 |
| Total | 485,241 | 510,758 | 516,135 | 503,264 | 506,941 |

(1) Preliminary

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

*Hotels and Related Services - Tourism*

During fiscal year 2003, the number of persons registered in tourist hotels was 1,733,300, an increase of 8.6% over the number of persons registered during fiscal year 2002, when tourism in Puerto Rico was adversely affected in the immediate aftermath of the terrorist attacks of September 11, 2001. The average occupancy rate in tourist hotels during fiscal year 2003 was 68.0% compared to 64.4% in fiscal year 2002. The average number of rooms rented in tourist hotels increased 9.1% during fiscal year 2003 compared with fiscal year 2002. The average number of rooms available in tourist hotels increased 3.5% during fiscal year 2003 compared with fiscal year 2002, representing openings of new hotels and hotel expansions. During fiscal year 2003, hotels comprising 870 new hotel rooms opened and, as of January 2004, several hotels, representing more than 4,000 additional rooms, are under various stages of development or construction.

In the first seven months of fiscal year 2004, the number of persons registered in tourist hotels was 1,000,000, an increase of 2.9% over the number of persons registered during the same period of fiscal year 2003. The number of non-resident tourists registered in tourist hotels during the first seven months of fiscal year 2004 increased 4.3% in comparison with the same period of fiscal year 2003. The average occupancy rate in tourist hotels during the first seven months of fiscal year 2004 was 69.5% compared to 64.9% in the same period of fiscal year 2003. The average number of rooms rented in tourist hotels increased 4.5% during the first seven months of fiscal year 2004 compared with the same period of fiscal year 2003.

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, 2003.

**Commonwealth of Puerto Rico**
**Tourism Data**

| | Number of Visitors | | | | |
|---|---|---|---|---|---|
| **Fiscal Years Ended June 30** | **Tourist Hotels[(1)]** | **Cruise Ship** | **Other[(2)]** | **Total** | **Total Visitors' Expenditures (in millions)** |
| 1999 | 1,042,000 | 1,197,200 | 1,982,100 | 4,221,300 | $2,138.5 |
| 2000 | 1,050,100 | 1,224,600 | 2,291,300 | 4,566,000 | 2,387.9 |
| 2001 | 1,186,800 | 1,356,600 | 2,364,400 | 4,907,800 | 2,728.1 |
| 2002 | 1,147,800 | 1,277,000 | 1,939,300 | 4,364,100 | 2,486.4 |
| 2003[(3)] | 1,239,200 | 1,163,900 | 1,999,200 | 4,402,300 | 2,676.6 |

(1) Includes visitors in guesthouses.
(2) Includes visitors in homes of relatives, friends, and in hotel apartments.
(3) Preliminary.

*Sources:* Puerto Rico Tourism Company and the Planning Board

*Government*

The government sector of Puerto Rico plays an important role in the economy. In fiscal year 2003, government accounted for $7.1 billion of Puerto Rico's gross domestic product, or 9.6%, of the total. The government is also a significant employer, providing jobs for 298,751 workers, or 30.1%, of total non-farm payroll employment in fiscal year 2003. The government's (including the central government, the public corporations and the municipalities, but excluding the federal government) share of non-farm payroll employment, measured according to the payroll survey, has decreased from 34.9% in fiscal year 1980, to 33.6% in fiscal year 1990, and to 26.4% in fiscal year 2000.

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.

*Transportation*

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

Luis Muñoz Marín International Airport is currently served by twenty-five 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 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, 2003, totaled approximately 4,591 miles. The highway system comprises 379 miles of primary system highways, 230 miles of primary urban system highways, 955 miles of secondary system highways and 3,027 miles of tertiary highways and roads.

The Commonwealth is conducting a request for proposal process to select a private company to develop, construct, operate and maintain a world-class container facility on the south coast of Puerto Rico, to be called the Port of the Americas. The Port of the Americas Authority, created by legislation, will select and negotiate with the developer and operator of the project. To date, approximately $17.7 million has been invested in the development of the project. Construction is expected to begin in 2004, and partial operation of the Port of the Americas could begin as early as 2006.

*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. However, during the period from fiscal year 1999 through fiscal year 2003, real construction investment decreased 3.1%. This decline is relatively small when compared to the relatively high levels of construction activity.

The total value of construction permits increased 70.3% for the same five-year period. Public investment has been an important component of construction investment. During fiscal year 2003, approximately 42% of the total investment in construction was related to public projects. During fiscal year 2003, the total value of construction permits increased 22.0% compared with fiscal year 2002. Total sales of cement, including imports, increased 3.2% during fiscal year 2003 in comparison with fiscal year 2002. Average payroll employment in the construction sector during fiscal year 2003 was 68,700, a decrease of 0.7% from fiscal year 2002.

During the first seven months of fiscal year 2004, the total value of construction permits increased 3.6% compared with the same period of fiscal year 2003. During the first nine months of fiscal year 2004, however, total sales of cement, including imports, decreased 3.1% compared with the same period of fiscal year 2003. This decrease in total sales of cement was attributable to heavy rains that affected the island in November 2003, causing a 31% decrease in sales as compared to November 2002. Excluding November 2003, total sales of cement for the first nine months of fiscal year 2004 show a slight increase of 0.5%. Notwithstanding the decline of November 2003, total sales of cement for fiscal year 2004 are expected to exceed 40 million bags, which indicates a relatively high level of investment in construction when compared to historical figures for Puerto Rico. Total imports of iron and steel products increased 36.2% during fiscal year 2003.

The Planning Board's forecast for construction investment, both public and private, for fiscal year 2004 is $6.7 billion, in nominal terms, which represents a real growth of 4.6% when compared to fiscal year 2003. For fiscal year 2004, approximately $3.1 billion are expected to be invested in public improvements. Public investment will be primarily in housing, new schools (and school reconstruction programs), water projects and other infrastructure projects to be undertaken by the Aqueduct and Sewer Authority, Convention Center District Authority, Electric Power Authority, Highway and Transportation Authority, Infrastructure Financing Authority, Ports Authority, Public Buildings Authority, Special Communities Perpetual Trust, and the University of Puerto Rico.

*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 2003, gross income from agriculture was $756.2 million, an increase of 1.7% compared with fiscal year 2002. 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, and other products. During fiscal year 2003, non-traditional crops, fruits, starchy and other vegetables, and ornamental plants have contributed a higher percentage of the sector's income.

The Commonwealth supports agricultural activities through incentives, subsidies, and technical and support services, in addition to income tax exemptions for qualified income derived by bona fide farmers. Act No. 225, approved on December 1, 1995, increased the tax benefits available to bona fide farmers. The Act 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, college attendance and college attendance as a percentage of the college age population continued to increase.

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

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

| | Commonwealth of Puerto Rico | | | Mainland United States | | |
|---|---|---|---|---|---|---|
| Academic Year | 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) | 15,312,000 | 56.4 |
| 2001 .................. | 425,519(3) | 185,015 | 43.5 | 27,831,000(3) | 15,873,000 | 57.0 |
| 2002 .................. | 422,549(3) | 190,776 | 45.1 | 28,342,000(3) | 15,608,000 | 55.1 |
| 2003 .................. | 418,390(3) | 199,842 | 47.8 | 28,899,571(4) | 15,756,000(4) | 54.5 |

(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.
(3) Estimated population (reference date July 1).
(4) Projected.

*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 2002-2003 was 69,555 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 43 public and private institutions of higher education located in Puerto Rico. Such institutions have a current enrollment in excess of 130,285 students and provide programs of study in liberal arts, education, business, natural sciences, technology, secretarial and computer sciences, nursing, medicine, and law. Degrees are offered by these institutions at the associate, bachelor, master, and doctoral levels.

**Tax Incentives**

One of the factors that has promoted and continues to promote the development of the manufacturing sector in Puerto Rico has been 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 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, 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, a law aimed at promoting investment in Puerto Rico.

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. The activities eligible for tax exemption include manufacturing, certain designated services performed for markets outside Puerto Rico, the production of energy from local renewable sources for consumption in Puerto Rico and laboratories for scientific and industrial research. For companies qualifying thereunder, the 1998 Tax Incentives Act imposes income tax rates ranging from 2% to 7% for periods ranging from 10 to 25 years. In addition, it grants 90% exemption from property taxes, 100% exemption from municipal license taxes during the first three semesters of operations and between 80% and 60% thereafter, and 100% exemption from excise taxes with respect to 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 equal 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.

*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, 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 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.

As part of the incentives to promote the tourism industry, the Commonwealth established the Tourism Development Fund as a subsidiary of Government Development Bank for Puerto Rico ("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 for financing hotel development projects. To date, the Fund has provided financial guarantees for loans made or bonds issued to finance the development of fifteen hotel projects representing over 3,600 new hotel rooms.

*Incentives under the 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 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 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 made in 1996 (the "1996 Amendments"), the tax credit is being phased out over a ten-year period for companies that were operating in Puerto Rico in 1995 and is no longer available for corporations that establish operations in Puerto Rico after October 13, 1995. The 1996 Amendments also eliminated the credit previously available for income derived from certain qualified investments in Puerto Rico.

*Section 30A*. The 1996 Amendments added Section 30A to the Code. Section 30A permits a "qualifying domestic corporation" ("QDC") that meets certain gross income tests to claim a credit (the "Section 30A Credit") against the federal income tax imposed on taxable income derived from sources outside the United States from the active conduct of a trade or business in Puerto Rico or from the sale of substantially all the assets used in such business ("possession income"). The Section 30A Credit will not be available for taxable years commencing after 2005.

The Section 30A Credit is limited to the sum of (i) 60% of qualified possession wages as defined in the Code, which includes wages up to 85% of the maximum earnings subject to the OASDI portion of Social Security taxes plus an allowance for fringe benefits of 15% of qualified possession wages, (ii) a specified percentage of depreciation deductions ranging between 15% and 65%, based on the class life of tangible property, and (iii) a portion of Puerto Rico income taxes paid by the QDC, up to a 9% effective tax rate (but only if the QDC does not elect the profit-split method for allocating income from intangible property).

In the case of taxable years beginning after December 31, 2001, the amount of possession income that qualifies for the Section 30A Credit is subject to a cap based on the QDC's possession income for an average adjusted base period ending before October 14, 1995 (the "income cap").

*Section 936*. Under Section 936 of the Code, as amended by the 1996 Amendments, United States corporations that meet certain requirements and elect its application ("Section 936 Corporations") are entitled to credit against their United States corporate income tax the portion of such tax attributable to income derived from the active conduct of a trade or business within Puerto Rico ("active business income") and from the sale or exchange of substantially all assets used in the active conduct of such trade or business.

Under Section 936, a Section 936 Corporation may elect to compute its active business income, eligible for the Section 936 credit, under one of three formulas: (i) a cost-sharing formula, whereby it is allowed to claim all profits attributable to manufacturing intangibles and other functions carried out in Puerto Rico provided it makes a cost sharing payment in the amount required under Section 936; (ii) a profit-split formula, whereby it is allowed to claim 50% of the combined net income of its affiliated group from the sale of products manufactured in Puerto Rico; or (iii) a cost-plus formula, whereby it is allowed to claim a reasonable profit on the manufacturing costs incurred in Puerto Rico.

The Section 936 credit is now only available to companies that were operating in Puerto Rico on October 13, 1995, and had elected the percentage of income credit provided by Section 936. Such percentage of income credit is equal to 40% of the federal income tax otherwise imposable on the Puerto Rico active business income or derived from the sale or exchange of substantially all assets used in such business.

In the case of taxable years beginning on or after 1998, the possession income subject to the Section 936 credit is subject to a cap based on the Section 936 Corporation's possession income for an average adjusted base period ending on October 14, 1995. The Section 936 credit is eliminated for taxable years commencing after 2005.

*Controlled Foreign Corporations*

Because of the credit limitations and impending phase out of Sections 30A and 936, many corporations previously operating thereunder have reorganized their operations in Puerto Rico to become controlled foreign corporations ("CFCs"). A CFC is a corporation which 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 over eighty corporations that have converted part or all of their operations to CFCs. These include most of the major pharmaceutical, instrument and electronics companies manufacturing in Puerto Rico.

CFCs operate under transfer pricing rules for intangible income that are different from those applicable to corporations operating under Sections 936 and 30A. 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 companies were exempted from Puerto Rico withholding taxes on any cost sharing payments they might have opted to make, but CFCs are subject to a ten percent Puerto Rico withholding tax on royalty payments.

## 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. The Constitution of Puerto Rico limits the amount of general obligation (full faith and credit) debt that can be issued or guaranteed by the Commonwealth. The Commonwealth's policy has been and continues to be to maintain the amount of such debt prudently below the constitutional limitation. Direct debt of the Commonwealth is supported by Commonwealth taxes. Debt of municipalities, other than bond anticipation notes, is supported by real and personal property taxes and municipal license taxes. Debt of public corporations, other than bond anticipation notes, is generally supported by the revenues of such corporations from 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 resolutions adopted by the respective municipal assemblies. Debt of public corporations is issued pursuant to resolutions adopted by the governing bodies of the public corporations 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 December 31, 2003. 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. Also excluded from the table is debt the inclusion of which would reflect double counting, including but not limited to $1.323 billion of outstanding bonds issued by the Municipal Finance Agency to finance its purchase of bonds of Puerto Rico municipalities, and $1.026 billion of obligations of GDB issued to purchase certain Commonwealth public sector debt and for other purposes, of which $267 million is guaranteed by the Commonwealth.

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

| | December 31, 2003 |
|---|---|
| Puerto Rico direct debt(1) | $8,515,633 |
| Municipal debt | 1,935,028 |
| Public corporations debt | |
| Puerto Rico guaranteed debt(2) | 643,295 |
| Debt supported by Puerto Rico appropriations or taxes(3) | 13,527,718 |
| Other non-guaranteed debt(4) | 7,694,201 |
| Total public corporations debt | 21,865,214 |
| Total public sector debt | $32,315,875 |

(1) Includes general obligation bonds, tax and revenues anticipation notes, and lines of credit provided by GDB. Includes $10 million of certain indebtedness originally issued by the Urban Renewal and Housing Corporation that was transferred to the Commonwealth by virtue of Act No. 134 of the Legislature of Puerto Rico, approved on December 13, 1994 ("Act No. 134") (such indebtedness is referred to as "Transferred CRUV Debt"). This amount excludes certain Commonwealth general obligation bonds 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 $501.5 million of bonds issued by the Aqueduct and Sewer Authority and $141.8 million of State Revolving Fund Loans, incurred under various federal water laws. Excludes Public Buildings Authority bonds in the principal amount of $2.053 billion as of December 31, 2003 and $267 million of GDB bonds payable from available moneys of GDB.

(3) Represents, among others, bonds and notes issued by the Aqueduct and Sewer Authority, the Highway and Transportation Authority, the Housing Finance Authority, the Infrastructure Financing Authority, the Public Buildings Authority and the Public Finance Corporation.

(4) Excludes $1.066 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. Excludes $1.155 billion of Children's Trust bonds which are payable solely from the payments to be received pursuant to the tobacco litigation settlement.

*Source:* Government Development Bank

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

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

The following table presents the debt service requirements for Commonwealth general obligation bonds outstanding as of December 31, 2003 and bonds of the Aqueduct and Sewer Authority for which debt service payments are being made under the Commonwealth guaranty.

The table excludes debt service on certain 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. With respect to other debt of the Aqueduct and Sewer Authority, see *Public Corporations*. 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 Years Ending June 30 | Outstanding Bonds: Principal | Interest | Total Debt Service | PRASA Bonds Debt Service | Grand Total |
|---|---|---|---|---|---|
| 2004 | $105,938 | $366,443 | $472,381 | $30,125 | $502,507 |
| 2005 | 183,455 | 344,563 | 528,018 | 30,127 | 558,145 |
| 2006 | 163,724 | 364,772 | 528,496 | 30,121 | 558,617 |
| 2007 | 150,682 | 377,682 | 528,364 | 30,126 | 558,490 |
| 2008 | 188,667 | 349,430 | 538,097 | 30,131 | 568,228 |
| 2009 | 227,105 | 306,635 | 533,740 | 30,123 | 563,863 |
| 2010 | 240,675 | 293,254 | 533,929 | 29,984 | 563,913 |
| 2011 | 251,617 | 279,916 | 531,534 | 29,928 | 561,462 |
| 2012 | 270,745 | 260,642 | 531,387 | 30,127 | 561,514 |
| 2013 | 285,600 | 245,834 | 531,434 | 30,128 | 561,562 |
| 2014 | 282,628 | 250,894 | 533,521 | 30,125 | 563,646 |
| 2015 | 295,925 | 237,850 | 533,774 | 30,126 | 563,900 |
| 2016 | 310,225 | 223,814 | 534,039 | 30,121 | 564,160 |
| 2017 | 324,957 | 209,459 | 534,415 | 30,122 | 564,537 |
| 2018 | 341,380 | 194,406 | 535,785 | 30,126 | 565,911 |
| 2019 | 373,701 | 162,726 | 536,427 | 30,125 | 566,551 |
| 2020 | 430,480 | 136,386 | 566,866 | 0 | 566,866 |
| 2021 | 299,740 | 115,198 | 414,938 | 0 | 414,938 |
| 2022 | 223,765 | 101,279 | 325,044 | 0 | 325,044 |
| 2023 | 190,000 | 91,211 | 281,211 | 0 | 281,211 |
| 2024 | 175,335 | 82,536 | 257,871 | 0 | 257,871 |
| 2025 | 183,300 | 74,838 | 258,138 | 0 | 258,138 |
| 2026 | 182,675 | 67,057 | 249,732 | 0 | 249,732 |
| 2027 | 191,375 | 58,542 | 249,917 | 0 | 249,917 |
| 2028 | 200,600 | 49,511 | 250,111 | 0 | 250,111 |
| 2029 | 210,680 | 39,517 | 250,197 | 0 | 250,197 |
| 2030 | 221,735 | 28,463 | 250,198 | 0 | 250,198 |
| 2031 | 233,065 | 17,130 | 250,195 | 0 | 250,195 |
| 2032 | 66,290 | 5,218 | 71,508 | 0 | 71,508 |
| 2033 | 36,555 | 1,880 | 38,435 | 0 | 38,435 |
| Total | $6,842,617 | $5,337,086 | $12,179,703 | $481,665 | $12,661,368 |

*Totals may not add due to rounding.

*Sources:* Government Development Bank and Department of the Treasury

### Commonwealth Guaranteed Debt

As of December 31, 2003, $2.053 billion of Commonwealth guaranteed bonds of the Public Buildings Authority were outstanding. Maximum annual debt service on these bonds is $176.8 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 bonds of the Public Buildings Authority.

As of December 31, 2003, $267 million of Commonwealth guaranteed obligations of GDB were outstanding. No payments under the Commonwealth guaranty have been required for any obligations of GDB to date.

As of December 31, 2003, the Commonwealth had guaranteed the Series 1995 revenue bonds of the Aqueduct and Sewer Authority in the aggregate outstanding principal amount of $318.1 million. On January 2, 1997, the Commonwealth began to make debt service payments under the Commonwealth guaranty and expects to make all debt service payments required on these revenue bonds.

In addition, in April 2000, the Commonwealth extended its guaranty to all of the outstanding bonds issued by the Aqueduct and Sewer Authority to the United States Department of Agriculture, Rural Development, and to all of the outstanding loans by the State Revolving Funds for the benefit of the Aqueduct and Sewer Authority. The guaranty will also cover any additional bonds and loans that may be issued until June 30, 2005. It is expected that this guaranty will be extended through new legislation to cover debt obligations issued until 2010. As of December 31, 2003, the principal amount outstanding on these bonds was $183.4 million and the principal amount outstanding of these loans was $141.8 million.

### 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 product (in current dollars) for the five fiscal years ended June 30, 2003 and the first six months of fiscal year 2004. As of December 31, 2003, outstanding short-term debt, relative to total debt, was 8.5%.

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

| | Public Sector Debt | | | | | Gross Product[(1)] | |
|---|---|---|---|---|---|---|---|
| June 30 | Long Term | Short Term[(2)] | Short Term as % of Total | Total | Rate of Increase | Amount | Rate of Increase |
| 1999……………….. | $20,905 | $1,773[(3)] | 7.8% | $22,678 | 1.6% | $38,281 | 9.0% |
| 2000……………….. | 21,620 | 2,202[(3)] | 9.2 | 23,822 | 5.0 | 41,419 | 8.2 |
| 2001[(4)]…………….. | 22,345 | 2,870[(5)] | 11.4 | 25,215 | 5.8 | 44,047 | 6.3 |
| 2002[(6)]…………….. | 26,737 | 1,250[(3)] | 4.5 | 27,987 | 11.0 | 45,008 | 2.2 |
| 2003[(7)]…………….. | 28,102 | 1,605[(3)] | 5.4 | 29,707 | 6.1 | 47,354 | 5.2 |
| December 31, 2003[(8)] | 29,554 | 2,762 | 8.5 | 32,316 | 8.8 | N/A | N/A |

*Totals may not add due to rounding.
(1) In current dollars.
(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 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.
(4) Excludes $397.0 million of bonds of Children’s Trust outstanding on this date. If these bonds had been included, the rate of growth of public sector debt for fiscal year 2001 would have been 12.1%. Excludes $1.093 billion of bonds of Infrastructure Financing Authority outstanding on this date, 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.
(5) Includes a $164 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 in lieu of funds available therefor in the General Fund.
(6) Excludes $390.1 million of bonds of Children’s Trust outstanding on this date. Excludes $1.082 billion of bonds of Infrastructure Financing Authority outstanding on this date, 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.
(7) Excludes $1.171 billion of bonds of Children’s Trust outstanding on this date. Excludes $1.074 billion of bonds of Infrastructure Financing Authority outstanding on this date, 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.
(8) Excludes $1.155 billion of bonds of Children’s Trust outstanding on this date. Excludes $1.066 billion of bonds of Infrastructure Financing Authority outstanding on this date, 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.

*Source:* Government Development Bank

The following table shows the trend of public sector debt by major category for the five fiscal years ended June 30, 2003 and for the first six months of fiscal year 2004.

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

| | Commonwealth | | | Municipalities | | | Public Corporations(1) | | | Total | | Grand Total(4) |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| June 30 | Long Term(4) | Short Term(2) | Total | Long Term | Short Term(2) | Total | Long Term | Short Term(2) | Total | Long Term | Short Term(2) | |
| 1999 | $5,097 | $0(3) | $5,097 | $1,215 | $60 | $1,275 | $14,593 | $1,713 | $16,306 | $20,905 | $1,773 | $22,678 |
| 2000 | 5,349 | 0(3) | 5,349 | 1,396 | 68 | 1,464 | 14,875 | 2,134 | 17,008 | 21,620 | 2,202 | 23,822 |
| 2001 | 5,674 | 164(5) | 5,838 | 1,469 | 163 | 1,632 | 15,201(6) | 2,543 | 17,744 | 22,345 | 2,870 | 25,215 |
| 2002 | 6,025 | 91(3) | 6,116 | 1,618 | 177 | 1,795 | 19,094(7) | 982 | 20,076 | 26,737 | 1,250 | 27,987 |
| 2003 | 6,709 | 177(3) | 6,886 | 1,754 | 201 | 1,955 | 19,639(8) | 1,227 | 20,866 | 28,102 | 1,605 | 29,707 |
| Dec. 31, 2003 | 7,312 | 1,204 | 8,516 | 1,739 | 196 | 1,935 | 20,503(9) | 1,362 | 21,865 | 29,554 | 2,762 | 32,316 |

*Totals may not add due to rounding.
(1) Includes Commonwealth guaranteed debt.
(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 the Transferred CRUV Debt.
(5) Includes a $164 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 in lieu of funds available therefor in the General Fund.
(6) Excludes $397.0 million original principal amount of bonds issued by Children's Trust. Excludes $1.093 billion original principal amount of bonds issued by Infrastructure Financing Authority, 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.
(7) Excludes $390.1 million of bonds of Children's Trust outstanding on this date. Excludes $1.082 billion of bonds of Infrastructure Financing Authority outstanding on this date, 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.
(8) Excludes $1.171 billion original principal amount of bonds of Children's Trust. Excludes $1.074 billion of bonds of Infrastructure Financing Authority outstanding on this date, 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.
(9) Excludes $1.155 billion original principal amount of bonds of Children's Trust. Excludes $1.066 billion of bonds of Infrastructure Financing Authority outstanding on this date, 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.

*Source:* Government Development Bank

## PUBLIC CORPORATIONS

In Puerto Rico, many governmental or quasi-governmental functions are performed by public corporations. These are governmental entities created by the Legislature with varying degrees of independence from the central government. Public corporations are generally created to perform 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 appointed by the Governor with the advice and consent of the Senate, but some public corporations are subsidiaries of departments of the central government. Capital improvements of most of the larger public corporations are financed by revenue bonds under trust agreements or bond resolutions or notes under loan agreements. The following table presents the outstanding bonds and notes of certain of the public corporations as of December 31, 2003 ("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 or 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
## December 31, 2003
## (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 | $ 501,479 | $0 | $ 501,479 | $141,816 | $ 11,711[1] | $ 153,527 | $ 643,295 | $ 11,711[1] | $ 655,006 |
| Electric Power Authority | 0 | 5,033,219 | 5,033,219 | 0 | 163,809 | 163,809 | 0 | 5,197,028 | 5,197,028 |
| Highway and Transportation Authority | 0 | 5,263,014 | 5,263,014 | 0 | 28,114 | 28,114 | 0 | 5,291,128 | 5,291,128 |
| Housing Finance Authority | 0 | 685,567 | 685,567 | 0 | 135,807 | 135,807 | 0 | 821,374 | 821,374 |
| Industrial Development Company | 0 | 301,845 | 301,845 | 0 | 32,966 | 32,966 | 0 | 334,811 | 334,811 |
| Infrastructure Financing Authority | 0 | 927,990[2] | 927,990 | 0 | 8,664 | 8,664 | 0 | 936,654 | 936,654 |
| Public Buildings Authority | 2,053,453 | 0 | 2,053,453 | 0 | 294,839 | 294,839 | 2,053,453 | 294,839 | 2,348,292 |
| Public Finance Corporation | 0 | 4,237,781[3] | 4,237,781 | | 0 | 0 | 0 | 4,237,781[3] | 4,237,781 |
| Ports Authority | 0 | 78,955 | 78,955 | 0 | 299,898 | 299,898 | 0 | 378,853 | 378,853 |
| University of Puerto Rico | 0 | 430,278 | 430,278 | 0 | 517 | 517 | 0 | 430,795 | 430,795 |
| Others | 0 | 0 | 0 | 0 | 1,23,492 | 1,233,492 | 0 | 1,233,492 | 1,233,492 |
| Total[4] | $2,554,932 | $16,958,649 | $19,513,581 | $141,816 | $2,209,817 | $2,351,633 | $2,696,748 | $19,168,466 | $21,865,214 |

(1) Principal of and interest on this debt is reimbursed from Commonwealth appropriations.
(2) Excludes $1.066 billion of outstanding bonds of Infrastructure Financing Authority, 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.
(3) Payable primarily from Commonwealth appropriations.
(4) Excludes accretion of interest from the respective issuance dates on capital appreciation bonds. Also excludes $1.155 billion original principal amount of Children's Trust Tobacco Settlement Asset-Backed Bonds, Series 2002, issued on October 10, 2002, which will be repaid from payments made by certain tobacco companies under a master settlement agreement. See "Other Public Corporations" below.

*Source:* Government Development Bank

### Government Development Bank for Puerto Rico

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

As of December 31, 2003, $1.725 billion of bonds and notes of GDB were outstanding. As of said date, GDB also had $3.101 billion in loans to the central government of the Commonwealth and its public corporations and municipalities. 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 December 31, 2003.

Act No. 271 of November 21, 2002, requires GDB to provide the Special Communities Perpetual Trust with a $500 million line of credit and to make a capital contribution to the Trust of $500 million. This contribution shall be withdrawn from GDB's equity capital and disbursed gradually to the Trust after full disbursement of the line of credit. See "Other Public Corporations – Special Communities Perpetual Trust" below. GDB expects to replenish its equity capital with future operating net income. To date, the Trust has drawn approximately $7 million on the line of credit.

Act No. 82 of June 16, 2002, authorizes GDB to transfer every year to the Commonwealth's General Fund up to 10% of its audited net income or $10,000,000, whichever is greater.

GDB has the following principal subsidiaries:

*Housing Finance Authority* (formerly known as Housing Finance Corporation) was originally created in November 1977 to provide needed rental-housing units and stimulate the construction industry under federally subsidized programs. Effective February 8, 2002, the Housing Finance Corporation became the Housing Finance Authority and the Housing Bank and Finance Agency was dissolved and its powers transferred to the Authority. The Authority is engaged in insuring and servicing mortgages originated by the Urban Renewal and Housing Corporation. It also 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. Housing Finance Corporation had issued tax-exempt revenue bonds and notes to finance the construction of housing units approved for federal rental subsidies and to finance home ownership of single family housing units, which bonds and notes are now limited obligations of the Housing Finance Authority payable solely from revenues collected in respect to such housing units. The Federal Housing Administration has insured mortgages on certain of the housing units. As of December 31, 2003, $1.518 billion of Housing Finance Authority bonds were outstanding.

As of December 31, 2003, the Authority also had outstanding $684.8 million of bonds issued to (i) pay obligations of the Commonwealth under law, (ii) fund certain payments of the Commonwealth under its mortgage subsidy program for low and moderate income families, (iii) guarantee certain insurance obligations of the Housing Bank and Finance Agency under certain programs.

*Tourism Development Fund* was created in November 1993 to promote Puerto Rico's hotel and tourism industry, primarily by making available guarantees to secure the payment of private financing used for new hotel development projects. The Tourism Development Fund is also authorized to make capital investments and provide direct financing to tourism related projects. As of December 31, 2003, the Tourism Development Fund had outstanding loans and guarantees with respect to the financing of fifteen hotel projects in an aggregate amount in excess of $580 million.

As of December 31, 2003, the Tourism Development Fund has made and continues to make disbursements under its guarantees relating to certain hotel projects, including disbursements of $83.8 million, $75.3 million, and $9.3 million made in September 2002, August 2003, and December 2003, respectively, to repay the bonds of three projects, which bonds had been declared due and payable at the direction of Tourism Development Fund due to the failure of the borrowers of such projects to comply with their obligations under the related reimbursement agreements. The unaudited capital of Tourism Development Fund as of December 31, 2003, was $96.3 million and its unaudited allowance for losses on guarantees and letters of credit was approximately $30.9 million.

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

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

*Public Finance Corporation* was created in December 1984 to provide agencies and instrumentalities of Puerto Rico with alternate means of meeting their financing requirements. As of December 31, 2003, the Corporation had $4.238 billion aggregate principal amount of bonds outstanding, substantially all of which have been issued to purchase debt of agencies and instrumentalities of the Commonwealth, and are payable from Commonwealth appropriations.

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 a system of public water supply and sanitary sewer facilities.

PRASA needs to make a substantial investment in infrastructure and a major overhaul of its operations to maintain the viability of the existing system and to finance its expansion for new users. Funds for this investment are expected to be provided through a combination of revenues from PRASA, bond issues, legislative appropriations, and federal grants. Debt service on revenue bonds is payable from net revenues of the system after payment of current expenses. Due to PRASA's financial difficulties (discussed below) and its inability to access the bond market, Act No. 45 was enacted in July 1994 to provide a Commonwealth guaranty of the principal and interest payments to the bondholders of all outstanding revenue bonds issued by PRASA. In addition, Act No. 45 was amended in 2000 to extend the Commonwealth payment guaranty to all outstanding bonds issued by PRASA 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. The guaranty will cover additional debt obligations issued by PRASA prior to July 1, 2005. It is expected that this guaranty will be extended through new legislation to include debt obligations issued until 2010.

PRASA has reported net losses of $100.7 million, $0.5 million, $191.8 million and $185.8 million during fiscal years 2000, 2001, 2002 and 2003, respectively. The net losses reported for fiscal years after 2000 are not comparable to the losses reported in prior fiscal years due to the implementation of a change in government accounting rules which allows governmental grants to be treated as revenues instead of as capital contributions. Without such favorable treatment of government grants, PRASA's net loss would have been $169.6 million in fiscal year 2001, $349 million in fiscal year 2002 and $189.3 million in fiscal year 2003. These losses reflect the continuing financial and operating difficulties that PRASA has experienced in recent years. The total debt of PRASA, including outstanding loans of $153.5 million, was $655 million as of December 31, 2003.

From May 1995 until March 2004, the operation, management, repair, and maintenance of PRASA's systems were in the hands of private companies. The most recent agreement for the private management of PRASA's systems was entered into in May 2002 with Ondeo Puerto Rico, Inc. ("Ondeo"), an affiliate of Suez. However, in January 2004, Ondeo and PRASA agreed to terminate their agreement and in April 2004, the operation, management, repair, and maintenance of the PRASA systems returned to PRASA. Ondeo will continue to provide operating support to PRASA until mid-2004.

As part of the plan for the return of the operation and management of the PRASA systems to PRASA, legislation was enacted in March 2004 to restructure PRASA and provide further powers to improve its operational and financial management. The main areas of this restructuring included (i) decentralizing the administration of PRASA by creating five regions to provide greater efficiency in, and financial control of, the day to day administration and operational decision making process and execution; (ii) creating the positions of five Executive Regional Directors and an Executive Director for Infrastructure, who will, respectively, manage each region and manage capital improvement projects; and (iii) providing for six-year appointments for each of the Executive Regional Directors, Executive Director for Infrastructure and Executive President aiming to give continuity to top management in order to better implement, supervise and revise as needed the ten-year plan and goals identified for PRASA in 2002 and included in the management contract with Ondeo. Further powers granted include the authority to make certain determinations and take certain actions with respect to compliance of the water and sewer system with various Federal environmental laws.

*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 $1.171 billion aggregate principal amount of Tobacco Settlement Asset-Backed Bonds in October 2002. As of December 31, 2003, the outstanding principal amount of the bonds was $1.155 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 participating manufacturers under the Master Settlement Agreement. To date, all payments required to be made under the Master Settlement Agreement have been made on a timely basis and Puerto Rico's share thereof has been received by Children's Trust.

*Convention Center District Authority* was created on September 2, 2000 to own, develop, finance, plan, design, build, operate, maintain, administrate and promote the Convention Center and designated private parcels located within the Convention Center District in San Juan. The Authority currently has lines of credit with GDB totaling $221 million, of which $154.3 million was outstanding as of December 31, 2003.

*Electric Power Authority* owns and operates the island's electric system. The capital improvement program for the five-year period ending June 30, 2008, is estimated to cost approximately $2.1 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 December 31, 2003, the Authority's total debt was $5.197 billion, including $5.033 billion of bonds outstanding (not including accretion of interest from the respective issuance date on capital appreciation bonds). As a means of reducing its dependency on oil, the Authority has entered into long-term power purchase contracts with the operators of two cogeneration plants that use fuels other than oil. These two cogeneration projects consist of EcoElectrica LP's 507 megawatts liquefied natural gas plant at Guayanilla and a 454 megawatts clean coal facility at Guayama operated by an affiliate of Applied Energy Systems ("AES"). EcoElectrica's and AES's plants started commercial operations in March 2000 and November 2002, respectively. It is expected that these two cogeneration plants will initially provide approximately one-third of the Authority's energy needs.

*Health Insurance Administration* was created in 1993 to implement the health reform by negotiating and contracting 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 several 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 all of the municipalities, and approximately 1.5 million persons were covered by the system during fiscal year 2004.

The total cost of the health insurance program for fiscal year 2004 is expected to be $1.326 billion, compared to $1.248 billion for fiscal year 2003 and $1.271 billion for fiscal year 2002. For fiscal year 2004, the General Fund is expected to cover $970 million of the total cost of the health insurance program, while the remaining $357 million is expected to be paid from other federal and municipal sources. The fiscal year 2005 budget estimates the cost of the health insurance program to be $1.360 billion, of which the General Fund is estimated to cover $990 million, while the remaining $370 million is estimated to be paid from other federal and municipal sources.

*Highway and Transportation Authority* is responsible for highway construction in Puerto Rico. Such construction is financed by debt (interim notes and revenue bonds), revenues of the Authority, and federal and Commonwealth grants. Debt service on the Authority's revenue bonds constitutes a first lien on its gross revenues, which consist currently of all the proceeds of the gasoline tax; one-half of the proceeds of the tax on gas oil or diesel oil; all the proceeds of the excise taxes on crude oil, unfinished oil and derivative products, up to $120 million per fiscal year; highway toll revenues; and the gross receipts of $15.00 per vehicle per year from certain motor vehicle license fees. Such revenues (except for toll revenues) may be applied first to the payment of debt service on general obligation bonds and notes of the Commonwealth and 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 December 31, 2003, the Authority's total debt was $5.291 billion, including $28.1 million in loans.

The Authority has under construction the first phase of a new mass transit system, known as Tren Urbano, to serve a portion of metropolitan San Juan. The first phase of Tren Urbano is being constructed under several design/build contracts, including a design/build/operate contract covering the design and construction of the system and the operation of Tren Urbano for five years with an additional five-year option at the Authority's election. The cost of the first phase is estimated to be $2.3 billion, which cost is being financed by Federal Transit Administration grants, other federal funding sources and the Authority's own resources, including bond financings.

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 December 31, 2003, 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 as 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.

*Puerto Rico 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 December 31, 2003, the Company's total debt was $334.8 million, including $32.9 million in loans.

*Industrial, Tourist, Educational, Medical and Environmental Control Facilities Financing Authority* ("AFICA") was created in June 1977. The Authority has issued revenue bonds to finance industrial, tourist, environmental control, medical, and educational facilities in Puerto Rico for the use of private companies, non-profit entities, or government agencies. The bonds are payable solely from payments to be made to the Authority by such private companies, non-profit entities, or government agencies, and do not constitute a debt of the Commonwealth or any of its other public corporations or municipalities. As of December 31, 2003, approximately $2.3 billion of the Authority's bonds were outstanding. The Authority has financed the construction of a multi-purpose coliseum in San Juan with a line of credit provided by GDB, which line had an outstanding balance of $119.9 million as of December 31, 2003. The coliseum is near completion. It is expected that, upon completion, the coliseum will be transferred to the Tourism Company.

*Infrastructure Financing Authority* was created in June 1988 to provide financial, administrative, consulting, technical, advisory, and other types of assistance to other public corporations and governmental instrumentalities of Puerto Rico authorized to develop infrastructure facilities and to establish alternate means for financing infrastructure 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 public corporations and instrumentalities of the Commonwealth. The Authority's enabling act also established the Puerto Rico Infrastructure Fund, 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 $70 million, and it will increase to $90 million for fiscal years 2007 to 2052. The Authority is using these amounts to provide financial support to water and sewer projects. As of December 31, 2003, the Authority's total debt was $936.7 million, including $8.7 million in loans.

The Authority is providing assistance to Puerto Rico Aqueduct and Sewer Authority covering (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.

In June 1998, the Authority's enabling act was amended to establish the Infrastructure Development Fund, a permanent trust fund to be utilized by the Authority for the purpose of financing infrastructure projects. The Infrastructure Development Fund was initially funded in March 1999 with $1.2 billion of proceeds received by the Telephone Authority from the sale of a controlling interest in Puerto Rico Telephone Company. This initial amount will remain permanently deposited in a segregated, perpetual account, denominated the "corpus account," and must be invested exclusively in U.S. government or U.S. government-backed obligations. The income from such investment may only be used to finance infrastructure projects related to the Commonwealth's water and sewer systems. Other moneys in the Infrastructure Development Fund not attributable to the corpus account or the investment income thereon may be used for other infrastructure projects. The Authority is the custodian and administrator of the Infrastructure Development Fund. In October 2000, the Authority issued $1.093 billion of bonds payable from and secured by a pledge of the interest received by the Authority from the investments of the Infrastructure Development Fund. The proceeds of this bond issue are being used to finance certain aqueduct and sewer infrastructure development projects.

*Maritime Shipping Authority* commenced operations in 1974 upon the acquisition of three shipping lines serving Puerto Rico and the United States mainland. In 1995, the assets and operations of the Maritime Shipping Authority were sold to a private investor group. The remaining debt of the Authority was refinanced through the issuance of bonds by Public Finance Corporation, a subsidiary of

GDB. The aggregate principal amount of such bonds outstanding as of December 31, 2003, was $312.2 million (not including accreted values of capital appreciation bonds outstanding). The bonds are payable from funds to be appropriated annually by the Legislature of Puerto Rico.

*Municipal Finance Agency* was created in 1972 as a municipal "bond bank" for Puerto Rico. The Agency is authorized to issue bonds to purchase general obligation bonds and notes of Puerto Rico municipalities and to fund a debt service reserve. Debt service on the Agency's bonds is payable from debt service payments on municipal bonds held by the Agency and from the 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 Legislature, which appropriation is authorized but not legally required to be made. To date no such payments have been required. As of December 31, 2003, the Agency had $1.323 billion of bonds outstanding.

*Ports 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 seaport equipment and property. Act No. 1 of January 1, 2000, authorized the transfer of the Authority's unprofitable maritime ferry operations to Puerto Rico Maritime Transportation Authority, a newly created government agency. As of December 31, 2003, the Authority had $378.9 million in debt, including $299.9 million in loans.

*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 further 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 December 31, 2003, $2.053 billion of such bonds of the Authority was outstanding (not including accretion of interest from the respective issuance dates on capital appreciation bonds). Also, as of December 31, 2003, the Authority had a $400 million GDB line of credit with an outstanding balance of $294.8 million.

*Special Communities Perpetual Trust* is an irrevocable and permanent trust created in November 2002 as a public corporation. The Trust's principal purpose is to fund development projects which address the infrastructure and housing needs of underprivileged communities. The Trust's capital will consist of moneys drawn under a $500 million GDB line of credit, which is currently in use by the Trust, and a $500 million grant from GDB to be disbursed over time after the line of credit has been fully disbursed. As of December 31, 2003, the Trust's GDB line of credit had an outstanding balance of $7.2 million.

*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 March 1999, the Telephone Authority sold a controlling interest in PRTC to a consortium led by GTE International Telecommunications Incorporated, which was acquired by Verizon Communications, Inc. The net proceeds of the sale received at closing were applied to defease outstanding bonds of the Authority in the principal amount of $756 million, to make a $1.2 billion deposit to the Infrastructure Development Fund held by the Infrastructure Financing Authority and to pay certain benefits to PRTC employees. In January 2002, Verizon exercised its option to purchase an additional 15% of PRTC stock for $172 million. The Commonwealth retains a 28% stock participation in PRTC.

The proceeds from the Verizon stock option exercise and the remaining 28% ownership interest were transferred to the Employees Retirement System of the Commonwealth and its instrumentalities.

*University of Puerto Rico* (the "University"), with 69,555 students in academic year 2002-2003, 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 December 31, 2003, the University's total debt was $430.8 million, including $500,000 in loans.

On December 21, 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 is being built and will be operated by Desarrollos Universitarios, Inc., a Puerto Rico not-for-profit corporation, and will be leased to the University for a term equal to the term of the bonds with lease payments being in sufficient amounts to pay debt service on said bonds as they become due.

*Other public corporations* have outstanding debt in the aggregate amount of $863.4 million as of December 31, 2003. Debt service on $292.8 million of such outstanding debt is being paid from legislative appropriations. However, the Commonwealth is not 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 the Aqueduct and Sewer Authority, which is insured through arrangements and policies obtained by the respective Authorities. Personal injury awards against the Commonwealth are limited by law to $150,000 per occurrence.

## RETIREMENT SYSTEMS

Public employees of the Commonwealth and its instrumentalities are covered by five retirement systems: the Employees Retirement System of the Commonwealth and its instrumentalities (the "Employees Retirement System"), the Annuity and Pension System for the Teachers of Puerto Rico (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.

The Teachers Retirement System covers primarily public school teachers, the Judiciary Retirement System covers judges, and the Employees Retirement System covers all other employees of the Commonwealth, its municipalities and instrumentalities. As of June 30, 2003, the total number of active members of the three systems was as follows: Employees Retirement System, 166,914; Teachers Retirement System, 49,046; and Judiciary Retirement System, 338. The three systems are financed by contributions made by employers (the Commonwealth, public corporations, and municipalities) and employees, and investment income. The central government is responsible for approximately 67% of total employer contributions to the Employees Retirement System, and the other 33% 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 employees are determined by law. Required employers' contributions to the systems are determined by law and are not actuarially determined. For the Employees Retirement System, required employer contributions consist of 9.275% of applicable payroll in the case of municipalities, central government and public corporations. 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 consist of 20% of applicable payroll for the employer and 8% for the employees.

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, 2001, the total pension benefit obligation for the Employees Retirement System and Judiciary Retirement System was $9.881 billion and $162.2 million, respectively. The unfunded pension benefit obligation of the Employees Retirement System and Judiciary Retirement System for the same period was $7.453 billion and $92.1 million, respectively, representing a funding ratio of 25% and 43%, respectively. This funding ratio does not take into account the reduction in the value of their respective equity portfolios resulting from the decline in the equities market since fiscal year 2001. It is estimated that as of June 30, 2002, the total pension benefit obligation for the Employees Retirement System is $10.540 billion and the unfunded pension benefit obligation is $8.560 billion, representing a funding ratio of 19%.

The most recent actuarial valuation was completed in accordance with the "Projected Unit Credit" method. An investment return of 8.5% per year, a salary increase of 5% per year, and a post-retirement benefit increase of 3% every third year were assumed. In the case of the Employees Retirement System, Act No. 10 of May 21, 1992 provided three benefit increases of 3% each. 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 Legislature approved a law providing 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 Legislature approved a law providing 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. Subsequent increases will depend upon the explicit approval of the System's Board of Trustees and the Legislature, and must provide a funding source. In the case of the Judiciary Retirement System, Act No. 41 of June 13, 2001 provides a 3% 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.

In 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 contribution to the System and limited the retirement benefits for new employees by increasing the length of time for the vesting of certain benefits and reducing the level of benefits in the case of early retirement. The legislation also 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 liability 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.) 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 Employees Retirement System's disbursements of benefits during fiscal years 2002 and 2003 exceeded contributions and investment income for those years. This cash shortfall was covered with a portion of the proceeds from the sale to Verizon of the 15% stock ownership in PRTC.

The Employees Retirement System anticipates that its future cash flow needs for disbursement of benefits to participants may exceed the sum of the employer and employee contributions received and its investment and other recurring income. The Employees Retirement System expects to cover this cash flow imbalance in the next few fiscal years with the proceeds from the sale of the remaining shares of PRTC stock. The Employees Retirement System is currently evaluating other measures to increase its revenues.

According to the most recent actuarial valuation of the Teachers Retirement System submitted by a firm of independent consulting actuaries, as of June 30, 2001, the accrued actuarial liability of the system was $3.684 billion and the value of assets amounted to $2.284 billion, representing a funding ratio of 62%, and the resulting unfunded accrued liability was $1.400 billion. This funding ratio does not take into account the recent significant decline in the equities market and the resulting reduction in the value of the equity portfolio. As of June 30, 2000, the remaining amortization period for the unfunded liability was 19 years. The actuarial valuation assumed an investment return of 8% per year and salary increases of 5% per year. Act No. 45 of January 27, 2000 increased the amount of the employee contribution from 7% to 9%, effective immediately. This will result in an increase of employee contributions of $1.5 million per month.

The following table presents, in summary form, the income and expenses of the retirement systems for the fiscal years ended June 30, 2001, June 30, 2002, and June 30, 2003. The investment income figures presented in the table include unrealized gains and losses.

**Commonwealth of Puerto Rico**
**Retirement Systems**
**Income and Expenses**
**(in thousands)**

| | Employees Retirement System | Judiciary Retirement System | Teachers Retirement System |
|---|---|---|---|
| **Fiscal Year Ended June 30, 2003** | | | |
| Income: | | | |
| Employers' contributions | $330,404 | $ 5,536 | $ 140,264 |
| Employee contributions | 276,347 | 2,479 | 104,403 |
| Investment income | 57,132 | 4,131 | 51,998 |
| Total | $663,883 | $ 12,146 | $ 296,665 |
| Expenses: | | | |
| Benefit payments | 667,390 | 9,330 | $ 298,529 |
| Administrative and other expenses | 28,768 | 1,473 | 22,565 |
| Total | 696,158 | 10,803 | $ 321,094 |
| Net Income (Loss) | $(32,275) | $ 1,343 | ($ 24,429) |
| **Fiscal Year Ended June 30, 2002** | | | |
| Income: | | | |
| Employers' contributions | $308,228 | $ 5,412 | $ 124,152 |
| Employee contributions | 259,203 | 2,448 | 99,454 |
| Investment income | (306,008) | (7,791) | (41,068) |
| Total | $261,423 | $ 69 | $ 182,538 |
| Expenses: | | | |
| Benefit payments | $683,106 | $8,462 | $ 278,168 |
| Administrative and other expenses | 27,304 | 1,072 | 20,833 |
| Total | $710,410 | $9,714 | $ 299,001 |
| Net Income (Loss) | ($448,987) | ($9,645) | ($ 116,463) |
| **Fiscal Year Ending June 30, 2001** | | | |
| Income: | | | |
| Employers' contributions | $302,234 | $5,394 | $ 116,134 |
| Employee contributions | 245,221 | 2,240 | 94,295 |
| Special Contribution-PRTC Stock | 701,000(1) | N/A | N/A |
| Investment income | (232,479) | (11,048) | (173,097) |
| Total | $1,015,976 | ($3,414) | $ 37,332 |
| Expenses: | | | |
| Benefit payments | $600,674 | $8,262 | $ 240,761 |
| Administrative and other expenses | 28,404 | 1,049 | 22,507 |
| Total | $629,078 | $9,311 | $ 263,268 |
| Net Income (Loss) | $386,898 | ($12,725) | ($ 225,936) |

(1) Value of 28% stock ownership interest in PRTC based on an appraisal made by an independent firm. As of December 31, 2002, the shares of PRTC held by the Employee Retirement System after the sale of certain optioned shares to Verizon were valued at $362.7 million.

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

## COMMONWEALTH FINANCIAL STATEMENTS

For fiscal year 2002, the 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), and certain activities, funds and component units identified separately in their report. Those financial statements were audited by other 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, was based solely on the reports of the other auditors.

It is expected that the financial statements of the Commonwealth for fiscal year 2003 will be available during the second quarter of fiscal year 2004. Preparation of the financial statements of the Commonwealth involved the collection and combination of audited financial statements from approximately fifty separate reporting entities.

## 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 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 revenues and expenditures of the General Fund on a cash basis for fiscal year 2000 through fiscal year 2003 and the budgeted revenues and expenditures for fiscal year 2004. The information through fiscal year 2003 is based on actual fiscal year-end results. (The information relating to fiscal year 2003 is preliminary and subject to audit adjustments.) The information relating to fiscal year 2004 is based on the current budget of revenues and expenditures for fiscal year 2004.

The amounts shown on the 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. For example, in fiscal year 2003, there were approximately $150 million of such expenditures that are not reflected in the table. A discussion of the budget for fiscal year 2004 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 Legislature has by resolution agreed to appropriate funds. “Transfers to Agencies” represents moneys appropriated for the operation of the Health Facilities and Services Administration or, after the dissolution of that Administration, the Department of Health. 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)

| | 2000 | 2001 | 2002 | 2003(p) | 2004(c) |
|---|---|---|---|---|---|
| Beginning cash balance | $ 474,759 | $ 287,055 | $ 125,154 | $ 350,284 | $ 179,058 |
| Revenues from internal sources: | | | | | |
| Income Taxes: | | | | | |
| Individuals | 2,352,066 | 2,259,090 | 2,471,782 | 2,517,678 | 2,816,000 |
| Corporations | 1,781,862 | 1,696,766 | 1,584,719 | 1,776,985 | 1,826,000 |
| Partnerships | 2,339 | 3,026 | 2,670 | 2,101 | 2,000 |
| Withheld from non-residents | 557,276 | 696,835 | 583,256 | 517,141 | 560,000 |
| Tollgate taxes | 111,130 | 49,511 | 59,515 | 45,321 | 22,000 |
| Interest | 11,674 | 14,782 | 14,310 | 11,278 | 13,000 |
| Dividends | 39,664 | 58,580 | 62,548 | 49,790 | 47,000 |
| Total income taxes | 4,856,011 | 4,778,590 | 4,778,800 | 4,920,294 | 5,286,000 |
| Commonwealth excise taxes: | | | | | |
| Alcoholic beverages | 236,374 | 237,512 | 249,705 | 299,582 | 313,000 |
| Cigarettes | 115,157 | 119,135 | 116,055 | 149,487 | 159,000 |
| Motor vehicles | 389,995 | 406,252 | 418,024 | 499,252 | 543,000 |
| Other excise taxes | 668,820 | 579,050 | 674,762 | 703,029 | 738,000 |
| Total Commonwealth excise taxes | 1,410,346 | 1,341,949 | 1,458,546 | 1,651,350 | 1,753,000 |
| Property taxes | 1,131 | 287 | - | - | - |
| Inheritance and gift taxes | 3,109 | 7,475 | 1,962 | 2,825 | 3,000 |
| Licenses | 73,801 | 76,338 | 82,575 | 85,876 | 87,000 |
| Other: | | | | | |
| Lottery | 63,779 | 57,482 | 61,358 | 67,621 | 66,000 |
| Electronic Lottery | 70,209 | 70,211 | 57,897 | 89,443 | 88,000 |
| Miscellaneous non-tax revenues | 169,246 | 299,758 | 668,226[1] | 438,457 | 292,000 |
| Total Other | 303,234 | 427,451 | 787,481 | 595,521 | 446,000 |
| Total revenues from internal sources | 6,647,632 | 6,632,090 | 7,109,364 | 7,255,866 | 7,575,000 |
| Revenues from non-Commonwealth sources: | | | | | |
| Federal excise taxes | 245,750 | 286,890 | 314,253 | 309,958 | 330,000 |
| Customs | 50,231 | 43,154 | 30,595 | 25,918 | 20,000 |
| Total revenues from non-Commonwealth sources | 295,981 | 330,044 | 344,848 | 335,876 | 350,000 |
| Total revenues | 6,943,613 | 6,962,134 | 7,454,212 | 7,591,742 | 7,925,000 |
| Other Income (refunds)[2] | 64,325 | 84,878 | 111,411 | (78,927) | 305,468 |
| Transfers to Redemption Fund[3] | (410,046) | (245,814) | (274,773) | (331,925) | (407,948) |
| Proceeds of notes and other borrowings[4] | 778,863 | 825,703 | 1,161,856 | 2,259,775 | 1,568,397 |
| Repayment of notes and other borrowings[5] | (787,155) | (686,024) | (1,201,084) | (2,021,832) | (1,574,634) |
| Adjusted revenues | 6,589,600 | 6,940,877 | 7,251,622 | 7,418,833 | 7,816,283 |
| Expenditures: | | | | | |
| Grants and subsidies | 2,864,215 | 3,078,505 | 2,862,288 | 3,773,579 | 2,626,738 |
| Personal services | 2,737,159 | 2,779,989 | 2,884,636 | 3,119,476 | 4,718,184 |
| Other services | 745,194 | 778,236 | 764,655 | 583,343 | 344,406 |
| Materials and supplies | 109,081 | 106,072 | 106,294 | 80,491 | 146,036 |
| Equipment purchases | 56,404 | 48,326 | 20,397 | 33,170 | 21,187 |
| Capital outlays and other debt service | 101,178 | 33,235 | 73,806 | - | - |
| Transfers to agencies | 164,073 | 280,415 | 314,416 | - | - |
| Prior year disbursements | - | - | - | - | 88,432 |
| Total expenditures | 6,777,304 | 7,102,778 | 7,026,492 | 7,590,059 | 7,944,984 |
| Adjusted revenues less expenditures | (187,704) | (161,901) | 225,130 | (171,226) | (128,701) |
| Ending cash balance | $ 287,055 | $ 125,154 | $ 350,284 | $ 179,058 | $ 50,357 |

(p) Preliminary
(c) Current budget.
(1) Includes certain non-recurring revenues totaling $244.1 million.
(2) Consists of net revenue from 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 to the Redemption Fund from non-General Fund revenues.
(4) Consists of proceeds of Commonwealth tax and revenue anticipation notes and borrowings from Government Development Bank.
(5) Consists of repayment of Commonwealth tax and revenue anticipation notes and borrowings from Government Development Bank.

*Source*: Department of the Treasury

*Budgeted Fiscal Year 2004 Compared to Preliminary Fiscal Year 2003*

The General Fund budget for fiscal year 2004, which commenced on July 1, 2003, provides for total resources and appropriations of $8.295 billion, which represents an increase of $452 million, or 5.8%, over the fiscal year 2003 budget. Total resources include $7.925 billion of total revenues and $370 million of other sources, which are included as part of "Other Income (refunds)." General Fund total budgeted and actual resources for fiscal year 2003, which ended on June 30, 2003, were $7.842 billion. This amount includes total revenues of $7.592 billion and $250 million reported as part of "Proceeds of notes and other borrowings." The $250 million represents a loan from GDB. The loan has a term of five years, and may be repaid sooner to the extent that sufficient revenues are available for such purpose.

The major changes in revenues from fiscal year 2003 are expected to be: (i) projected increases in total income taxes of $366 million; (ii) projected increases in total excise taxes of $102 million; and (iii) projected decreases in other revenues of $150 million. The budgeted General Fund revenues for fiscal year 2004 assumes a 6.1% nominal and 2.9% real growth in gross product, and additional revenues of $225 million from new legislative measures.

For the first nine months of fiscal year 2004, General Fund revenues were $5.363 billion, which is $411 million, or 8.3%, higher than General Fund revenues during the first nine months of fiscal year 2003, and $9.9 million, or 0.2%, higher than budgeted revenues for this period.

Total cash expenditures for fiscal year 2004 are budgeted to increase to $7.945 billion, which amount includes $88 million in disbursements related to fiscal year 2003. After considering (i) $408 million in debt service payments (separately identified on the table as "Transfers to Redemption Fund"), (ii) net repayments of $6 million to GDB and (iii) $306 million in other sources from the General Fund's non-budgetary funds and a 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 would be reduced from $179 million at the end of fiscal year 2003 to $64 million at the end of fiscal year 2004.

*Preliminary Fiscal Year 2003 Compared to Fiscal Year 2002*

Preliminary General Fund total revenues for fiscal year 2003 were $7.592 billion, representing an increase of $138 million, or 1.8%, from actual fiscal year 2002 revenues. This amount excludes proceeds of a loan of $250 million obtained from GDB, mentioned above, 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 $46 million and in corporate income taxes of $192 million; (ii) increases in excise taxes on alcoholic beverages and cigarettes of $83 million, and increases in motor vehicle 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 $230 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 do not apply to fiscal year 2003.

Preliminary total cash expenditures for fiscal year 2003 were $7.590 billion, which amount excludes certain amounts related to fiscal year 2003 but disbursed or to be 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 reserves 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.

*Fiscal Year 2002 Compared to Fiscal Year 2001*

General Fund total revenues for fiscal year 2002 were $7.454 billion, representing an increase of $492 million, or 7.1%, from fiscal year 2001 revenues. The major changes from fiscal year 2001 were: (i) an increase in income taxes from individuals of $213 million; (ii) increases in Commonwealth excise taxes of $117 million; (iii) an increase in miscellaneous non-tax revenues of $368 million; (iv) a decrease in income taxes from corporations of $112 million; and (v) a decrease in income taxes withheld from non-residents, tollgate taxes and dividend taxes totaling $100 million.

The increase in miscellaneous non-tax revenues relates to certain special revenue raising measures adopted by the Secretary of the Treasury in fiscal year 2002. Such measures included the transfer to the General Fund of funds on deposit in a contingency fund related to the sale of PRTC stock and of certain compulsory insurance premiums, the sale of certain tax receivables to GDB, and savings generated by the refinancing of certain Commonwealth bonds.

Total cash expenditures for fiscal year 2002 were $7.026 billion. After considering (i) $275 million in debt service payments (separately identified on the table as "Transfers to Redemption Fund"), (ii) net repayments of $39 million to GDB and other sources, and (iii) $111 million in other sources from the General Fund's non-budgetary funds, the ending cash balance of the General Fund increased from $125 million at the end of fiscal year 2001 to $350 million at the end of fiscal year 2002.

*Fiscal Year 2001 Compared to Fiscal Year 2000*

General Fund total revenues for fiscal year 2001 were $6.962 billion, an increase of $19 million from fiscal year 2000. The major changes from fiscal year 2000 were (i) a decrease of $85 million in corporate income taxes; (ii) a decrease of $93 million in individual income taxes; (iii) a decrease of $62 million in tollgate taxes; (iv) a decrease of $90 million in other excise taxes; (v) an increase in income tax withheld from non-residents of $140 million; and (vi) an increase in federal excise taxes of $41 million.

Total cash expenditures for fiscal year 2001 were $7.103 billion. After considering (i) $246 million in debt service payments (separately identified on the table as "Transfers to Redemption Fund"), (ii) $140 million in net borrowings from GDB and other sources, and (iii) $85 million in other sources from the General Fund's non-budgetary funds, the ending cash balance of the General Fund decreased from $287 million at the end of fiscal year 2000 to $125 million at the end of fiscal year 2001.

**Major Sources of General Fund Revenues**

*Income Taxes*

The Commonwealth's income tax law, the Internal Revenue Code of 1994, as amended (the "PR 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. A withholding tax is imposed on certain payments made to non-residents of Puerto Rico.

*Individuals*. Resident individuals are subject to tax on their taxable income from all sources. Prior to January 1, 2000, the PR Code had five tax brackets for individuals with tax rates of 8%, 12%, 18%, 31% and 33%. As a result of legislation enacted in 1999 and thereafter, the first four brackets have been reduced to 7.5%, 11%, 16.5% and 29.5% for the taxable year commencing on January 1, 2000, to

7%, 10%, 15% and 28% for taxable years commencing after December 31, 2000. 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 20%. It is taxed at a rate of 10% if the capital asset consists of certain property located or deemed located in Puerto Rico. Gains realized by Puerto Rico resident individuals, trusts and estates from the sale of stock of certain Puerto Rico corporations in an initial public offering made prior to January 1, 2008 are subject to a special capital gains rate of 7%.

Interest income in excess of $2,000 on deposits with Puerto Rico financial institutions is taxed at a rate of 17%; the first $2,000 of interest income 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 and estates qualifies for a special 17% tax rate. Legislation has recently been enacted that will reduce this 17% tax rate to 10% under certain circumstances.

*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.

The PR 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. 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 25% or 12.5% if the capital asset consists of certain property located or deemed located in Puerto Rico sold or exchanged after December 31, 2000. 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. A special tax rate of 17% is applicable to dividend distributions of REITs received by corporations.

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 PR Code also provides for an alternative minimum tax of 22%. 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.

The PR 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 10%. 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 10% 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.

The Treasury Department is presently evaluating a plan to reform the Commonwealth's tax system. The objective of this reform would be to reduce the income tax rates for individuals while expanding the tax base by taxing persons not currently participating in the income tax system and simplifying the tax system in order to make its administration more effective. The tax reform is expected to be implemented beginning on January 1, 2006. The Treasury Department expects that the tax reform will produce additional General Fund revenues.

*Excise Taxes*

The PR Code imposes a tax on articles and commodities that are imported into or manufactured in Puerto Rico for consumption in Puerto Rico and a tax on certain transactions, such as hotel occupancy, public shows, and horse racing. The excise tax on certain articles and commodities, such as cigarettes, alcohol and petroleum products, is based upon the quantity of goods imported. The excise tax on motor vehicles is based on its suggested retail price. The PR Code imposes a tax at an effective rate of 6.6% of the F.O.B. factory price for imported goods and 3.6% of the sales price of goods manufactured in Puerto Rico, except sugar, cement, cigarettes, motor vehicles and certain petroleum products, which are taxed at different rates. Goods to be used by the government, except for motor vehicles and construction equipment, are not exempt. Exemptions apply to certain articles, such as food and medicines, and to articles designated for certain users.

*Other Taxes and Revenues*

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

Non-tax revenues consist principally of lottery proceeds, documentary stamps, permits, fees and forfeits, proceeds of land sales and receipts from 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, $13.25 per gallon was returned to the Treasury of Puerto Rico during the period from July 1, 1999 to December 31, 2003. Effective January 1, 2004, the amount returned was reduced to $10.50 per gallon. However, legislation is currently pending in both houses of the United States Congress that would extend the period during which the tax returned to Puerto Rico remains at $13.25 per gallon to June or December 2004, depending on which version is enacted.

*Property Taxes*

Personal property, which accounts for approximately 53% 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 the fiscal years ending June 30, 1999 through 2003.

**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 |
|---|---|---|---|---|---|
| 1999 | $20,042,738 | $642,555 | $523,886 | $47,309 | $571,195 |
| 2000 | 20,514,014 | 704,568 | 594,151 | 64,812 | 658,963 |
| 2001 | 21,575,063 | 736,667 | 614,411 | 70,496 | 684,907 |
| 2002 | 22,743,568 | 792,799 | 645,117 | 60,677 | 705,794 |
| 2003 | 23,138,903 | 824,933 | 671,163 | 79,421 | 750,584 |

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

*Source:* Municipal Revenues Collection Center

## Collections of Income and Excise Taxes

The Department of the Treasury has continued its program for improving tax collections, which began in fiscal year 1986. The program has consisted, in part, of taking the initiative in sponsoring and implementing tax reform, particularly in the areas of excise taxes and income taxes, in order to decrease the incidences of nonpayment of taxes and to expand the taxpayer base. The program has also included (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.

## 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 $4.768 billion for fiscal year 2005, a decrease of $33 million, or 0.7%, from fiscal year 2004. The following table presents revenues from federal grants by broad program areas, which are accounted in the central accounting system of the Department of the Treasury. The figures for fiscal years 2001 and 2002 are actual figures. The preliminary figures for fiscal year 2003 and the estimated figures for fiscal years 2004 and 2005 are based on the information submitted by each agency to the Office of Management and Budget.

**Commonwealth of Puerto Rico**
**Federal Grants[1]**
**(in thousands)**

| | 2001 | 2002 | 2003[2] | 2004[3] | 2005[3] |
|---|---|---|---|---|---|
| Education | $ 642,082 | $ 734,917 | $ 828,992 | $1,046,443 | $1,064,964 |
| Social Services | 1,665,248 | 1,711,360 | 1,849,000 | 1,769,246 | 1,771,417 |
| Health | 297,865 | 333,154 | 367,916 | 391,521 | 424,011 |
| Labor and Human Resources[4] | 339,772 | 376,119 | 334,350 | 222,070 | 235,230 |
| Crime | 16,965 | 15,689 | 32,479 | 38,794 | 28,928 |
| Housing[5] | 336,175 | 385,592 | 321,870 | 385,408 | 402,904 |
| Drug and Justice | 17,524 | 9,822 | 17,802 | 31,677 | 12,463 |
| Agriculture and Natural Resources | 6,265 | 13,119 | 7,883 | 10,216 | 8,170 |
| Contributions to Municipalities | 56,809 | 59,191 | 59,191 | 59,002 | 56,371 |
| Other | 7,256 | 13,538 | 11,071 | 19,172 | 18,061 |
| TOTAL | $3,385,961 | $3,652,501 | $3,830,554 | $3,973,549 | $4,022,519 |

(1) Federal grants to public corporations, including the Highway and Transportation Authority, are not included in this table. Public corporations are estimated to receive 746 million in federal grants during fiscal year 2005.
(2) Preliminary.
(3) Estimated.
(4) Amounts include grants to the Right to Work Administration, the Occupational Development, and Human Resources Council.
(5) Amounts include grants to the Public Housing Administration.

*Source:* Office of Management and Budget

## BUDGET OF THE COMMONWEALTH OF PUERTO RICO

### Office of Management and Budget

The Office of Management and Budget's ("OMB") 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 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 OMB, in coordination with the Planning Board, the Department of the Treasury, and other government offices and agencies. Section 7 of Article VI of the Constitution provides that "The appropriations made for any fiscal year shall not exceed the total revenues, including available surplus, estimated for said fiscal year unless the imposition of taxes sufficient to cover said appropriations is provided by law."

The annual budget, which is developed utilizing elements of program budgeting, 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 her judgment are necessary, convenient, and in conformity with the four-year investment plan prepared by the Planning Board.

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

**Financial Control and Adjustment Procedures**

Revenue estimates for budgetary purposes are prepared by the Department of 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 expenditure in excess of appropriations.

During any fiscal year in which the resources available to the Commonwealth are insufficient to cover the appropriations approved for such year, the Governor may take administrative measures to reduce expenses and submit to both houses of the Legislature a detailed report of any adjustment necessary to balance the budget, or make recommendations to the Legislature for new taxes or 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 February 29, 2004, the balance in the Budgetary Fund was $57.6 million.

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. The Governor or, by designation, the Director of OMB, may order the deposit of funds from any source into the Emergency Fund in an amount greater than the amount fixed in Act No. 91 when deemed convenient. When said funds are ordered deposited into the Emergency Fund, however, the balance thereof cannot exceed five percent of the budget approved for the fiscal year in which such deposit is ordered. As part of the fiscal year 2004 budget process, Act No. 91 was amended to set an upper limit to the Emergency Fund of $150 million. As of February 29, 2004, the balance in the Emergency Fund was $112.7 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 for contributions to public corporations, municipalities, and private organizations. Such appropriations are made by a single annual law known as the Joint Resolution of the General Budget.

(ii) General Fund appropriations for special operating expenses and for capital expenditures. Such appropriations are authorized by separate 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 has many functions, which in the fifty states are the responsibility of local government, such as providing public education, police and fire protection. The central government provides significant annual grants to the Aqueduct and Sewer Authority, the University of Puerto Rico and to the municipalities. In the summaries of the central government budgets presented below, grants to the University of Puerto Rico are included in current expenses for education and debt service on general obligation bonds is included in current expenses for debt service. Debt service on Sugar Corporation notes paid by the Commonwealth is included in current expenses for economic development, and debt service on Urban Renewal and Housing Corporation bonds and notes and on Housing Finance Authority mortgage subsidy bonds paid by the Commonwealth is included in current expenses for housing.

Approximately 30% of the General Fund is committed for payment of fixed charges such as municipal subsidies, grants to the University of Puerto Rico, contributions to the Aqueduct and Sewer Authority, funding for the judiciary branch, rental payments to the Public Buildings Authority, among others, and debt service on direct debt of the Commonwealth. In the case of the judiciary branch, legislation approved in December of 2002 provides that, commencing with fiscal year 2004, the Commonwealth will appropriate annually to the judiciary 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.

**Fiscal Year 2004 Budget**

The consolidated budget for fiscal year 2004 totaled $23.782 billion. Of this amount, $13.577 billion is assigned to the central government. This includes General Fund total resources and appropriations of $8.295 billion, which represents an increase of $452 million, or 5.8%, over budgeted amounts for fiscal year 2003. These total resources include $7.925 billion of total revenues and $370 million of other sources. The following table presents a summary of the Commonwealth's central government budget for the fiscal year ending June 30, 2004.

# Commonwealth of Puerto Rico
# Summary of Central Government Annual Budget
# Fiscal Year Ending June 30, 2004
# (in thousands)

| | General Fund[1] | Bond Fund | Special Funds | Total |
|---|---|---|---|---|
| Revenues from internal sources: | | | | |
| Property taxes | $ 0 | - | $ 103,524 | $ 103,524 |
| Personal income taxes | 2,816,000 | - | - | 2,816,000 |
| Retained non-resident income tax | 560,000 | - | - | 560,000 |
| Corporate income taxes | 1,826,000 | - | - | 1,826,000 |
| Partnership income taxes | 2,000 | - | - | 2,000 |
| Tollgate taxes | 22,000 | - | - | 22,000 |
| 17% withholding tax on interest | 13,000 | - | - | 13,000 |
| 10% withholding tax on dividends | 47,000 | - | - | 47,000 |
| Inheritance and gift taxes | 3,000 | - | - | 3,000 |
| Excise taxes: | | | | |
| Alcoholic beverages | 313,000 | - | - | 313,000 |
| Motor vehicles and accessories | 543,000 | - | - | 543,000 |
| Cigarettes | 159,000 | - | - | 159,000 |
| Special excise tax on certain petroleum products | 22,000 | - | | 22,000 |
| General 5% excise tax | 543,000 | - | | 543,000 |
| Other | 173,000 | - | 57,900 | 230,900 |
| Licenses | 87,000 | - | - | 87,000 |
| Miscellaneous non-tax revenues: | | | | |
| Contributions from lottery fund | 66,000 | - | - | 66,000 |
| Electronic lottery | 88,000 | - | - | 88,000 |
| Registration and document certification fees | 171,000 | - | - | 171,000 |
| Other | 121,000 | - | 259,032 | 380,032 |
| Total revenues from internal sources | 7,575,000 | - | 420,456 | 7,995,456 |
| Revenues from non-Commonwealth sources: | | | | |
| Federal excise taxes on off-shore shipments | 330,000 | - | - | 330,000 |
| Federal grants | 0 | - | 3,973,549 [2] | 3,973,549 |
| Customs | 20,000 | - | - | 20,000 |
| Total revenues from non-Commonwealth sources | 350,000 | - | 3,973,549 | 4,323,549 |
| Total revenues | $7,925,000 | - | $4,394,005 | $12,319,005 |
| Other: | | | | |
| Other Income | 369,995 | - | - | 369,995 |
| Balance from previous year | - | - | 347,902 | 347,902 |
| Bonds authorized | - | 540,000 | - | 540,000 |
| Total other sources | 369,995 | 540,000 | 347,902 | 1,257,897 |
| Total resources | $ 8,294,995 | $ 540,000 | $4,741,907 | $13,576,902 |
| Appropriations: | | | | |
| Current expenses: | | | | |
| General government | 803,036 | - | 54,069 | 857,105 |
| Education | 2,552,438 | - | 977,036 | 3,529,474 |
| Health | 1,403,772 | - | 419,118 | 1,822,890 |
| Welfare | 404,015 | - | 2,099,589 | 2,503,604 |
| Economic development | 182,973 | - | 63,204 | 246,177 |
| Public safety and protection | 1,394,746 | - | 87,608 | 1,482,354 |
| Transportation and communications | 83,549 | - | 44,857 | 128,406 |
| Housing | 24,802 | - | 205,965 | 230,767 |
| Contributions to municipalities | 362,857 | - | 2,091 | 364,948 |
| Special pension contributions | 187,173 | - | 0 | 187,173 |
| Debt service | 407,948 | - | 103,524 | 511,472 |
| Other debt service | 487,686 | - | 25,300 | 512,986 |
| Total appropriations-current expenses | 8,294,995 | - | 4,082,361 | 12,377,356 |

| | General Fund[1] | Bond Fund | Special Funds | Total |
|---|---|---|---|---|
| Capital improvements | 0 | 540,000 | 258,538 | 798,538 |
| Total appropriations | 8,294,995 | 540,000 | 4,340,899 | 13,175,894 |
| Year-end balance | 0 | - | 401,008 | 401,008 |
| Total appropriations and year-end balance | $8,294,995 | $540,000 | $4,741,907 | $13,576,902 |

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

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

In the fiscal year 2004 budget, revenues and other resources of all budgetary funds total $12.689 billion, excluding balances from the previous fiscal year and general obligation bonds authorized. The net increase in General Fund revenues in the fiscal year 2004 budget, as compared to fiscal year 2003 preliminary results, is accounted mainly by increases in corporate income taxes (up $49 million), personal income taxes (up $298 million), excise taxes on motor vehicles and accessories (up $44 million), retained non-resident income tax (up $43 million), federal excise taxes on offshore shipments (up $20 million), excise taxes on alcoholic beverages (up $14 million), excise taxes on cigarettes (up $10 million) and decreases in customs (down $6 million) and tollgate taxes (down $23 million).

Current expenses and capital improvements of all budgetary funds total $13.176 billion, an increase of $575 million from fiscal year 2003. The major changes in General Fund expenditures by program in fiscal year 2004 are: health (up $127.9 million), education (up $106.5 million), debt service on Commonwealth's general obligation and guaranteed debt (up $33.8 million), other debt service, consisting principally of Commonwealth appropriation debt (up $63.2 million), special pension contributions (up $56.6 million), contributions to municipalities (up $7.8 million), transportation and communications (up $6.5 million), public safety and protection (up $5.6 million), welfare (up $3.6 million), housing (up $1.9 million), general government (up $43.2 million) and a decrease in economic development (down $4 million).

Although General Fund expenditures were budgeted at $8.295 billion, actual expenditures are projected to be $8.546 billion, or $251 million higher than originally budgeted. The higher expenditures are expected to be mainly in the areas of education, public safety and protection and health. The government expects, however, to cover any shortfall in the budget from expected reimbursements of certain Federal funds relating to education, transfers to the General Fund from the Budgetary Fund and through a series of other initiatives, among which are measures taken by OMB to reduce expenditures and the refinancing and restructuring of debt of the Commonwealth at lower interest rates.

The general obligation bond authorization for the fiscal year 2004 budget is $540 million.

**Fiscal Year 2005 Proposed Budget**

On February 25, 2004, the Governor of Puerto Rico submitted a proposed budget for fiscal year 2005 to the Legislature of Puerto Rico. This budget is expected to be approved before June 30, 2005. The following table presents a summary of the Commonwealth's proposed central government budget for the fiscal year ending June 30, 2005.

# Commonwealth of Puerto Rico
## Summary of Central Government Annual Budget
## Fiscal Year Ending June 30, 2005
## (in thousands)

| | General Fund | Bond Fund | Special Funds | Total |
|---|---|---|---|---|
| Revenues from internal sources: | | | | |
| Property taxes | $ 0 | - | $ 109,849 | $ 109,849 |
| Personal income taxes | 2,865,000 | - | - | 2,865,000 |
| Retained non-resident income tax | 560,000 | - | - | 560,000 |
| Corporate income taxes | 1,935,000 | - | - | 1,935,000 |
| Partnership income taxes | 2,000 | - | - | 2,000 |
| Tollgate taxes | 30,000 | - | - | 30,000 |
| 17% withholding tax on interest | 15,000 | - | - | 15,000 |
| 10% withholding tax on dividends | 53,000 | - | - | 53,000 |
| Inheritance and gift taxes | 3,000 | - | - | 3,000 |
| Excise taxes: | | | | |
| Alcoholic beverages | 304,000 | - | - | 304,000 |
| Motor vehicles and accessories | 560,000 | - | 0 | 560,000 |
| Cigarettes | 150,000 | - | - | 150,000 |
| Special excise tax on certain products | 10,000 | - | | 10,000 |
| General 5% excise tax | 598,000 | - | | 598,000 |
| Other | 197,000 | - | 61,400 | 258,400 |
| Licenses | 90,000 | - | - | 90,000 |
| Miscellaneous non-tax revenues: | | | | |
| Contributions from lottery fund | 70,000 | - | - | 70,000 |
| Electronic lottery | 90,000 | - | - | 90,000 |
| Registration and document certification fees | 208,000 | - | - | 208,000 |
| Other | 130,000 | - | 279,058 | 409,058 |
| Total revenues from internal sources | 7,870,000 | - | 450,307 | 8,320,307 |
| Revenues from non-Commonwealth sources: | | | | |
| Federal excise taxes on off-shore shipments | 350,000 | - | - | 350,000 |
| Federal grants | 0 | - | 4,022,519 | 4,022,519 |
| Customs | 30,000 | - | - | 30,000 |
| Total revenues from non-Commonwealth sources | 380,000 | - | 4,022,519 | 4,402,519 |
| Total revenues | $8,250,000 | - | $4,472,826 | $12,319,005 |
| Other: | | | | |
| Other Income | 550,000 | - | - | 550,000 |
| Balance from previous year | - | - | 401,008 | 401,008 |
| Bonds authorized | - | 550,000 | - | 550,000 |
| Total other sources | 550,000 | 550,000 | 401,008 | 1,501,008 |
| Total resources | $8,800,000 | 550,000 | $4,873,834 | $14,223,834 |
| Appropriations: | | | | |
| Current expenses: | | | | |
| General government | 800,432 | - | 51,992 | 852,424 |
| Education | 2,823,242 | - | 1,097,358 | 3,920,600 |
| Health | 1,431,205 | - | 456,266 | 1,887,471 |
| Welfare | 427,893 | - | 2,103,780 | 2,531,673 |
| Economic development | 193,341 | - | 66,603 | 259,944 |
| Public safety and protection | 1,552,204 | - | 86,102 | 1,638,306 |
| Transportation and communications | 92,136 | - | 51,303 | 143,439 |
| Housing | 26,539 | - | 206,259 | 232,798 |
| Contributions to municipalities | 358,951 | - | 2,031 | 360,982 |
| Special pension contributions | 239,158 | - | 0 | 239,158 |
| Debt service | 369,985 | - | 109,849 | 479,834 |
| Other debt service | 484,914 | - | 25,000 | 509,914 |
| Total appropriations-current expenses | 8,800,000 | - | 4,256,543 | 13,056,543 |

| | General Fund | Bond Fund | Special Funds | Total |
|---|---|---|---|---|
| Capital improvements | 0 | 550,000 | 243,199 | 793,199 |
| Total appropriations | 8,800,000 | 550,000 | 4,499,742 | 13,849,742 |
| Year-end balance | 0 | - | 374,092 | 374,092 |
| Total appropriations and year-end balance | $8,800,000 | $550,000 | $4,873,834 | $14,223,834 |

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

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

In the proposed fiscal year 2005 budget, revenues and other resources of all funds total $13.273 billion, excluding balances from the previous fiscal year and general obligation bonds authorized. The proposed fiscal year 2005 budget provides for total General Fund resources and appropriations of $8.8 billion, which represents an increase of $505 million, or 6.1%, over fiscal year 2004 budgeted resources of $8.295 billion. Total resources include $8.250 billion of total revenues, which represents an increase of $325 million, or 4.1%, over the fiscal year 2004 estimated revenues of $7.925 billion, and $550 million of additional resources relating to the conversion into cash (through a sale or other transaction with GDB) of certain tax receivables held by the Puerto Rico Treasury Department. The budgeted General Fund revenues for fiscal year 2005 assume a 5.7% nominal growth, or 2.7% real growth, in gross product, and additional revenues of $120 million from proposed tax measures, including a 50% reduction in capital gains rates for fiscal year 2005, a 10% withholding tax on jackpot winnings on casino slot machines, and a withholding tax on interest paid on commercial loans to non-resident lenders. Said measures require the enactment of legislation.

The net increase in General Fund revenues in the fiscal year 2005 proposed budget, as compared to the fiscal year 2004 budgeted revenues, are accounted mainly by corporation income taxes (up $109 million), general 5% excise taxes (up $55 million), personal income taxes (up $49 million), motor vehicles and accessories (up $17 million), federal excise taxes on off-shore shipments (up $20 million), and customs (up $10 million) and decreases in cigarettes (down $9 million) and alcoholic beverages (down $9 million).

Current expenses and capital improvements of all funds total $13.850 billion, an increase of $673.8 million from fiscal year 2004. The major changes in General Fund expenditures by program in fiscal year 2005 are: education (up $270.8 million), public safety and protection (up $157.5 million), special pension contributions (up $52 million), health (up $27.4 million), welfare (up $23.9 million), transportation and communications (up $8.6 million), and housing (up $1.7 million) and decreases in general governmental (down $2.6 million), other debt service (down $2.8 million), contributions to municipalities (down $3.9 million), and debt service (down $38 million).

The general obligation bond authorization for the proposed fiscal year 2005 budget is $550 million.

**Differences between Budget and Basic Financial Statements**

Revenue and expenditures, as reported by the Department of 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 Department of the Treasury include accruals and other adjustments as required by government accounting standards.

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

(iii) Bonds are authorized by the Commonwealth in accordance with a four-year capital improvement program. Since bond sales are determined by bond market conditions and other factors, the 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 the Legislature of Puerto Rico, approved on 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 the Legislature of Puerto Rico, approved on 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, 2003, the Commonwealth will include in its financial statements reported liabilities of approximately $70 million for awarded and anticipated unfavorable judgments. This amount represented 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 in local and federal district court by an association of insurance companies seeking to recover from the Commonwealth approximately $74 million of compulsory insurance premiums allegedly belonging to the insurance companies or their policyholders which were transferred by the Secretary of the Treasury to the General Fund. The Commonwealth believes that its ultimate liability, if any, would not be significant.

The Commonwealth is a defendant in a lawsuit alleging violations of civil rights. The amounts claimed approximate $23 million; however, the ultimate liability cannot be presently determined. No provision for any liability that may result upon adjudication of this lawsuit has been recognized in the financial statements by the Commonwealth. The Commonwealth believes that the ultimate liability, if any, would not be significant.

Several officers of the Commonwealth are defendants in a class action lawsuit filed in 1979 in the United States District Court for the District of Puerto Rico by various inmates who alleged that their constitutional rights were being violated because of overcrowding and lack of adequate healthcare in the island's correctional system. In 1980, the United States District Court issued a preliminary injunction and required the defendants to provide additional capacity for the cells of the correctional facilities and to improve the healthcare services available to inmates. Fines in the amount of $280 million have been assessed against the defendants in order to assure compliance with the space and healthcare requirements imposed by the United States District Court. Of the fines imposed, $150 million have already been paid by the Commonwealth.

**APPENDIX II**

## SUMMARY OF THE TRUST AGREEMENT

The following is a summary of certain provisions of the Trust Agreement. The statements contained herein do not purport to be complete and this summary is qualified in its entirety by reference to the Trust Agreement.

### Definitions of Certain Terms

The following words and terms have the following meanings, unless the context otherwise requires. Words importing the singular number include the plural number in each case and vice versa, and words importing persons include firms and corporations.

"**Accreted Value**" shall mean with respect to any Capital Appreciation Bond or Capital Appreciation and Income Bond (i) as of any Valuation Date, the amount set forth for such date in the resolution authorizing such Capital Appreciation Bond or Capital Appreciation and Income Bond and (ii) as of any date other than a Valuation Date, the sum of (a) the Accreted Value on the preceding Valuation Date (or, if there is no preceding Valuation Date, the initial principal amount) and (b) the product of (1) a fraction, the numerator of which is the number of days having elapsed from the preceding Valuation Date (or from the original issue date if there is no preceding Valuation Date) and the denominator of which is the number of days from such preceding Valuation Date (or from the original issue date if there is no preceding Valuation Date) to the next succeeding Valuation Date and (2) the difference between the Accreted Values for such Valuation Dates (or between the initial principal amount and the Accreted Value on the first Valuation Date).

**"Acts"** shall mean (i) Act Number One Hundred Sixty-Four (164) of the Legislature of Puerto Rico, approved December seventeenth ($17^{th}$), two thousand one (2001) ("Act 164"); (ii) Act Number Eighty-Five (85) of the Legislature of Puerto Rico, approved June thirteenth ($13^{th}$), nineteen hundred ninety-eight (1998) ("Act 85"); (iii) Joint Resolution Five Hundred Twenty-Three (523) of the Legislature of Puerto Rico, approved August twenty-fourth ($24^{th}$), two thousand (2000) ("Joint Resolution 523"); (iv) Act Number One Hundred Thirteen (113) of the Legislature of Puerto Rico, approved September twenty-seventh ($27^{th}$), nineteen hundred ninety-four (1994) ("Act 113"); and (v) any other Act or Joint Resolution of the Legislature of Puerto Rico which authorizes the issuance of bonds by the Corporation which bonds are refunded in whole or in part with the proceeds of Bonds issued hereunder.

"**Additional Payments**" shall mean (A) any payments required to be made under any interest rate swap agreement; (B) termination payments under interest rate swap agreements or investment agreements; (C) required deposits to a debt service reserve fund; (D) redemption premiums; (E) trustee fees; (F) letter of credit fees; and (G) any other payment required to be made under a bond of the Corporation or the Trust Agreement.

"**Allocable Share**" shall mean that percentage (determined from time to time by the Corporation in its absolute discretion and certified to the Trustee by the President or any Vice President of the Corporation at the time bonds are issued under the Trust Agreement), which represents the proportion that the principal amount of bonds issued under the Trust Agreement to refund a particular series of Prior Bonds bears to the aggregate principal amount of bonds Outstanding under the Trust Agreement.

"**Amortization Requirement**" shall mean, for the Term Bonds of any Series for any Bond Year, the principal amount fixed or computed for the retirement by purchase or redemption of Term Bonds in such Bond Year.

The Amortization Requirement for the Term Bonds of each Series shall be initially in the respective principal amounts for each Bond Year as fixed in a resolution of the Corporation adopted prior to the issuance of the Bonds of such Series, and the aggregate amount of such Amortization Requirements for the Term Bonds of such Series shall be equal to the aggregate principal amount of the Term Bonds of such Series.

If at the close of any Bond Year the total principal amount of Term Bonds of any Series retired by purchase or redemption, or called for redemption under the provisions of the Trust Agreement during such Bond Year, shall be in excess of the amount of the Amortization Requirement for the Term Bonds of such Series for such Bond Year, then the amount of the Amortization Requirement for the Term Bonds of such Series shall be reduced for such subsequent Bond Years in such amounts aggregating the amount of such excess as shall be determined by the President of the Corporation in an order filed with the Trustee on or before the fifteenth (15th) day of the August following the close of such Bond Year.

It shall be the duty of the Trustee, on or before the 15th day of each Bond Year, to compute the Amortization Requirement for the then current Bond Year for the Term Bonds of each Series then Outstanding. The Amortization Requirement for the then current Bond Year shall continue to be applicable during the balance of such current Bond Year and no adjustment shall be made therein by reason of Term Bonds purchased or redeemed or called for redemption during such current Bond Year.

"**Appreciated Value**" shall mean, with respect to any Capital Appreciation and Income Bond (i) up to the Interest Commencement Date set forth in the resolution of the Board providing for the issuance of such Bond, an amount equal to the Accreted Value of such Bond and (ii) as of any date of computation on and after the Interest Commencement Date, an amount equal to the Accreted Value of such Bond on the Interest Commencement Date.

**"Authorized Debtors"** shall mean (i) the Department of Health, (ii) the Department of the Treasury of the Commonwealth of Puerto Rico, (iii) the Puerto Rico Infrastructure Finance Authority, (iv) the Puerto Rico Solid Waste Authority, (v) the Puerto Rico Aqueduct and Sewer Authority, (vi) the Puerto Rico Land Authority, (vii) the Puerto Rico Sugar Corporation, (viii) the Office for the Improvement of Public Schools, (ix) the Puerto Rico Maritime Shipping Authority, (x) the Housing Bank and Finance Agency of Puerto Rico and its successor in interest, the Puerto Rico Housing Finance Authority, (xi) the Hotel Development Corporation and (xii) any other debtor of the Corporation or the Government Development Bank for which the Corporation has issued Prior Bonds.

"**Board**" shall mean the Board of Directors of the Corporation as constituted from time to time and which shall be the Board of Directors of Government Development Bank as provided by Resolution Number Five Thousand Forty-Four (5044), adopted December twelfth (12th), nineteen hundred eighty-four (1984) by the Board of Directors of Government Development Bank, as amended, or, if said Board shall be abolished, the board or body succeeding to the principal functions thereof or to whom the powers of the Corporation shall be given by law.

**"Bond Year"** shall mean the period commencing on the first day of August of any year and ending on the last day of July of the following year.

"**Bondholder**," "**Holder**," "**holder**," "**Holder of Bonds**," or "**Owner**" or any similar term, shall mean any person who shall be the registered owner of any Outstanding Bond or Bonds.

"**Bonds**" or "**bonds**" shall mean the bonds of the Corporation issued under the provisions of the Trust Agreement.

"**Budgetary Appropriation**" shall mean the funds appropriated by the Legislature of Puerto Rico in the annual budget of capital improvements and operating expenses of the Commonwealth for any Fiscal Year for the payment of the Notes and the Parity Notes pursuant to the provisions of the Acts or, in the case such budget of the Commonwealth for any Fiscal Year has not been approved by the commencement of such Fiscal Year, until such budget is approved, the funds representing the amounts which had been appropriated in the budget of the Commonwealth for the previous Fiscal Year for the payment of the Notes and the Parity Notes pursuant to the provisions of the Acts in accordance with Article VI, Section 6 of the Constitution of the Commonwealth.

"**Business Day**" means a day other than a Saturday, Sunday or a day on which commercial banks in the City of New York, New York, or San Juan, Puerto Rico, are closed to the public.

"**Capital Appreciation Bonds**" shall mean any Bonds the accruing interest on which is compounded periodically on each of the dates designated for compounding in the resolution authorizing said Bonds and payable in an amount equal to the then current Accreted Value only at the maturity, earlier redemption or other payment date therefor, all as so provided by such resolution, and which may be either Serial Bonds or Term Bonds.

"**Capital Appreciation and Income Bonds**" shall mean any Bonds the accruing interest on which is not paid prior to the Interest Commencement Date specified in the resolution authorizing such Bonds and the

Appreciated Value for such Bonds is compounded periodically on the dates designated in such resolution prior to the Interest Commencement Date for such Capital Appreciation and Income Bonds, and which may be either Serial Bonds or Term Bonds.

**"Corporation"** shall mean Puerto Rico Public Finance Corporation, a governmental instrumentality of the Commonwealth of Puerto Rico and a wholly-owned subsidiary of Government Development Bank for Puerto Rico.

"**Corporation Swap Payments"** means the net payments required to be made by the Corporation to the Hedge Counterparty under a Rate Swap (if applicable).

"**Credit Facility**" shall mean an irrevocable letter of credit, policy of municipal bond insurance, guaranty, purchase agreement, credit agreement or similar facility in which the person providing such facility irrevocably agrees to provide funds to make payment of the principal of, premium, if any, and interest on Bonds to which such Credit Facility relates.

"**Fiscal Year**" shall mean the period commencing on the first day of July of any year and ending on the last day of June of the following year or any other twelve month period designated by the Board.

"**GDB Letters of Credit**" shall mean the irrevocable transferable stand-by letters of credit issued by Government Development Bank in favor of the Trustee solely for the benefit of the holders of Bonds of one or more Series.

"**Government Development Bank**" shall mean Government Development Bank for Puerto Rico.

"**Government Obligations**" shall mean (i) direct obligations of, or obligations the timely payment of principal of and the interest on which is unconditionally guaranteed by, the United States Government, (ii) direct obligations of, or obligations the principal of and interest on which are unconditionally guaranteed by, any of the following: Banks for Cooperatives, Federal Farm Credit Banks, Federal Home Loan Banks, Export-Import Bank of the United States, Federal Financing Bank, Government National Mortgage Association, Farmer's Home Administration, Federal Home Loan Mortgage Corporation, Federal National Mortgage Association or Federal Housing Administration, and which obligations are rated at the time of purchase in the highest rating category by both Moody's and Standard & Poor's, (iii) all other obligations issued or unconditionally guaranteed as to principal and interest by an agency or instrumentality controlled or supervised by and acting as an instrumentality of the United States Government pursuant to authority granted by the Congress, which obligations are rated at the time of purchase in the highest rating category by both Moody's and Standard & Poor's and (iv) receipts evidencing the ownership of payments of principal of or interest on any of such obligations, which receipts are rated in the highest rating category by both Moody's and Standard & Poor's.

"**Hedge Counterparty**" means the provider of any Rate Swap with respect to the Bonds as counterparty under a Swap Agreement which provider must have a rating with respect to its long-term unsecured debt which is rated in one of the three highest rating categories (without regard to any gradation within such category) by Standard & Poor's or Moody's.

"**Hedge Counterparty Swap Payments**" means the net payments required to be made by a Hedge Counterparty to the Corporation under a Rate Swap.

"**Interest Commencement Date**" shall mean, with respect to any Capital Appreciation and Income Bond, the date specified in the resolution providing for the issuance of such Bond after which interest accruing on such Bond shall be payable on a periodic basis, with the first such payment date being the applicable Interest Payment Date immediately succeeding such Interest Commencement Date.

"**Interest Payment Dates**" shall mean the dates on which interest on a Series of Bonds or portion thereof is scheduled to be due and payable, as is provided by a resolution of the Board adopted prior to the issuance of such Series of Bonds.

"**Interim Bonds**" shall mean any Bonds issued on an interim basis that are expected to be repaid from the proceeds of Bonds or other indebtedness.

**“Investment Agreement”** shall mean any agreement for the investment of moneys entered into by the Trustee with a Qualified Financial Institution or collateralized at all times by Government Obligations having a market value at least equal to the principal amount of such agreement, as to which collateral the Trustee has a perfected first priority security interest, which collateral is held by the Trustee or its agent free and clear of claims by third parties and which collateral will result in the agreement being rated in the highest rating category by both Moody’s and Standard & Poor’s.

“**Investment Obligations**” shall mean (i) Government Obligations, (ii) time deposits, certificates of deposit or similar arrangements with, or banker’s acceptances issued by, any bank, banking association or trust company, including the Trustee, which is a member of the Federal Deposit Insurance Corporation having a combined capital and surplus aggregating not less than $150,000,000 and reported deposits of not less than $250,000,000, (iii) repurchase agreements with banks mentioned in (ii) above, including the Trustee, or with primary government dealers having a capital and surplus in excess of $150,000,000, with respect to any of the securities mentioned in (i) above, provided such securities are on deposit with the Trustee (or any duly appointed agent of the Trustee) and such agreements are structured as sale - purchase agreements rather than secured loans, (iv) obligations issued by the Commonwealth or any state or territory of the United States, which are rated in one of the three highest rating categories (without regard to any gradations within such category) by both Moody’s and Standard & Poor’s, (v) municipal obligations, the payment of the principal of and the interest on which is insured, which are rated in one of the three highest rating categories (without regard to any gradations within such category) by both Moody’s and Standard & Poor’s, (vi) commercial paper rated, or backed by a letter of credit or line of credit the provider of which is rated, in the highest rating category (without regard to any gradations within such category) by both Moody’s and Standard & Poor’s, (vii) an Investment Agreement, (viii) money market accounts of any state, Commonwealth or federally chartered bank, banking association, trust company or subsidiary trust company, including the Trustee, that is rated or whose parent bank is rated in the highest short-term rating category or in the highest long-term rating category by Moody’s or Standard & Poor’s (without regard to any gradations within such category) or money market funds registered under the Investment Company Act of 1940, as amended, whose shares are registered under the Securities Act of 1933, as amended, and having a rating by Standard & Poor’s of “AAAm-G” or “AAAm”, (ix) units of beneficial interest in any non-arbitrage investment program pools created by Government Development Bank or any of its subsidiaries or affiliates, (x) any obligation permitted under the laws of the Commonwealth which are rated in one of the three highest rating categories (without regard to any gradations within such category) by both Moody’s and Standard & Poor’s, and (xi) any securities otherwise permitted as eligible collateral under Act No. 69 of the Legislature of Puerto Rico, approved August 14, 1991, as amended.

“**Legislative Appropriation**” shall mean the Budgetary Appropriations appropriated by the Legislature of Puerto Rico for the payment of the Notes.

“**Liquidity Facility**” shall mean a letter of credit, policy of municipal bond insurance, guaranty, purchase agreement or similar facility in which the person providing such facility agrees to provide funds to pay the purchase price of Put Bonds upon their tender by the Holders of Put Bonds.

“**Maximum Difference**” shall mean, with respect to any Series of Bonds, the maximum increase from one Fiscal Year to the next (through the date specified in the resolution authorizing such Series of Bonds) in the aggregate debt service on such Bonds.

**“Moody’s”** means Moody’s Investors Service, Inc., a corporation organized and existing under the laws of the State of Delaware, its successors and their assigns, and, if such corporation shall be dissolved or liquidated or shall no longer perform the functions of a securities rating agency, “Moody’s” shall be deemed to refer to any other nationally recognized securities rating agency designated by the Corporation.

“**Notes**” shall mean promissory notes of the Authorized Debtors executed in connection with the refunding of all or a portion of the outstanding Prior Bonds pursuant to certain Supplemental Assignment Agreements and pledged to the Trustee pursuant to the Trust Agreement.

“**Outstanding**” when used with reference to the Bonds shall mean, as of any date of determination, all Bonds theretofore authenticated and delivered except:

a) Bonds theretofore cancelled by the Trustee or delivered to the Trustee for cancellation;

b) Bonds that are deemed paid and no longer outstanding, as provided in the Trust Agreement;

c) Bonds paid or Bonds in lieu of which other Bonds have been issued pursuant to the provisions of the Trust Agreement relating to Bonds destroyed, mutilated, stolen or lost, unless evidence satisfactory to the Trustee has been received that any such Bond is held by a bona fide purchaser;

d) Bonds tendered or deemed tendered, as provided in the resolution of the Board for any Series of Bonds; and

e) for purposes of any consent or other action to be taken under the Trust Agreement by the Holders of a specified percentage principal amount of Bonds, Bonds actually known by the Trustee to be held by or for the account of the Corporation.

**"Parity Bonds"** shall mean bonds of the Corporation issued pursuant to the Acts and secured by one or more Parity Notes.

**"Parity Notes"** shall mean promissory notes of the Authorized Debtors securing the Parity Bonds.

"**Pledged Revenues**" shall mean all of the Corporation's right, title and interest in and to (i) all amounts paid and to be paid in respect of the Notes, (ii) all moneys and Investment Obligations on deposit to the credit of the Sinking Fund, (iii) the Hedge Counterparty Swap Payments, if any, and (iv) all investment earnings on the foregoing.

**"Prior Bonds"** shall mean bonds issued by the Corporation to finance the purchase of certain promissory notes of Authorized Debtors in connection with the restructuring and refunding of certain loans by such Authorized Debtors.

"**Put Bonds**" shall mean Bonds that by their terms may be tendered by and at the option of the Holder thereof for payment prior to the stated maturity thereof.

"**Qualified Financial Institution**" means the Federal National Mortgage Association, or any bank, trust company or national banking association, or a corporation subject to registration with the Board of Governors of the Federal Reserve System under the Bank Holding Company Act of 1956, as amended, or any government securities dealer, insurance company or other financial institution, in each case whose unsecured obligations or uncollateralized long term debt obligations (or obligations guaranteed by its parent entity) shall at all times during the term of the Investment Agreement issued by such Qualified Financial Institution have been assigned a rating by Standard & Poor's and Moody's in one of the three highest rating categories (without regard to any gradations within any such category), or which has issued a letter of credit, contract or agreement in support of debt obligations which at all times shall have been so rated.

"**Rate Swap**" means any interest rate swap arrangement between the Corporation and a Hedge Counterparty pursuant to any Swap Agreement and related documentation.

"**Rating Agencies**" shall mean Standard & Poor's and Moody's.

"**Reimbursement Agreement**" shall mean any letter of credit and reimbursement agreement or other similar agreement to pay the amounts due to the provider of a Credit Facility or a Liquidity Facility between the Corporation and any provider of a Credit Facility or a Liquidity Facility.

"**Reimbursement Obligation**" shall mean all amounts payable by the Corporation to a provider of a Credit Facility or Liquidity Facility pursuant to its agreement with such provider, including any fees payable and expenses reimbursable to such provider.

"**Reserve Account**" shall mean the account of that name which may be established in the Sinking Fund.

"**Reserve Account Insurance Policy**" shall mean the insurance policy, surety bond or other evidence of insurance deposited to the credit of the Reserve Account in lieu of or in partial substitution for cash or securities on deposit therein, which policy, bond or other evidence of insurance constitutes an unconditional senior obligation of the issuer thereof. The issuer thereof shall be a municipal bond insurer whose senior debt obligations, ranking pari passu with its obligations under such policy, bond or other evidence of insurance, are rated, at the time of deposit for the credit of the Reserve Account, in any of the three highest rating categories (without regard to any gradations within any such category) by Moody's and Standard & Poor's.

"**Reserve Account Letter of Credit**" shall mean the irrevocable, transferable letter of credit deposited to the credit of the Reserve Account in lieu of or in partial substitution for cash or securities on deposit therein, which letter of credit constitutes an unconditional senior obligation of the issuer thereof. The issuer of such letter of credit shall be Government Development Bank or a banking association, bank or trust company or branch thereof whose senior debt obligations, ranking pari passu with its obligations under such letters of credit are rated at the time of deposit to the credit of the Reserve Account, in any of the three highest rating categories (without regard to any gradations within any such category) by Moody's and Standard & Poor's.

"**Serial Bonds**" shall mean the Bonds designated as serial bonds in the resolutions authorizing such Bonds.

"**Series**" shall mean all of the Bonds authenticated and delivered at one time on original issuance and pursuant to any resolution authorizing such Bonds as a separate Series of Bonds, or any Bonds thereafter authenticated and delivered in lieu of or in substitution for such Bonds pursuant to the Trust Agreement, regardless of variations in maturity, interest rate or other provisions.

"**Sinking Fund**" shall mean the "Puerto Rico Public Finance Corporation Restructuring Sinking Fund," a special fund created and designated pursuant to the Trust Agreement.

"**Standard & Poor's**" means Standard & Poor's Ratings Services, a division of the McGraw-Hill Companies, Inc., a corporation organized and existing under the laws of the State of New York, its successors, their assigns, and, if such corporation shall be dissolved or liquidated or shall no longer perform the functions of a securities rating agency, "Standard & Poor's" shall be deemed to refer to any other nationally recognized securities rating agency designated by the Corporation.

"**Supplemental Assignment Agreements**" shall mean the Supplemental Debt Restructuring and Assignment Agreements, each dated as of June 1, 2004 and each by and among an Authorized Debtor, Government Development Bank and PFC.

"**Swap Agreement**" shall mean any Interest Rate Swap Agreement between the Corporation and a Hedge Counterparty related to the Bonds.

"**Term Bonds**" shall mean the Bonds designated as term bonds in the resolutions authorizing such Bonds.

"**Valuation Date**" shall mean, with respect to any Capital Appreciation Bond or Capital Appreciation and Income Bond, the date or dates set forth in the resolution authorizing such bonds on which Accreted Values are assigned to the Capital Appreciation Bonds or Capital Appreciation and Income Bonds.

"**Variable Rate Bonds**" shall mean Bonds issued with a variable, adjustable, convertible or similar interest rate that is not fixed in percentage at the date of issue for the term thereof.

**Sinking Fund and Accounts**

A special fund is created under the Trust Agreement and designated the "Puerto Rico Public Finance Corporation Restructuring Sinking Fund" (the "Sinking Fund") to be held by the Trustee. There are created three separate accounts in the Sinking Fund designated "Bond Service Account," "Redemption Account," and "Surplus Account." If the resolution of the Board providing for the issuance of Bonds under the Trust Agreement requires that a Reserve Account be established, a separate account in the Sinking Fund designated "Reserve Account" is authorized to be created in accordance with such resolution. Subject to the terms and conditions set forth in the Trust Agreement, moneys held to the credit of the Sinking Fund shall be held in trust and applied by the Trustee solely for the purposes set forth below and pending such application shall be subject to the lien and charge created pursuant to the Trust Agreement until paid out or transferred as provided therein.

The Corporation shall cause the Secretary of the Treasury of the Commonwealth to transfer to the Trustee, no later than July 15 of each Fiscal Year while the Bonds are Outstanding, funds representing the entire Legislative Appropriation for such Fiscal Year.

All funds received by the Trustee representing the Legislative Appropriation (or funds received in substitution therefor or in respect of the Notes, including any moneys received pursuant to a draw under the GDB Letter of Credit) and other funds received by the Trustee, including any Hedge Counterparty Swap Payments (other than any moneys received from draws made under any Credit Facility or Liquidity Facility, other than the GDB Letter of Credit, which moneys will be deposited in special subaccounts as provided below), shall be deposited in the Sinking Fund in the following order:

> first, to the credit of the Bond Service Account, such amount as may be required to make the total amount then to the credit of the Bond Service Account equal to the sum of (i) the amount of interest then or to become due and payable on the Bonds of each Series then Outstanding during the Bond Year commencing within the Fiscal Year with respect to which such Legislative Appropriation is made or such funds are received and (ii) the amount of principal then or to become due and payable not later than July 31 of such Bond Year on the Serial Bonds of each Series then Outstanding;
>
> second, to the credit of the Redemption Account, such amount as may be required to make the total amount then to the credit of the Redemption Account in the Bond Year commencing within the Fiscal Year with respect to which such Legislative Appropriation is made or such funds are received equal to the Amortization Requirement for such Bond Year for the Term Bonds of each Series then Outstanding; and
>
> third, to the credit of the Surplus Account, any remaining amount.

In lieu of any required deposit or in substitution of moneys on deposit to the credit of the Reserve Account (if applicable), the Corporation may cause to be deposited to the credit of the Reserve Account a Reserve Account Insurance Policy or a Reserve Account Letter of Credit in an amount equal to such required deposit, which Reserve Account Insurance Policy or Reserve Account Letter of Credit shall be satisfactory in form and substance to the Trustee and shall be payable or available to be drawn upon, as the case may be (upon the giving of notice as required thereunder), on any payment date for the Bonds on which a withdrawal from the Reserve Account would be required under the Trust Agreement, and give the Trustee the right to draw on any Reserve Account Insurance Policy or Reserve Account Letter of Credit prior to the expiration thereof unless the Corporation has furnished a replacement Reserve Account Insurance Policy or Reserve Account Letter of Credit or has provided sufficient moneys to make the amounts then on deposit to the credit of the Reserve Account equal to the amount required therefor. If a disbursement is made under a Reserve Account Insurance Policy or a Reserve Account Letter of Credit, the funds thereafter becoming available for deposit to the credit of the Reserve Account shall be used by the Trustee to reinstate the amounts available to be drawn under such Reserve Account Insurance Policy or Reserve Account Letter of Credit in an amount at least equal to the amount being reimbursed to the provider of such Reserve Account Insurance Policy or Reserve Account Letter of Credit or, if such reinstatement is not available, to deposit to the credit of the Reserve Account moneys in the amount of the disbursement made under such Reserve Account Insurance Policy or Reserve Account Letter of Credit or a combination of such alternatives.

If the Corporation issues Variable Rate Bonds pursuant to the Trust Agreement, the assumptions for calculating interest for the current Bond Year to ensure a sufficient deposit for the payment of said interest shall be made on the basis established in the resolution authorizing the issuance of such Variable Rate Bonds.

If there is a Credit Facility or a Liquidity Facility issued by a provider in connection with the issuance of a Series of Bonds, any moneys received from draws under such Credit Facility or a Liquidity Facility shall be deposited in separate subaccounts in the Bond Service Account or the Redemption Account, as appropriate, and used to pay the principal of and interest on the Bonds secured thereby.

To the extent required by a resolution of the Board in connection with the issuance of any Series of Bonds, the Trustee shall establish one or more subaccounts within the Bond Service Account and the Redemption Account to segregate amounts paid under any of the Notes and make withdrawals from such subaccounts to make payments under any Series of Bonds designated in such resolution. Nothing in the foregoing sentence shall be deemed to affect the parity status of the Bonds.

**Withdrawals from Bond Service Account**

On each Interest Payment Date or as otherwise provided in the resolution of the Board authorizing the issuance of a Series of Bonds, the Trustee shall withdraw from the Bond Service Account and (1) remit by mail (or by wire transfer if so provided by resolution of the Board) to each Holder of Bonds the amounts required for paying interest upon such Bonds as such interest becomes due, and (2) set aside sufficient moneys for paying the principal of Serial Bonds as such principal becomes due.

**Withdrawals from Redemption Account**

Moneys held to the credit of the Redemption Account shall be applied to the retirement of Bonds as follows:

(a) Subject to the provisions of paragraph (c) below, the Trustee shall endeavor to purchase Bonds or portions of Bonds, whether or not such Bonds or portions shall then be subject to redemption, at the most advantageous price obtainable by it with reasonable diligence, such price not to exceed the principal of such Bonds plus the amount of the premium, if any, that would be payable on the next redemption date to the holders of such Bonds under the redemption provisions of the Trust Agreement if such Bonds or portions of Bonds should be called for redemption on such date from the moneys in the Sinking Fund. The Trustee shall pay the interest accrued on such Bonds or portions of Bonds to the date of delivery thereof from the Bond Service Account and the principal portion of such purchase price from the Redemption Account. No such purchase shall be made by the Trustee within the period of forty-five (45) days immediately preceding the date on which such Bonds are subject to call for redemption under the redemption provisions of the Trust Agreement except from moneys in excess of the amounts set aside or deposited for such redemption of Bonds;

(b) Subject to the provisions of paragraph (c) below, the Trustee shall call for redemption on each date on which Bonds are subject to redemption from moneys in the Sinking Fund such amount of Bonds or portions of Bonds then subject to redemption as, with the redemption premium, if any, will exhaust the moneys then held for the credit of the Redemption Account as nearly as may be; provided, however, that not less than $100,000 principal amount of Bonds shall be called for redemption at any one time. Such redemption shall be made pursuant to the redemption provisions of the Trust Agreement. Prior to calling Bonds or portions of Bonds for redemption the Trustee shall withdraw from the Bond Service Account and from the Redemption Account (including moneys transferred from the Reserve Account (if applicable) to the credit of the Redemption Account) and set aside in separate accounts or deposit with the paying agents the respective amounts required for paying the interest on, and the principal and redemption premium, if any, of the Bonds or portions of Bonds so called for redemption;

(c) Moneys in the Redemption Account shall be applied by the Trustee in each Bond Year to the retirement of Bonds of each Series then Outstanding in the following order:

first, the Term Bonds of each such Series to the extent of the Amortization Requirement, if any, for such Bond Year for the Term Bonds of each such Series then Outstanding, plus the applicable premium, if any, and, if the amount available in such Bond Year shall not be sufficient therefor, then in proportion to the Amortization Requirement, if any, for such Bond Year for the Term Bonds of each such Series then Outstanding, plus the applicable premium, if any;

second, any balance then remaining shall be applied to the purchase of any Bonds then Outstanding whether or not such Bonds shall then be subject to redemption, in accordance with the provisions of paragraph (a) above; and

third, any balance then remaining shall be applied to the retirement of Bonds of each Series as directed by the Corporation.

**Withdrawals from Surplus Account**

Moneys held to the credit of the Surplus Account shall be applied by the Trustee to make payments in the following order: (i) to make up any deficiency in the Bond Service Account and the Redemption Account; (ii) to pay the compensation of the Trustee and other amounts payable to the Trustee under the Trust Agreement upon the written request of the Corporation; (iii) to make Corporation Swap Payments (if applicable); (iv) to pay any fees and expenses payable to the providers of any Credit Facility, Liquidity Facility, Reserve Account Insurance Policy or Reserve Account Letter of Credit (if applicable); and (v) to reimburse or pay any provider of such facilities (if applicable) for any other amounts due under the agreement with such provider.

Any moneys held to the credit of the Surplus Account after all amounts described in the preceding paragraph required to be paid in respect of a Bond Year have been paid shall, upon the written request of the Corporation, be transferred to the credit of the Bond Service Account or the Redemption Account.

**Reserve Account**

If the resolution of the Board providing for the issuance of Bonds under the Trust Agreement requires that a Reserve Account be established, a separate account in the Sinking Fund designated "Reserve Account" is authorized to be created in accordance with said resolution, in which Reserve Account there shall be established separate subaccounts as provided in such resolution. In such event the Trustee shall, from the funds received by the Trustee in accordance with the Trust Agreement, prior to depositing any amounts to the credit of the Surplus Account, deposit to the credit of each subaccount within the Reserve Account such amount as may be required to make the amount then on deposit to the credit of each such subaccount equal to the amount established in such resolution of the Board. Any Reserve Accounts created under the Trust Agreement will be applicable to one or more Series of Bonds issued under the Trust Agreement as provided in the resolution of the Board authorizing any such Series.

**Additional Bonds**

Additional Bonds may be issued under and secured by the Trust Agreement, subject to certain conditions, at any time or times solely for the purpose of (i) refunding Bonds or Parity Bonds of the Corporation, (ii) making a deposit to a Reserve Account (if applicable), (iii) paying capitalized interest on such additional bonds, and (iv) paying the costs of issuance of such additional Bonds. No additional Bonds may be issued unless the amounts of principal, interest and Additional Payments payable under the Notes and the Parity Notes after the issuance of such additional Bonds are sufficient to pay the principal of and interest on all Bonds and Parity Bonds Outstanding after the issuance of such additional Bonds, together with other amounts required to be paid by the Corporation with respect to the Bonds, the Parity Bonds, any Credit Facility or Liquidity Facility relating thereto, any Corporation Swap Payments and the Trust Agreement. In addition, no additional Bonds may be issued unless the GDB Letter of Credit is amended to change the stated amount, if necessary, or a successor or additional letter of credit issued in favor of the Trustee is obtained, so that in each case the aggregate stated amount of the GDB Letter of Credit or such successor letter of credit and any additional letter of credit is not less than the estimated Maximum Difference after the issuance of such additional Bonds as certified by the Corporation. Any successor letter of credit must be issued by a bank, banking association or trust company whose long-term debt obligations are rated at the time of issuance of such successor letter of credit in any of the three highest rating categories (without regard to any gradations within any such category) by Moody's and Standard & Poor's.

**Investment of Moneys**

Moneys held to the credit of the Bond Service Account and the Redemption Account (except any subaccounts established by one or more resolutions of the Board to segregate amounts received from a Credit Facility or a Liquidity Facility, which resolution or resolutions may provide for the investment of moneys deposited to the credit of any such subaccount) shall, as nearly as may be practicable, be continuously invested and reinvested, at the written direction of the Corporation specifying the particular investment to be made, in (i) Government Obligations that shall mature, or that shall be subject to redemption by the holder thereof at the option of such holder, not later than the respective dates when moneys held for the credit of said accounts will be required for the purposes intended; or (ii) Investment Agreements pursuant to which funds would be available not later than the respective dates when moneys held for the credit of said accounts would be required for the purposes intended. Moneys held to the credit of the Surplus Account shall be continuously invested and reinvested at the written direction of the Corporation in any Investment Obligations selected by it. Moneys held to the credit of the Reserve

Account (if applicable) shall, as nearly as may be practicable, be continuously invested and reinvested at the written direction of the Corporation in Investment Obligations selected by it that shall mature no later than the final maturity of the Bonds.

Obligations so purchased as an investment of moneys in any such fund or account shall be deemed at all times to be a part of such fund or account, and any investment earnings and profit or loss realized on the sale or maturity thereof, shall be credited or debited to such fund or account; provided, however, that if the required deposit to any account in the Sinking Fund has been made for the current Bond Year, the investment earnings on moneys held to the credit of such account shall be deposited to the credit of any other account of the Sinking Fund for which such required deposit has not been made, in the order required by the Trust Agreement, and thereafter shall be deposited to the credit of such account in the Sinking Fund as shall be directed by the Corporation.

**No Impairment**

The Corporation covenants and agrees that, so long as any of the Bonds shall be Outstanding and so long as any of its other obligations under any Reimbursement Agreement (if applicable) or Swap Agreement (if applicable) shall remain unpaid, none of the Pledged Revenues will be used for any purpose other than as provided in the Trust Agreement, and that no contract or contracts will be entered into or any action taken by which the rights of the Trustee, the holders or such other parties secured by the Trust Agreement to such Pledged Revenues might be impaired or diminished.

**Inclusion of Principal and Interest Requirement in Budget**

Each year while any Bonds are Outstanding, the Corporation shall file a timely request with the Director of the Office of Management and Budget of Puerto Rico to include in the annual budget of capital improvements and operating expenses of the Commonwealth for the next Fiscal Year the necessary Legislative Appropriation so that payments in respect of the Notes shall be sufficient to cover the principal and interest payable with respect to the Bonds and all other amounts payable in respect of the Bonds or payable under the Trust Agreement during the Bond Year commencing within such Fiscal Year.

**Enforcement of Remedies**

At the request of the holders of not less than 20% of the aggregate principal amount of Bonds then Outstanding, the Trustee shall proceed, subject to the Trustee's rights to indemnification under the Trust Agreement, to protect and enforce its rights and the rights of the holders under the laws of Puerto Rico or under the Trust Agreement, including all rights with respect to the Notes and the Pledged Revenues, provided, that the Trustee may not sell or otherwise dispose of the Notes.

**Pro Rata Application of Funds**

If at any time the moneys in the Sinking Fund shall not be sufficient to pay the interest on or the principal of the Bonds as the same shall become due and payable, such moneys (except for any moneys obtained from a drawing on a Credit Facility, other than the GDB Letter of Credit, or Liquidity Facility (if applicable) and deposited in a separate subaccount which shall secure only one or more specified Series of Bonds or moneys deposited in any subaccount within the Reserve Account that secures only such specified Series of Bonds), together with any moneys then available or thereafter becoming available for such purpose, whether through the exercise of the remedies provided for in the Trust Agreement or otherwise, shall be applied as follows:

> first, to the payment to the persons entitled thereto of all installments of interest then due and payable in the order in which such installments became due and payable and, if the amount available shall not be sufficient to pay in full any particular installment, then to the payment, ratably, according to the amounts due on such installment, to the persons entitled thereto, without any discrimination or preference except as to any difference in the respective rates of interest specified in such Bonds;
>
> second, to the payment to the persons entitled thereto of the unpaid principal of any of the Bonds which shall have become due and payable (other than Bonds called for redemption for the payment of which moneys are held pursuant to the provisions of the Trust Agreement) in the order

of their due dates, with interest on such Bonds at the respective rates specified therein from the respective dates upon which such Bonds became due and payable, and, if the amount available shall not be sufficient to pay in full the principal of such Bonds due and payable on any particular date, together with such interest, then to the payment first of such interest, ratably, according to the amount of such interest due on such date, and then to the payment of such principal, ratably, according to the amount of such principal due on such date, to the persons entitled thereto, without any discrimination or preference except as to any difference in the respective rates of interest specified in such Bonds;

third, to the payment of the interest on and the principal of such Bonds, to the purchase and retirement of Bonds and to the redemption of Bonds, all in accordance with the provisions of the Trust Agreement;

fourth, to the payment of any amounts then due and owing to a provider of a Credit Facility or a Liquidity Facility (if applicable); and

fifth, to the payment of any amounts then due and payable to a Hedge Counterparty under a Swap Agreement (if applicable).

**Supplemental Agreements Without Bondholders' Consent**

The Corporation and the Trustee may, without the consent or approval of, or notice to, any of the Bondholders, from time to time and at any time, enter into agreements supplemental to the Trust Agreement as shall not be inconsistent with the terms and provisions thereof, for the following purposes:

(a) to cure any ambiguity or formal defect or omission in the Trust Agreement or in any supplemental agreement or to correct or supplement any provision contained therein that may be defective or inconsistent with any other provisions contained therein; or

(b) to grant to or confer upon the Trustee for the benefit of the Bondholders any additional rights, remedies, powers, authority or security that may lawfully be granted to or conferred upon the Bondholders or the Trustee; or

(c) to add to the conditions, limitations and restrictions on the issuance of Bonds under the provisions of the Trust Agreement, other conditions, limitations and restrictions thereafter to be observed; or

(d) to add to the covenants and agreements of the Corporation in the Trust Agreement other covenants and agreements thereafter to be observed by the Corporation or to surrender any right or power therein reserved to or conferred upon the Corporation; or

(e) to permit the issuance of Bonds in coupon form; or

(f) to qualify the Bonds or any of the Bonds for registration under the Securities Act of 1933, as amended, or the Securities Exchange Act of 1934, as amended; or

(g) to qualify the Trust Agreement as an "indenture" under the Trust Indenture Act of 1939, as amended; or

(h) to make such changes as may be necessary to adjust the terms of the Trust Agreement so as to facilitate the issuance of Variable Rate Bonds, Capital Appreciation Bonds, Capital Appreciation and Income Bonds, Put Bonds, Interim Bonds and such other Bonds as may be marketable from time to time; or

(i) to make such changes as may be necessary to comply with the provisions of Puerto Rico law relating to the exclusion of interest on the Bonds from gross income thereunder; or

(j) to make such changes as may evidence the right and interest of an issuer of a Credit Facility or a Liquidity Facility that secures any Series of Bonds; or

(k) to make such changes as may be necessary to create a Reserve Account for any Bonds.

**Modification with Consent of Holders of Majority of Bonds**

Subject to the terms and provisions contained in the Trust Agreement, and not otherwise, the holders of not less than a majority in aggregate principal amount of the Bonds at the time Outstanding (or in case less than all of several Series of Bonds then Outstanding are affected by the proposed supplemental agreement, the holders of not less than a majority in principal amount of the Bonds of each Series so affected and Outstanding at the time the consent is given) shall have the right, from time to time, anything contained in the Trust Agreement to the contrary notwithstanding, to consent to and approve the execution by the Corporation and the Trustee of such agreement or agreements supplemental thereto as shall be deemed necessary or desirable by the Corporation for the purpose of modifying, altering, amending, adding to or rescinding, in any particular, any of the terms or provisions contained in the Trust Agreement or in any supplemental agreement; provided, however, that nothing contained in the Trust Agreement shall permit, or be construed as permitting, without the consent of the holders of 100% of the Bonds Outstanding affected by the proposed supplemental agreement (a) an extension of the time for the payment of the principal of or the interest on any Bond, or (b) a reduction in the principal amount of any Bond or the redemption premium or the rate of interest thereon, or (c) the creation of any lien or a pledge of funds other than the lien and pledge created by the Trust Agreement, or (d) a preference or priority of any Bond or Bonds over any other Bond or Bonds, or (e) a reduction in the aggregate principal amount of the Bonds required for consent to such supplemental agreement or any waiver under the Trust Agreement.

**Amendments to the Notes**

The Trustee (as assignee of the Notes) may, without the consent or approval of, or notice to any of the Bondholders, enter into, from time to time and at any time, such amendments to the Notes, in form satisfactory to the Trustee, as shall not be inconsistent with the terms and provisions thereof to (a) cure any ambiguity or formal defect or omission in the Notes, provided such action shall not materially adversely affect the interests of the Bondholders, or (b) grant to or confer upon the Corporation or Trustee for the benefit of the Bondholders any additional rights, remedies, powers, authority or security that may lawfully be granted to or conferred upon the Corporation or Bondholders or the Trustee, or (c) provide for the substitution of any Notes for other notes of Authorized Debtors, provided that such substitution does not restrict, limit or reduce the obligation of the Authorized Debtors to make payments sufficient to pay the principal of and interest on the Bonds, or otherwise impair the security of the Bondholders of any Series of Bonds under the Trust Agreement, or (d) change the Allocable Share and/or the Applicable Percentage (as defined in the Notes) with respect to any Notes, provided that such change does not restrict, limit or reduce the obligation of the Authorized Debtors to make payments sufficient to pay the principal of and interest on the Bonds, or (e) permit the refunding of all or any portion of the Bonds issued hereunder, provided that such refunding does not restrict, limit or reduce the obligation of the Authorized Debtors to make payments sufficient to pay the principal of and interest on the Bonds, or otherwise impair the security of the Bondholders of any Series of Bonds under this Agreement, or (f) make any other change which, in the judgment of the Trustee, based upon an opinion of counsel, will not restrict, limit or reduce the obligation of the Authorized Debtors to make the payments under the Notes sufficient to pay the principal of or interest on the Bonds, or otherwise impair the security of the Bondholders under the Trust Agreement.

Except for amendments provided for in the preceding paragraph, the Trustee shall not enter into any amendment to the Notes unless notice of the proposed amendment shall have been given and the holders of not less than a majority in aggregate principal amount of the Bonds then Outstanding shall have consented to and approved the execution thereof, all as provided for under "Modification with Consent of Holders of Majority of Bonds" above; and provided further that without the consent of all of the holders of the Bonds Outstanding affected by such change, no such amendment shall be entered into by the Trustee which would restrict, limit or reduce the obligations of the Authorized Debtors with respect to the Bonds.

**Supplements and Amendments to the GDB Letter of Credit**

The Trustee, the Corporation and Government Development Bank may, without the consent or approval of, or notice to, any of the Bondholders, agree to and execute, from time to time and at any time, such amendments and supplements to any GDB Letter of Credit as shall not be inconsistent with the terms and provisions thereof, which amendments or supplements in the opinion of the Trustee, based upon an opinion of counsel, shall not be detrimental to the interests of the Holders of the Bonds to:

(a) cure any ambiguity or formal defect or omission in such GDB Letter of Credit or in any supplement thereto, or

(b) grant to or confer upon the Trustee for the benefit of the Holders of the Bonds any additional rights, remedies, powers, authority or security that may lawfully be granted to or conferred upon the Holders of the Bonds or the Trustee, or

(c) reduce the stated amount of such GDB Letter of Credit to the extent that the Maximum Difference relating to the Bonds that have the benefit of such GDB Letter of Credit is reduced, as certified by the President or any Executive Vice President of the Corporation, or increase the stated amount of such GDB Letter of Credit, or

(d) make any other change which, in the judgment of the Trustee, based upon an opinion of counsel, will not restrict, limit or reduce the obligation of Government Development Bank to make the payments under such GDB Letter of Credit to pay the principal of or interest on the related Bonds or otherwise impair the security of the Holders of the related Bonds under the Trust Agreement.

Except for supplements and amendments described above, the Trustee shall not agree to any supplement or amendment to any GDB Letter of Credit unless notice of the proposed execution of such supplement or amendment shall have been given to the Holders of the Bonds that have the benefit of such GDB Letter of Credit and the Holders of not less than a majority in aggregate principal amount of such Bonds at the time Outstanding shall have consented to and approved the execution thereof. Except as described above, nothing contained in the Trust Agreement shall permit or be construed as permitting any amendment or modification of any provision of any GDB Letter of Credit which would reduce the amount of any payment required to be made thereunder to the Trustee, or would postpone the time of any such payment, or would alter the conditions under which any such payment is made, or any other amendment or modification which would adversely affect the security of the Holders of the Bonds, as the case may be.

**Defeasance**

If all the Outstanding Bonds shall have been paid or deemed to have been paid as provided below and all amounts due and owing to any provider of a Credit Facility, Liquidity Facility or Rate Swap shall have been paid, then and in that case the right, title and interest of the Trustee under the Trust Agreement shall cease, terminate and become void, and such Bonds shall cease to be entitled to any benefit or security under the Trust Agreement. In such event, the Trustee shall transfer and assign to the Corporation all property then held by the Trustee, shall execute such documents as may be reasonably required by the Corporation to evidence such transfer and assignment and shall turn over to the Corporation any surplus in any account in the Sinking Fund.

Any Outstanding Bond shall be deemed to have been paid within the meaning and with the effect expressed in the Trust Agreement when the whole amount of the principal of and interest on such Bond shall have been paid or when (a) there shall have been deposited with the Trustee or another fiduciary institution acting as escrow agent for the holder of such Bond either moneys in an amount which shall be sufficient, or Government Obligations, which shall not contain provisions permitting the redemption thereof at the option of the issuer, the principal of and interest on which when due, and without any reinvestment thereof, will provide moneys which, together with the moneys, if any, deposited with or held by the Trustee available therefor, shall be sufficient, to pay when due the principal of and premium, if any, and interest due and to become due on such Bond on or prior to the redemption date or maturity date thereof, as the case may be, and (b) in the event such Bond does not mature and is not to be redeemed within the next succeeding sixty 60 days, the Corporation shall have given the Trustee irrevocable instructions to give, as soon as practicable, a notice to the holder of such Bond by first-class mail, postage prepaid, stating that the deposit of moneys or Government Obligations has been made with the Trustee or another fiduciary institution acting as escrow agent for the holder of such Bond and that such Bond is deemed to have been paid in accordance with the Trust Agreement and stating such maturity or redemption date upon which moneys are to be available for the payment of the principal of and premium, if any, and interest on such Bond.

**APPENDIX III**

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June 28, 2004

Puerto Rico Public Finance Corporation
San Juan, Puerto Rico

Ladies and Gentlemen:

We have acted as Bond Counsel in connection with the authorization and issuance by the Puerto Rico Public Finance Corporation (the "Corporation"), an independent governmental instrumentality of the Commonwealth of Puerto Rico (the "Commonwealth") created by Government Development Bank for Puerto Rico ("Government Development Bank") as a wholly-owned subsidiary pursuant to Resolution No. 5044, adopted by the Board of Directors of Government Development Bank on December 12, 1984, as amended ("Resolution No. 5044"), of its $1,206,130,000 aggregate principal amount of Puerto Rico Public Finance Corporation 2004 Series A Bonds (Commonwealth Appropriation Bonds) (the "2004 Series A Bonds"). Government Development Bank is a corporation and governmental instrumentality of the Commonwealth created pursuant to Act No. 17 of the Legislature of the Commonwealth approved September 23, 1948, as amended ("Act No. 17"), which, among other things, acts as the financial advisor and fiscal agent for the Commonwealth, its instrumentalities, commissions, authorities, municipalities and political subdivisions, and makes loans and advances funds to the Commonwealth and such entities.

Simultaneously with the issuance of the 2004 Series A Bonds, the Corporation will issue $146,895,000 aggregate principal amount of Puerto Rico Public Finance Corporation 2004 Series B Bonds (Commonwealth Appropriation Bonds) (the "2004 Series B Bonds" and together with the 2004 Series A Bonds, the "Series 2004 Bonds"). The Series 2004 Bonds are being issued under and pursuant to a Trust Agreement, dated as of June 1, 2004 (the "Trust Agreement"), by and between the Corporation and U.S. Bank Trust National Association, as trustee thereunder (the "Trustee"), and a Resolution of the Board of Directors of the Corporation adopted on June 10, 2004 authorizing the issuance and sale of the Series 2004 Bonds (the "Series 2004 Bond Resolution"). Capitalized terms used herein and not otherwise defined shall have the meanings ascribed thereto in the Trust Agreement.

The Corporation will apply the proceeds of the 2004 Series A Bonds to restructure and refund certain bonds of the Corporation (the "Prior Bonds") issued under several trust agreements (the "Prior Bonds Trust Agreements"). The proceeds of the Prior Bonds were applied by the Corporation to purchase from the Government Development Bank debt obligations of various departments, agencies, instrumentalities and public corporations of the Commonwealth ("Authorized Debtors"). The Prior Bonds are secured by promissory notes of certain Authorized Debtors issued under the Acts (the "Existing Notes").

The portion of the Prior Bonds not being refunded with the proceeds of the Series 2004 Bonds, together with any other bonds of the Corporation issued under the Prior Bonds Trust Agreements, are hereinafter referred to as the "Parity Bonds."

The Series 2004 Bonds will be secured by promissory notes of the Authorized Debtors (the "Series 2004 Notes"), and the Existing Notes have been amended (such notes as so amended, together with any other notes of the Authorized Debtors securing the Parity Bonds, being collectively referred to as the "Parity Notes") to provide that payments under the Series 2004 Notes and the Parity Notes will be paid on a parity from annual Budgetary Appropriations made under the Acts.

Pursuant to the Trust Agreement, the Corporation is authorized to issue additional series of bonds from time to time, upon the terms and conditions set forth therein, to refund other bonds of the Corporation issued under the Acts, to refund the Series 2004 Bonds and any other bonds issued under the Trust Agreement, to fund a reserve account, if any, to pay capitalized interest on any such additional bonds and to pay the costs of issuance of any such additional bonds; and any such bonds will be on a parity with the Series 2004 Bonds, and all other bonds issued under the Trust Agreement (all such additional series of bonds, together with the Series 2004 Bonds, being herein collectively referred to as the "Bonds").

The principal of and the interest on the Series 2004 Bonds and all other Bonds issued under the Trust Agreement are payable solely from the Pledged Revenues (as such term is defined in the Trust Agreement), consisting initially of payments of principal of and interest on the Series 2004 Notes and other funds held by the Trustee under the Trust Agreement. Upon the issuance of additional Bonds under the Trust Agreement for the purpose of providing funds to refund outstanding bonds of the Corporation, the Pledged Revenues shall also include payments of principal of and interest on such additional promissory notes issued by Authorized Debtors for the purpose of securing such Bonds (such notes, together the Series 2004 Notes, being hereinafter referred to as the "Notes"). The principal of and interest on the Notes is payable solely from Legislative Appropriations made by the Legislature of the Commonwealth pursuant to the Acts.

The 2004 Series A Bonds are dated, mature, are payable, bear interest, are subject to redemption and mandatory tender for remarketing, in the manner and upon the terms set forth in the Series 2004 Bond Resolution and the Trust Agreement. The 2004 Series A Bonds are issuable in the form of fully registered bonds in denominations of $5,000 each or any integral multiple thereof and will be initially registered in the name of Cede & Co., as registered owner and nominee for The Depository Trust Company, New York, New York, which will act as securities depository for the 2004 Series A Bonds.

As Bond Counsel, we have examined Act No. 17, Resolution No. 5044, the Acts and such other laws as we have deemed necessary or appropriate for the purposes of rendering the opinions set forth below. We have also examined originals or copies, certified or otherwise identified to our satisfaction, of such instruments, certificates and documents (including all documents constituting the Transcript of Proceedings with respect to the issuance of the Series 2004 Bonds) as we have deemed necessary or appropriate for the purposes of rendering the opinions set forth below. In such examination, we have assumed the genuineness of all signatures, the authenticity and due execution of all documents submitted to us as originals and the conformity to the original documents of all documents submitted to us as copies. As to any facts material to our opinion, without having conducted any independent investigation, we have relied upon, and assumed the accuracy and truthfulness of, the aforesaid instruments, certificates and documents. In addition, in rendering the opinions set forth below, we have relied upon, among other things, certain representations, warranties and covenants made by the Corporation, Government Development Bank, the Authorized Debtors and certain other entities.

The Internal Revenue Code of 1986, as amended (the "Code"), establishes certain requirements that must be met subsequent to the issuance and delivery of the 2004 Series A Bonds in order that interest on the 2004 Series A Bonds be and remain excluded from gross income for federal income tax purposes under Section 103 of the Code. The Corporation, Government Development Bank, the Authorized Debtors and certain other entities have each covenanted to comply with certain provisions and procedures pursuant to which the pertinent Code requirements can be satisfied. Noncompliance with such requirements may cause interest on the 2004 Series A Bonds to become includable in gross income for Federal income tax purposes retroactive to their date of issue, irrespective of the date on which such noncompliance is ascertained. In rendering our opinion below in respect of the Federal income tax treatment of interest on the 2004 Series A Bonds, we have assumed compliance with the aforementioned covenants.

Based upon the foregoing, we are of the opinion that:

1. Act No. 17 has been validly enacted and is in full force and effect, and Resolution No. 5044 has been duly adopted and is in full force and effect, and the Corporation is a duly constituted and existing subsidiary corporation of Government Development Bank and an independent governmental instrumentality of the Commonwealth.

2. The Series 2004 Bond Resolution has been validly and legally adopted.

3. As authorized by Resolution No. 5044 and the Series 2004 Bond Resolution, the Trust Agreement has been duly executed and delivered.

4. The 2004 Series A Bonds have been duly authorized and issued, among other things, to provide funds for the refunding of a portion of the Prior Bonds.

5. The 2004 Series A Bonds are valid and binding obligations of the Corporation, payable solely from the Pledged Revenues.

6. The 2004 Series A Bonds do not constitute a debt of the Commonwealth, any of its public instrumentalities (other than the Corporation) or any of its municipalities or other political subdivisions, and neither the Commonwealth, any of its public instrumentalities (other than the Corporation) nor any of such municipalities or other political subdivisions are liable thereon.

7. Under existing laws, interest on the 2004 Series A Bonds is excludable from gross income for Federal income tax purposes and interest on the 2004 Series A Bonds is not an item of tax preference for purposes of the calculation of the alternative minimum tax imposed under the Code with respect to corporations and individuals. In addition, the 2004 Series A Bonds and interest thereon are exempt from Commonwealth, state and local income taxation.

In rendering this opinion, we are advising you that the enforceability of rights and remedies with respect to the 2004 Series A Bonds, the Series 2004 Bond Resolution and the Trust Agreement may be limited by bankruptcy, insolvency, reorganization, moratorium and other laws affecting creditors' rights or remedies generally heretofore or hereafter enacted, and is subject to general principles of equity (regardless of whether such enforceability is considered in a proceeding in equity or at law).

Except as stated in paragraph 7 above, we express no opinion as to any other federal, Commonwealth or state or local tax consequences of the ownership or disposition of the 2004 Series A Bonds. Furthermore, we express no opinion as to any federal, Commonwealth, state or local tax law consequences with respect to the 2004 Series A Bonds, or the interest thereon, if any action is taken with respect to the 2004 Series A Bonds or the proceeds thereof upon the advice or approval of bond counsel other than ourselves.

We have examined the first executed 2004 Series A Bond and, in our opinion, the form of said 2004 Series A Bond and its execution are regular and proper.

Very truly yours,

## GOVERNMENT DEVELOPMENT BANK FOR PUERTO RICO

The following information has been obtained from Government Development Bank. Neither the Corporation nor the Underwriters have verified such information, and they shall have no liability with respect to such information.

Government Development Bank is a government instrumentality of the Commonwealth created by Act No. 17 of the Legislature of Puerto Rico, approved September 13, 1948, as amended. Government Development Bank's primary purpose is to act as fiscal agent for the Commonwealth and its public entities. In that capacity, Government Development Bank acts as fiscal agent in connection with all short-term borrowings and bond issues of the Commonwealth, its public corporations and municipalities. In addition, Government Development Bank makes loans to the Commonwealth, its public corporations and municipalities, and to the private sector.

As of June 30, 2003, Government Development Bank had total assets of $8.87 billion, total deposits of $3.54 billion and capital of $2.16 billion. For the year ended June 30, 2003, it reported a net increase in net assets of $176.6 million. Government Development Bank's long-term debt is rated "A" by Standard & Poor's. Its short-term debt is rated "A-1" by Standard & Poor's.

The principal offices of Government Development Bank are located at Minillas Government Center, De Diego Avenue, Stop 22, Santurce, Puerto Rico. For more detailed information on Government Development Bank, please refer to its Annual Report for the year ended June 30, 2003, a copy of which may be obtained by calling or writing to Director - New York Office, Government Development Bank for Puerto Rico, 140 Broadway, 38th Floor, New York, NY 10005, telephone number (212) 422-6420 or to Director - Public Finance Department, Government Development Bank for Puerto Rico, P.O. Box 42001, San Juan, PR 00940, telephone number (787) 722-4170.

**APPENDIX V**

# REFUNDED BONDS

The 2004 Series A Bonds are being issued for the purpose of refunding the following bonds of the Corporation:

| Series Refunded | Principal Amount Outstanding | Principal Amount to be Refunded | Interest Rate | Maturity Date | Redemption Date | Redemption Price (% of Par) |
|---|---|---|---|---|---|---|
| 2001 Series E | $ 115,110,000 | $ 115,110,000 | 5.70 % | 08/01/2025 | 02/01/2010 | 100 |
| 2001 Series E | 537,345,000 | 401,645,000 | 5.50 | 08/01/2029 | 02/01/2012 | 100 |
| 2001 Series E | 218,610,000 | 218,610,000 | 5.75 | 08/01/2030 | 02/01/2007 | 100 |
| 2001 Series A | 9,380,000 | 9,380,000 | 4.40 | 08/01/2012 | 08/01/2011 | 100 |
| 2001 Series A | 9,810,000 | 9,810,000 | 4.50 | 08/01/2013 | 08/01/2011 | 100 |
| 2001 Series A | 2,400,000 | 2,400,000 | 4.55 | 08/01/2014 | 08/01/2011 | 100 |
| 2001 Series A | 7,900,000 | 7,900,000 | 5.50 | 08/01/2014 | 08/01/2011 | 100 |
| 2001 Series A | 1,410,000 | 1,410,000 | 4.65 | 08/01/2015 | 08/01/2011 | 100 |
| 2001 Series A | 9,455,000 | 9,455,000 | 5.50 | 08/01/2015 | 08/01/2011 | 100 |
| 2001 Series A | 1,695,000 | 1,695,000 | 4.75 | 08/01/2016 | 08/01/2011 | 100 |
| 2001 Series A | 9,775,000 | 9,775,000 | 5.50 | 08/01/2016 | 08/01/2011 | 100 |
| 2001 Series A | 1,655,000 | 1,655,000 | 4.80 | 08/01/2017 | 08/01/2011 | 100 |
| 2001 Series A | 10,450,000 | 10,450,000 | 5.50 | 08/01/2017 | 08/01/2011 | 100 |
| 2001 Series A | 440,000 | 440,000 | 4.85 | 08/01/2018 | 08/01/2011 | 100 |
| 2001 Series A | 12,340,000 | 12,340,000 | 5.50 | 08/01/2018 | 08/01/2011 | 100 |
| 2001 Series A | 380,000 | 380,000 | 4.90 | 08/01/2019 | 08/01/2011 | 100 |
| 2001 Series A | 13,120,000 | 13,120,000 | 5.50 | 08/01/2019 | 08/01/2011 | 100 |
| 2001 Series A | 555,000 | 555,000 | 4.90 | 08/01/2020 | 08/01/2011 | 100 |
| 2001 Series A | 13,705,000 | 13,705,000 | 5.50 | 08/01/2020 | 08/01/2011 | 100 |
| 2001 Series A | 15,030,000 | 15,030,000 | 5.00 | 08/01/2021 | 08/01/2011 | 100 |
| 2001 Series A | 15,830,000 | 15,830,000 | 5.375 | 08/01/2022 | 08/01/2011 | 100 |
| 2001 Series A | 16,705,000 | 16,705,000 | 5.375 | 08/01/2023 | 08/01/2011 | 100 |
| 2001 Series A | 17,625,000 | 17,625,000 | 5.375 | 08/01/2024 | 08/01/2011 | 100 |
| 2001 Series A | 100,340,000 | 100,340,000 | 5.00 | 08/01/2029 | 08/01/2011 | 100 |
| 2001 Series A | 51,400,000 | 51,400,000 | 5.00 | 08/01/2031 | 08/01/2011 | 100 |
| 1998 Series A | 8,725,000 | 8,725,000 | 4.125 | 06/01/2005 | At maturity | - |
| 1998 Series A | 14,100,000 | 14,100,000 | 5.00 | 06/01/2020 | 06/01/2008 | 101 |
| 1998 Series A | 60,325,000 | 60,325,000 | 5.00 | 06/01/2026 | 06/01/2008 | 101 |

**CDC IXIS Financial Guaranty North America, Inc.**
**825 Third Avenue, Sixth Floor**
**New York, NY 10022**
**For information, contact (212) 909-3939**
**Toll-free (866) 243-4212**

# FINANCIAL GUARANTY INSURANCE POLICY

ISSUER: Policy No.: CIFGNA-#

CUSIP: Effective Date:

OBLIGATIONS:

CDC IXIS FINANCIAL GUARANTY NORTH AMERICA, INC. ("CIFGNA"), for consideration received, hereby UNCONDITIONALLY AND IRREVOCABLY GUARANTEES to each Policyholder, subject only to the terms and conditions of this Policy (which includes each endorsement hereto), the full and complete payment by or on behalf of the Issuer of Regular Payments of principal of and interest on the Obligations.

For the further protection of each Policyholder, CIFGNA irrevocably and unconditionally guarantees:

(1) payment of any amount required to be paid under this Policy by CIFGNA following CIFGNA's receipt of notice and instruments of assignment as described in Endorsement No. 1 hereto and

(2) payment of the amount of any distribution of principal of and interest on the Obligations made during the Term of this Policy to such Policyholder that is subsequently avoided in whole or in part as a preference payment under applicable law (such payment to be made by CIFGNA in accordance with Endorsement No. 1 hereto).

CIFGNA shall be subrogated to the rights of each Policyholder to receive payments under the Obligations to the extent of any payment by CIFGNA hereunder. Upon disbursement in respect of an Obligation, CIFGNA shall become the owner of the Obligation, appurtenant coupon, if any, and all rights to payment of principal thereof or interest thereon.

The following terms shall have the meanings specified below, subject to and including any modifications set forth in any endorsement hereto, for all purposes of this Policy. "Policyholder" means, if the Obligations are in book-entry form, the registered owner of any Obligation as indicated on the registration books maintained by or on behalf of the Issuer for such purpose or, if the Obligations are in bearer form, the holder of any Obligation; *provided, however, that* any trustee acting on behalf of and for the benefit of such registered owner or holder shall be deemed to be the Policyholder to the extent of such trustee's authority. "Regular Payments" means payments of interest and principal which are agreed to be made during the Term of this Policy in accordance with the original terms of the Obligations when issued and without regard to any amendment or modification of such Obligations thereafter; payments which become due on an accelerated basis as a result of (a) a default by the Issuer or any other person, (b) an election by the Issuer to pay principal or other amounts on an accelerated basis or (c) any other cause, shall not constitute "Regular Payments" unless CIFGNA shall elect, in its sole discretion, to pay such principal due upon such acceleration together with any accrued interest to the date of acceleration. "Term of this Policy" shall have the meaning set forth in Endorsement No. 1 hereto.

This Policy sets forth in full the undertaking of CIFGNA, and shall not be modified, altered or affected by any other agreement or instrument, including any modification or amendment thereto or to the Obligations, except a contemporaneous or subsequent agreement or instrument given by CIFGNA or to which CIFGNA has given its written consent, or by the merger, consolidation or dissolution of the Issuer. The premiums paid in respect of this Policy are nonrefundable for any reason whatsoever, including payment, or provision being made for payment, of the Obligations prior to maturity. This Policy may not be cancelled or revoked during the Term of this Policy, including for nonpayment of premium due to CIFGNA. Payments under this Policy may not be accelerated except at the sole option of CIFGNA.

In witness whereof, CDC IXIS FINANCIAL GUARANTY NORTH AMERICA, INC. has caused this Policy to be executed on its behalf by its Authorized Officer.

CDC IXIS FINANCIAL GUARANTY NORTH AMERICA, INC.

By ______________________________
Authorized Officer

FORM #CIFGNA Bonds-1 (7-03)

ENDORSEMENT NO. 1
TO FINANCIAL GUARANTY INSURANCE POLICY NO. CIFGNA-##

CDC IXIS FINANCIAL GUARANTY NORTH AMERICA, INC.



1. Definitions. For all purposes of this Policy, the terms specified below shall have the meanings or constructions provided below. Capitalized terms used without definition herein shall have the meanings provided in the documents governing the Obligations unless the context shall otherwise require.

"Business Day" means any day (other than a Saturday or Sunday) that in the City of New York is neither a legal holiday nor a day on which banking institutions are authorized or obligated by law or executive order to be closed.

"CIFGNA" means CDC IXIS Financial Guaranty North America, Inc. and its successors and permitted assigns.

"Obligations" means the Obligations referenced on the first page of this Policy.

"Policy" means this Financial Guaranty Insurance Policy and includes each endorsement thereto.

"Receipt" and "Received" mean actual delivery to each of CIFGNA and the Fiscal Agent (as defined below), if any, prior to 12:00 noon, New York City time, on a Business Day; delivery either on a day that is not a Business Day, or after 12:00 noon, New York City time, shall be deemed to be Receipt on the next succeeding Business Day. If any notice or certificate given hereunder by the Policyholder is not in proper form or is not properly completed, executed or delivered in all material respects, it shall be deemed not to have been Received, and CIFGNA or its Fiscal Agent shall promptly so advise the Policyholder and the Policyholder may submit an amended notice.

"Regular Payment Date" means (i), when referring to interest on an Obligation, the stated date for payment of interest and (ii), when referring to the principal of an Obligation, the stated final maturity date thereof or the date on which the same shall have been duly called for mandatory redemption (by sinking fund or otherwise) and does not refer to any earlier date on which payment is due by reason of call for redemption (other than by such mandatory redemption), acceleration or other advancement of maturity unless CIFGNA shall elect, in its sole discretion, to pay such principal due upon such acceleration together with any accrued interest to the date of acceleration.

"Regular Payments" means any and all regularly scheduled payments of principal of and interest on the Obligations required to be made in accordance with their original terms and without regard to any subsequent amendment or modification thereof except amendments or modifications to which CIFGNA has given its prior written consent. Regular Payments shall not include, nor shall coverage be provided under this Policy in respect of: (1) payments which become due on an accelerated basis as a result of (a) a default by the Issuer or any other person, (b) an election by the Issuer to make payment on an accelerated basis, (c) early or rapid amortization of the Obligations, or (d) any other cause, unless CIFGNA shall elect, in its sole discretion, to pay any amount due upon such acceleration together with any accrued interest to the date of acceleration; (2) any amounts due in respect of the Obligations attributable to any increase in interest rate, penalty or other sum payable by the Issuer by reason of any default or event of default in respect of the Obligations, whether by the Issuer or any other person, or by reason of any deterioration of the creditworthiness of the Issuer or any other person, or (3) any taxes, withholding or other charge imposed by any governmental authority due in connection with the payment of any Regular Payment to the Policyholder.

"Term of this Policy" means the period from and including the Effective Date to and including the date on which (i) all Regular Payments have been paid and the Obligations have been terminated in accordance with their terms; (ii) any period during which any Regular Payment could have been avoided in whole or in part as a preference payment under applicable bankruptcy, insolvency, receivership or similar law shall have expired; and (iii) if any proceedings requisite to avoidance as a preference payment have been commenced prior to the occurrence of (i) and (ii), a final and nonappealable order in resolution of each such proceeding has been entered.

2. Notices and Conditions to Payment in Respect of Regular Payments. Following Receipt by CIFGNA of a notice of claim and certificate from the Policyholder in the form attached as Exhibit A to this Endorsement (a "Notice of Claim and Certificate"), CIFGNA will pay any amount payable hereunder in respect of Regular Payments on the Obligations on (i) in respect of the first Regular Payment Date after Receipt by CIFGNA of such Notice of Claim and Certificate, the later to occur of (a) 10:00 a.m., New York City time, on the Business Day following such Receipt and (b) 10:00 a.m., New York City time, on the Regular Payment Date on which such payment is due on the Obligations and (ii) in respect of each subsequent Regular Payment Date after Receipt by CIFGNA of such Notice of Claim and Certificate, 10:00 a.m., New York City time, on the Regular Payment Date on which such payment is due on the Obligations. Payments due hereunder in respect of Regular Payments will be disbursed to the Policyholder by wire transfer of immediately available funds to such account as the Policyholder shall specify in writing at the time of or prior to the delivery of the Notice of Claim and Certificate in respect of such Regular Payment.

CIFGNA shall be entitled to pay any amount hereunder in respect of Regular Payments on the Obligations, including any amount payable upon its election on the Obligations on an accelerated basis, whether or not any notice and certificate shall have been Received by CIFGNA as provided above; provided, however, that by acceptance of this Policy the Policyholder agrees to provide upon request to CIFGNA a Notice of Claim and Certificate in respect of any such payments or deliveries made by CIFGNA. CIFGNA's obligation hereunder in respect of Regular Payments shall be discharged to the extent funds are disbursed by CIFGNA as provided herein whether or not such funds are properly applied by any custodian or agent appointed by the Policyholder.

3. Notices and Conditions to Payment in Respect of Regular Payments Avoided as Preference Payments. If any Regular Payment is avoided as a preference payment under applicable bankruptcy, insolvency, receivership or similar law, CIFGNA will pay such amount out of the funds of CIFGNA on the later of (a) the date when due to be paid pursuant to the Order referred to below or (b) the first to occur of (i) the fourth Business Day following Receipt by CIFGNA from the Policyholder of (A) a certified copy of the order of the court or other governmental body of competent jurisdiction to the effect that the Policyholder is required to return principal or interest paid on the Obligations during the term of this Policy because such payments were avoidable as preference payments under applicable bankruptcy law (the "Order"), (B) a certificate of the Policyholder that the Order has been entered and is not subject to any stay and (C) an assignment duly executed and delivered by the Policyholder in such form as is reasonably required by CIFGNA, and provided to the Policyholder by CIFGNA, irrevocably assigning to CIFGNA all rights and claims of the Policyholder relating to or arising under the Obligations against the estate of the Issuer or otherwise with respect to such preference payment or (ii) the date of Receipt by CIFGNA from the Policyholder of the items referred to in clauses (A), (B) and (C) above if, at least four Business Days prior to such date of Receipt, CIFGNA shall have Received written notice from the Policyholder that such items were to be delivered on such date and such date was specified in such notice. Such payment shall be disbursed to the receiver, conservator, debtor-in-possession or trustee in bankruptcy named in the Order, and not the Policyholder directly (unless the Policyholder has previously paid such amount to the receiver, conservator, debtor-in-possession or trustee in bankruptcy named in the Order, in which case such payment shall be disbursed to the Policyholder upon proof of such payment reasonably satisfactory to CIFGNA).

4. Fiscal Agent. At any time during the Term of this Policy, CIFGNA may appoint a fiscal agent (the "Fiscal Agent") for purposes of this Policy by written notice to the Policyholder at the notice address specified in the documents governing the Obligations specifying the name and notice address of the Fiscal Agent. From and after the date of receipt of such notice by the Policyholder, (i) copies of all notices and documents required to be delivered to CIFGNA pursuant to this Policy shall be simultaneously delivered to the Fiscal Agent and CIFGNA and shall not be deemed Received until Received by each, and (ii) all payments required to be made by CIFGNA under this Policy may be made directly by CIFGNA or by the Fiscal Agent on behalf of CIFGNA. The Fiscal Agent is the agent of CIFGNA only and the Fiscal Agent shall in no event be liable to any Policyholder for any acts of the Fiscal Agent or any failure of CIFGNA to deposit, or cause to be deposited, sufficient funds to make payments due under the Policy.

5. Notices. All notices to be given hereunder shall be in writing (except as otherwise specifically provided herein) and shall be mailed by registered mail or personally delivered or telecopied to CIFGNA as follows:

CDC IXIS Financial Guaranty North America, Inc.
825 Third Avenue, Sixth Floor
New York, New York 10022
Attention: General Counsel
Telecopy No.: (212) 909-3959

CIFGNA may specify a different address or addresses by writing mailed or delivered to the Policyholder.

6. Priorities. In the event that any term or provision of the face of this Policy is inconsistent with the provisions of this Endorsement, the provisions of this Endorsement shall take precedence and shall be binding.

7. Assignment of CIFGNA Obligations. The obligations of CIFGNA hereunder may be assigned to any affiliate of CIFGNA that is licensed as a financial guaranty insurance corporation, provided that at the time of such assignment the insurance strength or insurance financial strength of such affiliate is rated at least equal to the insurance strength or insurance financial strength of CIFGNA, and that the rating of the Obligations shall not have been reduced as a result of such assignment, by Moody's Investors Service and Standard & Poor's Ratings Group or their respective successors as nationally recognized statistical rating organizations.

8. Surrender of Policy. The Policyholder shall surrender this Policy to CIFGNA for cancellation upon expiration of the Term of this Policy.

IN WITNESS WHEREOF, CDC IXIS FINANCIAL GUARANTY NORTH AMERICA, INC. has caused this Endorsement No. 1 to be executed by its Authorized Officer.

CDC IXIS FINANCIAL GUARANTY NORTH AMERICA, INC.

By ____________________________________
Authorized Officer

Exhibit A
To Endorsement No. 1

NOTICE OF CLAIM AND CERTIFICATE

CDC IXIS Financial Guaranty North America, Inc.
825 Third Avenue, Sixth Floor
New York, NY 10022

The undersigned, a duly authorized officer of [Policyholder] (or any permitted successor or assignee of its rights under the Obligations defined below) (the "Policyholder"), hereby certifies to CDC IXIS Financial Guaranty North America, Inc. ("CIFGNA"), with reference to Financial Guaranty Insurance Policy No. CIFGNA-## having an Effective Date of [month] [date], 200# (the "Policy") issued by CIFGNA in respect of the Obligations (capitalized terms used without definition herein having the meanings provided in the Policy unless the context shall otherwise require), that:

(i) The Policyholder is the Policyholder under the Policy.

(ii) [The Policyholder has not been timely advised in writing by the Issuer as to a source of funds reasonably satisfactory to the Policyholder sufficient to make payment in full of a Regular Payment required to be made on the immediately following Regular Payment Date] [The Regular Payment required to be made on the Regular Payment Date falling on [date] has not been paid in full]. The Regular Payment has been calculated as follows: [show calculation].

(iii) Accordingly, the Policyholder is hereby making a claim under the Policy for the amount of the foregoing Regular Payment and, when due, any subsequent Regular Payments. The Policyholder will withdraw this Notice of Claim and Certificate, or submit a restated Notice of Claim and Certificate reducing the amount of the claim hereunder, if the required amount of any Regular Payment has been reduced (including reduction to zero) on or prior to any date on which CIFGNA is required to make payment or delivery under the Policy.

(iv) If the Policyholder receives from the Issuer and CIFGNA an amount in excess of a Regular Payment, the Policyholder shall immediately return the excess amount to CIFGNA.

(v) In consideration of the payments made and to be made to the Policyholder by CIFGNA under the Policy, the Policyholder hereby assigns to CIFGNA all of its interest in and rights with respect to the Obligations (including the documents governing the Obligations). The foregoing assignment is in addition to, and not in limitation of, rights of subrogation otherwise available to CIFGNA in respect of such payments. Payments to CIFGNA in respect of the foregoing assignment shall in all cases be subject to and subordinate to the rights of the Policyholder to receive all Regular Payments in respect of the aforementioned Obligations. The Policyholder shall take such action and deliver such instruments as may be reasonably requested or required by CIFGNA to effectuate the purpose or provisions of this clause (v).

(vi) The Policyholder hereby agrees that, so long as no CIFGNA Termination Event (as defined below) shall have occurred and be continuing, CIFGNA may at any time during the continuation of any proceeding by or against the Issuer under any applicable bankruptcy, insolvency, receivership, rehabilitation or similar law (an "Insolvency Proceeding") direct all matters relating to such Insolvency Proceeding, including without limitation, (A) all matters relating to such Insolvency Proceeding seeking the avoidance as a preferential transfer of any payment made with respect to the Obligations (a "Preference Claim"), (B) the direction of any appeal of any order relating to any Preference Claim at the expense of CIFGNA and (C) the posting of any surety, supersedeas or performance bond pending any such appeal. In addition, so long as no CIFG Termination Event shall have occurred and be continuing, the Policyholder hereby agrees that CIFGNA shall be subrogated to, and the Policyholder hereby assigns, to the fullest extent permitted by law, the rights of the Policyholder in the conduct of any Insolvency Proceeding, including, without limitation, all rights of any party to an adversary proceeding or action with respect to any court order issued in connection with any such Insolvency Proceeding. A "CIFGNA Termination Event" shall be any event of default specified in the documents governing the Obligations with respect to CIFGNA as insurer of the Obligations or, if none is so specified, any of: (i) CIFGNA's failure to make a payment required under the Guaranty in accordance with its terms; (ii) its institution of a proceeding seeking a judgment of insolvency or bankruptcy; (iii) the institution against it of such a proceeding or petition that is not dismissed, discharged or stayed within 180 days of the institution of such a proceeding or petition; (iv) the appointment of an administrator, provisional liquidator, conservator, receiver, trustee, custodian or other similar official for it or for all or substantially all of its assets; or (v) its making of a general assignment for the benefit of its creditors.

(vii) Payment should be made by wire transfer directed to the following account in [city]:

[Policyholder's wire transfer information]

IN WITNESS WHEREOF, the Policyholder has executed and delivered this Notice of Claim and Certificate as of the _____________ day of ______________, ______________.

[POLICYHOLDER]

By_________________________

Title________________________

---

For CIFGNA or
Fiscal Agent Use Only

Wire transfer sent on _____________________ by _____________________

Confirmation Number ____________________

# FINANCIAL GUARANTY INSURANCE POLICY

## MBIA Insurance Corporation
## Armonk, New York 10504

Policy No. [NUMBER]

MBIA Insurance Corporation (the "Insurer"), in consideration of the payment of the premium and subject to the terms of this policy, hereby unconditionally and irrevocably guarantees to any owner, as hereinafter defined, of the following described obligations, the full and complete payment required to be made by or on behalf of the Issuer to [PAYING AGENT/TRUSTEE] or its successor (the "Paying Agent") of an amount equal to (i) the principal of (either at the stated maturity or by any advancement of maturity pursuant to a mandatory sinking fund payment) and interest on, the Obligations (as that term is defined below) as such payments shall become due but shall not be so paid (except that in the event of any acceleration of the due date of such principal by reason of mandatory or optional redemption or acceleration resulting from default or otherwise, other than any advancement of maturity pursuant to a mandatory sinking fund payment, the payments guaranteed hereby shall be made in such amounts and at such times as such payments of principal would have been due had there not been any such acceleration); and (ii) the reimbursement of any such payment which is subsequently recovered from any owner pursuant to a final judgment by a court of competent jurisdiction that such payment constitutes an avoidable preference to such owner within the meaning of any applicable bankruptcy law. The amounts referred to in clauses (i) and (ii) of the preceding sentence shall be referred to herein collectively as the "Insured Amounts." "Obligations" shall mean:

**[PAR]**
**[LEGAL NAME OF ISSUE]**

Upon receipt of telephonic or telegraphic notice, such notice subsequently confirmed in writing by registered or certified mail, or upon receipt of written notice by registered or certified mail, by the Insurer from the Paying Agent or any owner of an Obligation the payment of an Insured Amount for which is then due, that such required payment has not been made, the Insurer on the due date of such payment or within one business day after receipt of notice of such nonpayment, whichever is later, will make a deposit of funds, in an account with U.S. Bank Trust National Association, in New York, New York, or its successor, sufficient for the payment of any such Insured Amounts which are then due. Upon presentment and surrender of such Obligations or presentment of such other proof of ownership of the Obligations, together with any appropriate instruments of assignment to evidence the assignment of the Insured Amounts due on the Obligations as are paid by the Insurer, and appropriate instruments to effect the appointment of the Insurer as agent for such owners of the Obligations in any legal proceeding related to payment of Insured Amounts on the Obligations, such instruments being in a form satisfactory to U.S. Bank Trust National Association, U.S. Bank Trust National Association shall disburse to such owners, or the Paying Agent payment of the Insured Amounts due on such Obligations, less any amount held by the Paying Agent for the payment of such Insured Amounts and legally available therefor. This policy does not insure against loss of any prepayment premium which may at any time be payable with respect to any Obligation.

As used herein, the term "owner" shall mean the registered owner of any Obligation as indicated in the books maintained by the Paying Agent, the Issuer, or any designee of the Issuer for such purpose. The term owner shall not include the Issuer or any party whose agreement with the Issuer constitutes the underlying security for the Obligations.

Any service of process on the Insurer may be made to the Insurer at its offices located at 113 King Street, Armonk, New York 10504 and such service of process shall be valid and binding.

This policy is non-cancellable for any reason. The premium on this policy is not refundable for any reason including the payment prior to maturity of the Obligations.

IN WITNESS WHEREOF, the Insurer has caused this policy to be executed in facsimile on its behalf by its duly authorized officers, this [DAY] day of [MONTH, YEAR].

**MBIA Insurance Corporation**

SPECIMEN

______________________________
President

Attest: ______________________________
Assistant Secretary

STD-R-6
4/95

Ambac

# Financial Guaranty Insurance Policy

Ambac Assurance Corporation
One State Street Plaza, 15th Floor
New York, New York 10004
Telephone: (212) 668-0340

Obligor: Policy Number:

Obligations: Premium:

Ambac Assurance Corporation (Ambac), a Wisconsin stock insurance corporation, in consideration of the payment of the premium and subject to the terms of this Policy, hereby agrees to pay to The Bank of New York, as trustee, or its successor (the "Insurance Trustee"), for the benefit of the Holders, that portion of the principal of and interest on the above-described obligations (the "Obligations") which shall become Due for Payment but shall be unpaid by reason of Nonpayment by the Obligor.

Ambac will make such payments to the Insurance Trustee within one (1) business day following written notification to Ambac of Nonpayment. Upon a Holder's presentation and surrender to the Insurance Trustee of such unpaid Obligations or related coupons, uncanceled and in bearer form and free of any adverse claim, the Insurance Trustee will disburse to the Holder the amount of principal and interest which is then Due for Payment but is unpaid. Upon such disbursement, Ambac shall become the owner of the surrendered Obligations and/or coupons and shall be fully subrogated to all of the Holder's rights to payment thereon.

In cases where the Obligations are issued in registered form, the Insurance Trustee shall disburse principal to a Holder only upon presentation and surrender to the Insurance Trustee of the unpaid Obligation, uncanceled and free of any adverse claim, together with an instrument of assignment, in form satisfactory to Ambac and the Insurance Trustee duly executed by the Holder or such Holder's duly authorized representative, so as to permit ownership of such Obligation to be registered in the name of Ambac or its nominee. The Insurance Trustee shall disburse interest to a Holder of a registered Obligation only upon presentation to the Insurance Trustee of proof that the claimant is the person entitled to the payment of interest on the Obligation and delivery to the Insurance Trustee of an instrument of assignment, in form satisfactory to Ambac and the Insurance Trustee, duly executed by the Holder or such Holder's duly authorized representative, transferring to Ambac all rights under such Obligation to receive the interest in respect of which the insurance disbursement was made. Ambac shall be subrogated to all of the Holders' rights to payment on registered Obligations to the extent of any insurance disbursements so made.

In the event that a trustee or paying agent for the Obligations has notice that any payment of principal of or interest on an Obligation which has become Due for Payment and which is made to a Holder by or on behalf of the Obligor has been deemed a preferential transfer and theretofore recovered from the Holder pursuant to the United States Bankruptcy Code in accordance with a final, nonappealable order of a court of competent jurisdiction, such Holder will be entitled to payment from Ambac to the extent of such recovery if sufficient funds are not otherwise available.

As used herein, the term "Holder" means any person other than (i) the Obligor or (ii) any person whose obligations constitute the underlying security or source of payment for the Obligations who, at the time of Nonpayment, is the owner of an Obligation or of a coupon relating to an Obligation. As used herein, "Due for Payment", when referring to the principal of Obligations, is when the scheduled maturity date or mandatory redemption date for the application of a required sinking fund installment has been reached and does not refer to any earlier date on which payment is due by reason of call for redemption (other than by application of required sinking fund installments), acceleration or other advancement of maturity; and, when referring to interest on the Obligations, is when the scheduled date for payment of interest has been reached. As used herein, "Nonpayment" means the failure of the Obligor to have provided sufficient funds to the trustee or paying agent for payment in full of all principal of and interest on the Obligations which are Due for Payment.

This Policy is noncancelable. The premium on this Policy is not refundable for any reason, including payment of the Obligations prior to maturity. This Policy does not insure against loss of any prepayment or other acceleration payment which at any time may become due in respect of any Obligation, other than at the sole option of Ambac, nor against any risk other than Nonpayment.

In witness whereof, Ambac has caused this Policy to be affixed with a facsimile of its corporate seal and to be signed by its duly authorized officers in facsimile to become effective as its original seal and signatures and binding upon Ambac by virtue of the countersignature of its duly authorized representative.

Robert J. Genader
President

Anne G. Gill
Secretary

Effective Date:

Authorized Representative

THE BANK OF NEW YORK acknowledges that it has agreed to perform the duties of Insurance Trustee under this Policy.

Authorized Officer of Insurance Trustee

Form No.: 2B-0012 (1/01)

FGIC

**Financial Guaranty Insurance Company**
125 Park Avenue
New York, NY 10017
T 212·312·3000
T 800·352·0001

# Municipal Bond
# New Issue Insurance Policy

| | |
|---|---|
| **Issuer:** | **Policy Number:** |
| | **Control Number:** 0010001 |
| **Bonds:** | **Premium:** |



Financial Guaranty Insurance Company ("Financial Guaranty"), a New York stock insurance company, in consideration of the payment of the premium and subject to the terms of this Policy, hereby unconditionally and irrevocably agrees to pay to U.S. Bank Trust National Association or its successor, as its agent (the "Fiscal Agent"), for the benefit of Bondholders, that portion of the principal and interest on the above-described debt obligations (the "Bonds") which shall become Due for Payment but shall be unpaid by reason of Nonpayment by the Issuer.

Financial Guaranty will make such payments to the Fiscal Agent on the date such principal or interest becomes Due for Payment or on the Business Day next following the day on which Financial Guaranty shall have received Notice of Nonpayment, whichever is later. The Fiscal Agent will disburse to the Bondholder the face amount of principal and interest which is then Due for Payment but is unpaid by reason of Nonpayment by the Issuer but only upon receipt by the Fiscal Agent, in form reasonably satisfactory to it, of (i) evidence of the Bondholder's right to receive payment of the principal or interest Due for Payment and (ii) evidence, including any appropriate instruments of assignment, that all of the Bondholder's rights to payment of such principal or interest Due for Payment shall thereupon vest in Financial Guaranty. Upon such disbursement, Financial Guaranty shall become the owner of the Bond, appurtenant coupon or right to payment of principal or interest on such Bond and shall be fully subrogated to all of the Bondholder's rights thereunder, including the Bondholder's right to payment thereof.

This Policy is non-cancellable for any reason. The premium on this Policy is not refundable for any reason, including the payment of the Bonds prior to their maturity. This Policy does not insure against loss of any prepayment premium which may at any time be payable with respect to any Bond.

As used herein, the term "Bondholder" means, as to a particular Bond, the person other than the Issuer who, at the time of Nonpayment, is entitled under the terms of such Bond to payment thereof. "Due for Payment" means, when referring to the principal of a Bond, the stated maturity date thereof or the date on which the same shall have been duly called for mandatory sinking fund redemption and does not refer to any earlier date on which payment is due by reason of call for redemption (other than by mandatory sinking fund redemption), acceleration or other advancement of maturity and means, when referring to interest on a Bond, the stated date for payment of interest. "Nonpayment" in respect of a Bond means the failure of the Issuer to have provided sufficient funds to the paying agent for payment in full of all

FGIC

**Financial Guaranty Insurance Company**
125 Park Avenue
New York, NY 10017
T 212·312·3000
T 800·352·0001

# Municipal Bond
# New Issue Insurance Policy

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principal and interest Due for Payment on such Bond. "Notice" means telephonic or telegraphic notice, subsequently confirmed in writing, or written notice by registered or certified mail, from a Bondholder or a paying agent for the Bonds to Financial Guaranty. "Business Day" means any day other than a Saturday, Sunday or a day on which the Fiscal Agent is authorized by law to remain closed.

In Witness Whereof, Financial Guaranty has caused this Policy to be affixed with its corporate seal and to be signed by its duly authorized officer in facsimile to become effective and binding upon Financial Guaranty by virtue of the countersignature of its duly authorized representative.



Frank Bivona

**President**

**Effective Date:**

**Authorized Representative**

U.S. Bank Trust National Association, acknowledges that it has agreed to perform the duties of Fiscal Agent under this Policy.

**Authorized Officer**

FGIC

**Financial Guaranty Insurance Company**
125 Park Avenue
New York, NY 10017
T 212·312·3000
T 800·352·0001

# Endorsement

## To Financial Guaranty Insurance Company Insurance Policy

| **Policy Number:** | **Control Number:** 0010001 |
|---|---|



It is further understood that the term "Nonpayment" in respect of a Bond includes any payment of principal or interest made to a Bondholder by or on behalf of the issuer of such Bond which has been recovered from such Bondholder pursuant to the United States Bankruptcy Code by a trustee in bankruptcy in accordance with a final, nonappealable order of a court having competent jurisdiction.

NOTHING HEREIN SHALL BE CONSTRUED TO WAIVE, ALTER, REDUCE OR AMEND COVERAGE IN ANY OTHER SECTION OF THE POLICY. IF FOUND CONTRARY TO THE POLICY LANGUAGE, THE TERMS OF THIS ENDORSEMENT SUPERSEDE THE POLICY LANGUAGE.

In Witness Whereof, Financial Guaranty has caused this Endorsement to be affixed with its corporate seal and to be signed by its duly authorized officer in facsimile to become effective and binding upon Financial Guaranty by virtue of the countersignature of its duly authorized representative.

**President**

**Effective Date:**

**Authorized Representative**

**Acknowledged as of the Effective Date written above:**

**Authorized Officer**
**U.S. Bank Trust National Association, as Fiscal Agent**