NEW ISSUE - BOOK-ENTRY
See "Book-Entry Only System" under *The Bonds*

*In the opinion of Squire, Sanders & Dempsey L.L.P., Bond Counsel, under existing law, (i) assuming continuing compliance with certain covenants and the accuracy of certain representations and, in the case of the Refunding Bonds, assuming among other matters no Change in Law, as described in this Official Statement in "Delayed Delivery of the Refunding Bonds" under Plan of Financing, interest on the Bonds is excluded from gross income for federal income tax purposes and is not an item of tax preference for purposes of the federal alternative minimum tax imposed on individuals and corporations, and (ii) the Bonds and the interest thereon are exempt from state, Commonwealth of Puerto Rico and local income taxation. Interest on the Bonds may be subject to certain federal taxes imposed only on certain corporations, including the corporate alternative minimum tax on a portion of that interest. For a more complete discussion of the tax aspects, see the discussion under "Tax Matters" herein.*

# $555,295,000
# COMMONWEALTH OF PUERTO RICO
## $460,000,000 Public Improvement Bonds of 2003, Series A
## $95,295,000 Public Improvement Refunding Bonds, Series 2003
## (General Obligation Bonds)

Dated: Date of Delivery | Due: July 1, as shown below

The Bonds are issuable as registered bonds without coupons in denominations of $5,000 or any multiple thereof. Interest on the Public Improvement Bonds of 2003, Series A (the "Public Improvement Bonds") will be payable January 1, 2003 and each July 1 and January 1 thereafter. Interest on the Public Improvement Refunding Bonds, Series 2003 (the "Refunding Bonds," and together with the Public Improvement Bonds, the "Bonds") will be payable July 1, 2003 and each January 1 and July 1 thereafter. Certain of the Public Improvement Bonds are subject to redemption prior to maturity as set forth herein, the earliest possible date of redemption being July 1, 2012. See *The Bonds.*

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

The Bonds are offered for delivery when, as and if issued and accepted by the Underwriters subject to the approval of legality by Squire, Sanders & Dempsey L.L.P., Miami, Florida, Bond Counsel, and certain other conditions. Certain legal matters will be passed upon for the Underwriters by Pietrantoni Méndez & Alvarez LLP, San Juan, Puerto Rico. It is expected that settlement for the Public Improvement Bonds will occur in New York, New York, on or about August 8, 2002. It is expected that settlement for the Refunding Bonds will occur in New York, New York, on or about April 2, 2003.

LEHMAN BROTHERS    GOLDMAN, SACHS & CO.    UBS PAINEWEBBER INC.

ABN AMRO FINANCIAL SERVICES, INC.    BANC OF AMERICA SECURITIES LLC

BEAR, STEARNS & CO. INC.    MERRILL LYNCH & CO.    MORGAN STANLEY

SALOMON SMITH BARNEY    WACHOVIA BANK, NATIONAL ASSOCIATION

July 18, 2002

# $555,295,000
## COMMONWEALTH OF PUERTO RICO
## $460,000,000 Public Improvement Bonds of 2003, Series A
## $95,295,000 Public Improvement Refunding Bonds, Series 2003
## (General Obligation Bonds)

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### $460,000,000 Public Improvement Bonds of 2003, Series A

| Maturity | Amount | Interest Rate | Yield |
|---|---|---|---|
| 2008† | $ 9,255,000 | 5¼% | 3.10% |
| 2009† | 9,740,000 | 5¼ | 3.33 |
| 2010† | 10,250,000 | 4¾ | 3.55 |
| 2011† | 10,740,000 | 5¼ | 3.68 |
| 2012† | 11,300,000 | 5¼ | 3.78 |
| 2013† | 11,895,000 | 5½ | 3.90 |
| 2014† | 12,550,000 | 5½ | 4.02 |
| 2015† | 13,240,000 | 5½ | 4.13 |
| 2016† | 13,970,000 | 5½ | 4.21 |
| 2017† | 14,735,000 | 5½ | 4.29 |
| 2018† | 15,545,000 | 5½ | 4.37 |
| 2019† | 16,400,000 | 5½ | 4.45 |
| 2020† | 17,305,000 | 5½ | 4.54 |
| 2021† | 18,255,000 | 5½ | 4.60 |
| 2022† | 19,260,000 | 5½ | 4.66 |
| 2032† | 13,000,000 | 4.80 | 4.99 |

$112,270,000 5% Term Bonds due July 1, 2027 —Yield - 5.14 %

$130,290,000 5% Term Bonds due July 1, 2032 —Yield - 5.02%†

### $95,295,000 Public Improvement Refunding Bonds, Series 2003

| Maturity | Amount | Interest Rate | Yield |
|---|---|---|---|
| 2011† | $35,680,000 | 5½% | 4.03% |
| 2012† | 37,630,000 | 5½ | 4.13 |
| 2013† | 21,985,000 | 5½ | 4¼ |

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†Insured by Financial Guaranty Insurance Company.

# Commonwealth of Puerto Rico

**Governor**

SILA M. CALDERÓN

**Members of the Cabinet**

CÉSAR MIRANDA
*Chief of Staff*

FERDINAND MERCADO
*Secretary of State*

ANABELLE RODRÍGUEZ
*Secretary of Justice*

JUAN A. FLORES GALARZA
*Secretary of the Treasury*

CÉSAR REY
*Secretary of Education*

VÍCTOR RIVERA HERNÁNDEZ
*Secretary of Labor and Human Resources*

JOHNNY RULLÁN
*Secretary of Health*

LUIS RIVERO CUBANO
*Secretary of Agriculture*

JOSÉ IZQUIERDO
*Secretary of Transportation and Public Works*

RAMÓN CANTERO-FRAU
*Secretary of Economic Development and Commerce*

YOLANDA ZAYAS
*Secretary of Family Affairs*

ILEANA ECHEGOYEN
*Secretary of Housing*

SALVADOR SALAS
*Secretary of Natural and Environmental Resources*

RAFAEL CINTRÓN PERALES
*Acting Secretary of Consumer Affairs*

JORGE ROSARIO
*Secretary of Sports and Recreation*

VÍCTOR RIVERA GONZÁLEZ
*Secretary of Corrections and Rehabilitation*

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*Legislative Officers*

ANTONIO FAS ALZAMORA
President, Senate

CARLOS VIZCARRONDO
Speaker, House of Representatives

*Fiscal Officers*

MELBA ACOSTA
Director, Office of Management and Budget

HÉCTOR MÉNDEZ
President, Government Development Bank for Puerto Rico

No dealer, broker, sales representative or other person has been authorized by the Commonwealth 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 Commonwealth or any Underwriter. This Official Statement does not constitute an offer to sell or the solicitation of an offer to buy, nor shall there be any sale of the Bonds, by any person in any jurisdiction in which it is unlawful for such person to make such an offer, solicitation or sale. The information set forth herein has been obtained from the Commonwealth and other official sources that are believed to be reliable. The information and expressions of opinion herein are subject to change without notice, and neither the delivery of this Official Statement nor any sale made hereunder shall, under any circumstances, create any implication that there has been no change in the affairs of the Commonwealth since the date hereof. The Underwriters have provided the following sentence 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 BONDS AND THE COMMONWEALTH'S OUTSTANDING GENERAL OBLIGATION BONDS AT LEVELS ABOVE THOSE WHICH MIGHT OTHERWISE PREVAIL IN THE OPEN MARKET. SUCH STABILIZING, IF COMMENCED, MAY BE DISCONTINUED AT ANY TIME.

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# $555,295,000
# Commonwealth of Puerto Rico
## $460,000,000 Public Improvement Bonds of 2003, Series A
## $95,295,000 Public Improvement Refunding Bonds, Series 2003
## (General Obligation Bonds)

### INTRODUCTORY STATEMENT

This Official Statement of the Commonwealth of Puerto Rico (the "Commonwealth" or "Puerto Rico"), which includes the cover page, the inside cover page, the appendices hereto and the report incorporated by reference below, provides certain information in connection with the sale of $460,000,000 Commonwealth of Puerto Rico Public Improvement Bonds of 2003, Series A (the "Public Improvement Bonds") and $95,295,000Commonwealth of Puerto Rico Public Improvement Refunding Bonds, Series 2003 (the "Refunding Bonds" and together with the Public Improvement Bonds, the "Bonds").

The Public Improvement Bonds are being issued under the provisions of Act No. 100 of the Legislature of Puerto Rico, approved July 12, 2002 ("Act No. 100"), and pursuant to a resolution authorizing the issuance of the Public Improvement Bonds (the "Public Improvement Bond Resolution") adopted by the Secretary of the Treasury and approved by the Acting Governor of Puerto Rico on July 18, 2002. The Refunding Bonds are being issued under the provisions of Act No. 33 of the Legislature of Puerto Rico, approved December 7, 1942 ("Act No. 33" and together with Act No. 100, the "Acts") and pursuant to a resolution authorizing the issuance of the Refunding Bonds (the "Refunding Bond Resolution" and together with the Public Improvement Bond Resolution, the "Bond Resolutions") adopted by the Secretary of the Treasury and approved by the Acting Governor of Puerto Rico on July 18, 2002.

The Public Improvement Bonds, other than the Public Improvement Bonds due July 1, 2027, and the Refunding Bonds will be insured (such insured bonds being hereinafter referred to as the "Insured Bonds"), respectively, by separate insurance policies (collectively, the "Policy") issued by Financial Guaranty Insurance Company ("Financial Guaranty").

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

This Official Statement includes the cover page, the inside cover page, the appendices, and the Comprehensive Annual Financial Report of the Commonwealth for the fiscal year ended June 30, 2001 prepared by the Department of the Treasury (the "Commonwealth's Annual Financial Report"), which includes the general purpose financial statements of the Commonwealth for the fiscal year ended June 30, 2001, together with the independent auditor's report thereon, dated January 21, 2002, of KPMG LLP, certified public accountants, and is incorporated by reference herein. KPMG LLP did not audit the financial statements of the pension trust funds, the public university funds, and certain activities 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 on the general purpose financial statements, insofar as it relates to the amounts included in the general purpose financial statements pertaining to such activities and component units, is based solely on the reports of the other auditors.

The Commonwealth's Annual Financial Report has been filed by the Commonwealth with each nationally recognized municipal securities information repository ("NRMSIR"). Any appendix of an Official Statement of the Commonwealth or of any instrumentality of the Commonwealth containing the Commonwealth's Annual Financial Report filed with each NRMSIR and the Municipal Securities Rulemaking Board (the "MSRB") or any other document containing the Commonwealth's Annual Financial Report filed with each NRMSIR after the date hereof and prior to the termination of the offering of the Bonds shall be deemed to be incorporated by reference into this Official Statement and to be part of this Official Statement from the date of filing of such document. Any statement contained in the Commonwealth's Annual Financial Report incorporated herein by reference shall be deemed to be modified or superseded for purposes of this Official

Statement to the extent that a statement contained herein or in any subsequently filed document modifies or supersedes such statement. Any statement contained herein shall also be deemed to be modified or superseded to the extent that a statement contained in any 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, NY 10005, telephone number (212) 422-6420 or to Director-General Obligations Division, Government Development Bank for Puerto Rico, P.O. Box 42001, San Juan, PR 00940, telephone number (787) 722-7060.

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

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 which 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.

## OVERVIEW

The following is a summary of certain information regarding the Commonwealth contained in the Commonwealth of Puerto Rico Financial Information and Operating Data Report dated May 10, 2002 (the "Commonwealth Report"), attached hereto as *Appendix I*. This summary does not purport to be complete and is qualified in its entirety by reference to more detailed information appearing in the Commonwealth Report, which should be read in its entirety.

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

### Economic Trends

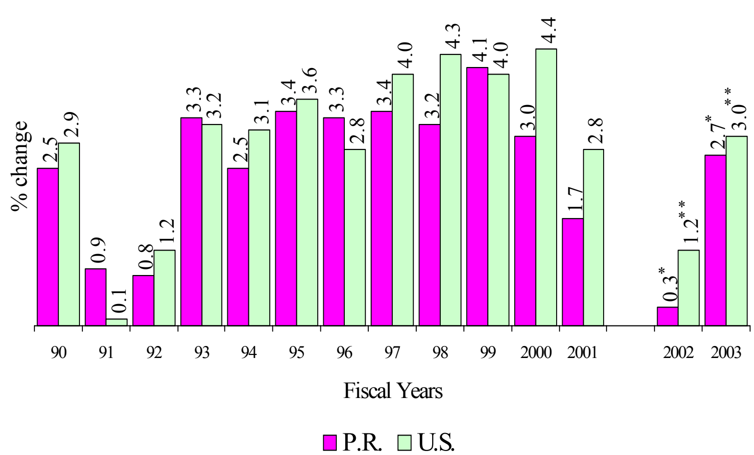
Puerto Rico has enjoyed almost two decades of uninterrupted economic expansion. Almost every sector of the economy has participated in this expansion and record levels of employment have been achieved. Factors contributing to this expansion include government-sponsored economic development programs, periodic declines in the exchange value of the United States dollar, increases in the level of federal transfers, the relatively low cost of borrowing and low oil prices.

Gross product increased from $32.3 billion in fiscal 1997 ($31.4 billion in 1996 prices) to $44.2 billion in fiscal 2001 ($35.3 billion in 1996 prices). This represents an increase of 36.7% from fiscal 1997 to 2001 (12.6% in 1996 prices). Since fiscal 1985, personal income, both aggregate and per capita, has increased consistently each fiscal year. In fiscal 2001, aggregate personal income was $41.5 billion ($37.2 billion in 1996 prices)[1] and personal income per capita was $10,816 ($9,713 in 1996 prices).

According to the Labor Department's Household Employment Survey, average employment increased from 1,128,300 in fiscal 1997, to 1,157,850 in fiscal 2001. Average unemployment decreased from 13.1% in fiscal 1997 to 10.5% in fiscal 2001. During the first ten months of fiscal 2002, total monthly employment averaged 1,167,100 compared to 1,161,500 in the same period of fiscal 2001, representing an increase of 0.5%. As a result of an increase in the labor participation rate which offset a small increase in average monthly employment, there was an increase in the unemployment rate from 10.2% during the first ten months of fiscal 2001 to 11.9% during the first ten months of fiscal 2002. The seasonally adjusted unemployment rate for April 2002 was 12.5%.

The Planning Board's gross product forecast for fiscal 2002 and fiscal 2003, made in March 2002, projected an increase of 0.3% for fiscal 2002 and 2.7% for fiscal 2003. The performance of the economy during fiscal 2002 was affected primarily by the performance of the United States economy, the amount of transfer payments, the level of oil prices and interest rates. In the past, Puerto Rico has been heavily dependent on oil imports for its energy needs. As a result of the construction of two cogeneration plants, however, one of which burns liquified natural gas and is now operational, and the other of which will burn coal and is expected to become operational during 2002, Puerto Rico's dependence on oil imports for its energy needs is expected to be reduced by approximately 30%. See "Other Public Corporations - Electric Power Authority" under *Public Corporations* in *Appendix I*.

## Real GNP Growth Rate




* Puerto Rico Planning Board Baseline Projection.

** DRI Forecast 05/02.

Puerto Rico has a diversified economy with manufacturing and services comprising its principal sectors. Manufacturing is the largest sector in terms of gross domestic product. According to the Planning Board's figures, manufacturing generated $27.1 billion, or 39.9%, of gross domestic product and accounted for 13.7% of total employment in fiscal 2001, as compared with fiscal 2000, when it generated $23.4 billion, or 38.3%, of gross domestic

[1] Different price deflators are used for gross product and personal income statistics.

product and accounted for 14.0% of total employment. See "Economic Performance by Sector" under *The Economy* in *Appendix I*. Manufacturing in Puerto Rico is now more diversified than during the earlier phases of its industrial development and includes several industries less prone to business cycles. In the last 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 heavy investment in the pharmaceutical, scientific instruments, computers and electrical products industries in Puerto Rico over the last decade. One of the factors assisting the development of the manufacturing sector has been the tax incentives offered by the federal and Puerto Rico governments. Federal legislation enacted in 1996, however, which amended Section 936 of the Internal Revenue Code of 1986, phases out the federal tax incentives during a ten-year period. See "Tax Incentives - Incentives Under the Code" under *The Economy* in *Appendix I*.

The services sector, which includes hotel and related services and currently accounts for approximately 48.2% of total employment, generated $26.8 billion, or 39.4%, of Puerto Rico's gross domestic product in fiscal 2001, as compared with $24.8 billion, or 40.6%, of gross domestic product in fiscal 2000.

Growth in construction has also contributed to increased economic activity from fiscal 1997 through fiscal 2000. During that period, construction investment increased 44.9%, and in fiscal 2001 it remained at $6.8 billion.

Tourism continues to make a significant contribution to economic activity. More than 4.9 million visitors spent $2.7 billion in Puerto Rico in fiscal 2000. San Juan has become the largest home port for cruise ships in the Caribbean and the fourth largest home port for cruise ships in the world. Twenty-six U.S. and international airlines offer scheduled service to and from San Juan, and a major airline uses San Juan as a hub for its intra-Caribbean operations. This reflects the importance of Puerto Rico as a tourist destination and as a transportation hub in the Caribbean.

**Recent Events**

*Revenues and Expenditures for Fiscal Year 2002.* For the first eleven months of fiscal year 2002 (July 2001 through May 2002), General Fund revenues were $6,375.7 million, which is $339.6 million or 5.6% higher than General Fund revenues during the first eleven months of fiscal year 2001, but $199.5 million or 3.0% less than budgeted revenues for this period. The Commonwealth government has identified other revenues and other funding sources to cover the estimated revenue shortfall, including certain excess reserves, the sale of certain receivables to Government Development Bank for Puerto Rico ("Government Development Bank"), and additional excise tax revenues from recently enacted legislation.

Expenditures for the full 2002 fiscal year, on the other hand, are projected to be $7,597.1 million, which is $131.4 million or 1.8% higher than the $7,465.7 million budgeted for the full fiscal year. The principal reasons for the higher expenditures are (i) health reform costs that are projected to be approximately $125 million higher than the amount budgeted; (ii) payroll and other costs of education that are projected to be approximately $64.9 million higher than the amount budgeted; (iii) public safety costs that are projected to be approximately $66.5 million higher than the amount budgeted; and (iv) lower projected expenditures in other areas of approximately $125 million, which partially offset the higher health, education and public safety expenditures. The Government expects to cover these additional expenditures with $111 million of reserve funds from the Commonwealth's Budgetary Fund and with $20.5 million of unused funds from certain agencies that have operating surpluses.

*Approved Budget for Fiscal Year 2003.* The approved budget for fiscal year 2003 (which commenced on July 1, 2002) includes General Fund expenditures of $7,839 million, or 5.0% higher than the $7,465.7 million budgeted for fiscal year 2002. The major changes in General Fund expenditures from fiscal year 2002 to fiscal year 2003 are the following: (i) an increase of $120.3 million or 5.2% in education; (ii) an increase of $119.6 million or 9.2% in public safety and protection; (iii) an increase of $88.4 million or 7.4% in health; (iv) an increase of $31.8 million or 45.8% in special pension contributions; (v) an increase of $16.2 million or 4.2% in welfare; (vi) a decrease of $15.1 million or 2.0% in general government expenses; and (vii) an increase of $10.7 million or 3.1% in contributions to the municipalities.

General Fund revenues for fiscal year 2003 are projected to be $7,836 million, which is $371 million or 5% higher than the $7,465 million in General Fund revenues budgeted for fiscal year 2002. In addition, the proposed budget includes $3 million of other funding sources, for a total of $7,839 million. The major changes from fiscal year 2002 to fiscal year 2003 are expected to be: (i) a projected increase in individual income taxes of $311 million; (ii) a projected increase in corporate income taxes of $111 million; (iii) a projected increase in Commonwealth excise taxes of $296 million; (iv) a projected decrease in miscellaneous revenues of $295 million; and (v) a projected decrease in income taxes withheld from non-residents of $109 million.

The projected General Fund revenues for fiscal year 2003 assume a 6.8% nominal, 2.7% real growth in gross national product, and additional revenues of $596 million from new legislative measures, most of which have already been enacted. Projected revenues do not take into consideration the result of a lawsuit filed by one of the eight air cargo carriers that service Puerto Rico. In the lawsuit, this air cargo carrier seeks to prevent the Treasury Department from implementing a local regulation that precludes the carrier from delivering goods brought into the island prior to the consignee evidencing the payment of the excise tax on such goods. The United States District Court for the District of Puerto Rico entered a permanent injunction in favor of the carrier. The Secretary of the Treasury appealed and moved for a stay pending the appeal. On July 18, 2002, the United States Court of Appeals granted the Secretary's motion and ordered the stay of the injunction while expediting the appeal. An oral hearing is scheduled for September 6, 2002. The total amount of excise taxes collected annually in recent years by the eight air cargo carriers that service Puerto Rico has been approximately $53 million.

*Contracts with Health Reform Insurance Companies.* The Government has entered into new contracts with the insurance companies providing coverage to health reform beneficiaries, which are for three-year terms commencing on July 1, 2002. Under the new contracts, and based on certain assumptions relating to the number of beneficiaries and other matters, the cost of the health insurance program for fiscal year 2003 is expected to exceed the amount in the approved budget for such fiscal year by approximately $75 million. However, the Government expects to reduce the insurance cost through audits of the health reform lists of eligible beneficiaries and from rebates on medications from pharmaceutical companies. Any remaining excess of expenditures over budgeted amounts would be covered from the Health Reform Stabilization Fund, which will be funded from certain excise taxes. The insurance cost for fiscal years 2004 and 2005 will be negotiated with the insurance companies before the commencement of each such fiscal year.

*Standard & Poor's Lowers Commonwealth's Debt Rating to "A-."* On May 30, 2002, Standard & Poor's Rating Services, a division of The McGraw Hill Companies, Inc. ("Standard & Poor's") lowered the Commonwealth's debt rating from "A" to "A-". Standard & Poor's stated that the downgrade "reflects five years of deficit operations and the use of deficit financing and back loading of debt to eliminate a large accumulated operating deficit." According to Standard & Poor's, "the downgrade also reflects the use of onetime revenues to balance general fund operations. . . , ongoing expenditure pressure in areas like health care, education and public safety that, despite substantial management improvements, have not been brought in line with recurring revenues; limited revenues and expenditure flexibility; and an unfunded pension liability of $7.4 billion." Standard & Poor's also stated that the Commonwealth's credit outlook was stable "based on expectations of balanced operations in fiscal 2003, the strong commitment by management to continue its ongoing efforts to reduce expenditure pressures in targeted areas, and gradual economic recovery."

**Fiscal Management**

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

Section 7 of Article VI of the Constitution of Puerto Rico provides that: "The appropriations made for any fiscal year shall not exceed the total revenues, including available surplus, estimated for said fiscal year unless the imposition of taxes sufficient to cover said appropriations is provided by law."

The financial statements of the Commonwealth for fiscal 2001 were audited by KPMG LLP, independent auditors whose report thereon is dated January 21, 2002. For a summary of the Commonwealth's significant accounting policies, see Note 1 to the Commonwealth's general purpose financial statements included in the Commonwealth's Annual Financial Report. Preparation of the audited financial statements of the Commonwealth involves the collection and combination of audited financial statements from 50 separate reporting entities. KPMG LLP did not audit the financial statements of the pension trust funds, the public university funds, and certain activities 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 on the general purpose financial statements, insofar as it relates to the amounts included in the general purpose financial statements pertaining to such activities and component units, is based solely on the reports of the other auditors.

**Debt Management**

The Constitution of Puerto Rico limits the amount of general obligation debt that can be issued. The Commonwealth's policy has been and continues to be to maintain the level of such debt within a prudent range below the constitutional limitation. See "Debt Limitation" under *The Bonds*.

Historically, the Commonwealth has maintained a fiscal policy which provides for a prudent relationship between the growth of public sector debt and the growth of the economic base required to service that debt. During fiscal 1996, 1997 and 1998, however, public sector debt increased at a rate greater than the growth of gross product due to an increase in the amount of debt incurred to finance certain key infrastructure projects, which are important to the development of the economy and are expected to produce long term economic benefits, and to refinance outstanding debt, enabling the Commonwealth to benefit from historically low levels of interest rates and realize debt service savings. During fiscal 1999 and 2000, growth of public sector debt was below the growth of gross product. Public sector debt increased by 12.1% during fiscal 2001, compared to a 6.7% increase in gross product for the same fiscal year. The increase in the rate of growth of public sector debt during fiscal 2001 is in part due to the issuance during such fiscal year of $1,092,550,000 of bonds of the Infrastructure Financing Authority and $397,005,000 of bonds of the Children's Trust Fund, both of which are payable from sources other than Commonwealth appropriations or taxes or revenues of public corporations derived from services or products. Excluding these bond issues, the rate of growth of public sector debt for fiscal 2001 was 5.9%. See "Trends of Public Sector Debt" under *Debt* and "Economic Performance by Sector - Construction" under *The Economy* in *Appendix I*.

## PLAN OF FINANCING

**The Public Improvement Bonds**

The net proceeds of the Public Improvement Bonds will be deposited in (i) the 2003 Public Improvements Fund established under Act No. 100 to carry out the capital improvement programs authorized by the Legislature, including but not limited to highways and transportation facilities, aqueduct and sewer facilities, schools, health and social welfare facilities, agricultural and tourism facilities, parks and other recreation facilities, flood control and solid waste facilities, housing construction and improvement, municipal projects, corrections and public safety projects, and other governmental projects, and (ii) the Extraordinary Maintenance Fund established under Act No. 66 of the Legislature of Puerto Rico, approved August 14, 1991, in the amounts specified below under "Sources and Uses of Funds."

**Refunding Bonds**

The Refunding Bonds will be issued on or about April 2, 2003 for the purpose of redeeming on July 1, 2003 $100,745,000 principal amount of the Commonwealth's Public Improvement Refunding Bonds, Series 1993, maturing July 1, 2013 (the "Refunded Bonds"), at a redemption price of 101.5%.

The Secretary of the Treasury will deposit the net proceeds of the Refunding Bonds and certain other available moneys into an escrow fund (the "Escrow Fund") with Banco Popular de Puerto Rico (the "Escrow Agent"). The net proceeds of the Refunding Bonds and such other available moneys will be invested in a guaranteed investment contract with Trinity Plus Funding Company, LLC, the payments on which will be sufficient to pay the principal of and premium on the Refunded Bonds on the redemption date mentioned above, which redemption date will be irrevocably designated by the Secretary of the Treasury, and to pay the interest thereon to such redemption date.

The sufficiency of the amount so deposited, with investment earnings thereon, to accomplish the refunding of the Refunded Bonds referred to above, will be verified by Samuel Klein and Company (the "Verification Agent"). Since the Refunded Bonds are being refunded with a guaranteed investment contract instead of investment securities that would result in a legal defeasance under Puerto Rico law, the Refunded Bonds will continue to be outstanding under the terms of their respective authorizing resolutions and for the purpose of applying the debt limitation under Section 2 of Article VI of the Constitution of Puerto Rico.

**Delayed Delivery of the Refunding Bonds**

The Refunding Bonds are expected to be issued on or about April 2, 2003. The Commonwealth is required to issue the Refunding Bonds and the Underwriters are required to purchase the Refunding Bonds unless (1) the Underwriters are not permitted to purchase or sell the Refunding Bonds because of a Change in Law (as defined below) or (2) the Commonwealth and the Underwriters do not receive the required closing documentation, including among others, (a) the opinion of Bond Counsel described below, and certain opinions of the Commonwealth's Attorney General and counsel to the Underwriters, (b) a supplement to this Official Statement (the "Supplement"), together with a certificate of the Commonwealth as to the accuracy of this Official Statement as so supplemented, (c) a certificate of the Secretary of the Treasury of the Commonwealth to the effect, among others, that it is not aware of the existence of any default under any agreement or instrument evidencing or relating to any outstanding indebtedness of the Commonwealth, and (d) evidence that the Refunding Bonds are rated "Aaa" by Moody's Investors Service ("Moody's) and "AAA" by Standard & Poor's.

The expected date of issue of the Refunding Bonds may be delayed if on such date (i) trading shall have been suspended or materially limited on the New York Stock Exchange or other national stock exchange, whether by virtue of a determination by the exchange or by order of the Securities and Exchange Commission or any other governmental body having jurisdiction; (ii) a material disruption in securities settlement, payment or clearance services in the United States shall have occurred and be continuing, or (iii) any moratorium on commercial banking activities shall have been declared by Federal, New York State or Commonwealth authorities and be continuing. The Refunding Bonds will be issued on the next business day in which the conditions set forth in (i), (ii), and (iii) above are not present.

ADVERSE CHANGES (FINANCIAL OR OTHER) IN THE AFFAIRS OF THE COMMONWEALTH WILL NOT EXCUSE THE UNDERWRITERS FROM PAYING FOR AND TAKING DELIVERY OF THE REFUNDING BONDS UNLESS ANY SUCH ADVERSE CHANGE HAS NOT BEEN ACCURATELY AND COMPLETELY DESCRIBED IN OR INCORPORATED BY REFERENCE IN THE SUPPLEMENT OR THE COMMONWEALTH IS UNABLE TO DELIVER THE CLOSING DOCUMENTATION DESCRIBED ABOVE.

It is a condition of the issuance of the Refunding Bonds that Bond Counsel deliver its approving opinion on the Refunding Bonds, substantially in the form set forth in *Appendix II*. Bond Counsel's ability to deliver this opinion is subject to its review and analysis at the time the Refunding Bonds are to be issued of certain matters, including, among others, (1) the application of the proceeds of the Refunding Bonds, (2) pertinent provisions of law, including, but not necessarily limited to, Puerto Rico law and federal income tax and securities laws then in effect or proposed to be in effect, and (3) certifications and representations delivered or made by the Commonwealth and the Underwriters at the time of issuance of the Refunding Bonds. Bond Counsel has advised the Commonwealth and the Underwriters that, (A) if the Commonwealth and the Underwriters satisfy their respective obligations set forth in the contract of purchase for the Refunding Bonds (the "Contract of Purchase") and (B) if there is no change in any applicable law, or in any other facts or circumstances (tax or otherwise) that, in Bond Counsel's view, affect or are material to its opinion, and (C) if such certifications and representations are delivered or made to Bond Counsel's satisfaction, Bond Counsel expects to be able to deliver an approving opinion substantially in the form attached hereto as *Appendix II*. No assurances can be given that there will be no change in applicable law prior to the time the Refunding Bonds are to be issued, that the facts and circumstances that are material to such opinion will not differ at the time the Refunding Bonds are to be issued from those currently expected, or that such certifications and representations will be delivered and made. As a consequence, no assurance can be made that an approving opinion on the Refunding Bonds will be delivered by Bond Counsel.

FAILURE TO DELIVER THE SUPPLEMENT OR THE OPINIONS AND CERTIFICATES IN THE FORM AND SUBSTANCE PROVIDED FOR IN THE CONTRACT OF PURCHASE (UNLESS SUCH FAILURE IS WAIVED BY THE UNDERWRITERS) WILL MEAN THAT THE REFUNDING BONDS WILL NOT BE ISSUED AND DELIVERED. THE UNDERWRITERS HAVE THE RIGHT, BUT ARE UNDER NO OBLIGATION, TO WAIVE ANY SUCH FAILURE.

In addition, the Underwriters are not required to purchase the Refunding Bonds if at any time on or prior to the date the Refunding Bonds are to be issued, as a result of a Change in Law, the Underwriters are or would be prohibited from lawfully purchasing the Refunding Bonds or lawfully selling the Refunding Bonds to the public.

As defined in the Contract of Purchase, "Change in Law" means (i) any change in federal, Puerto Rico or state law or any changes in regulations or other pronouncements or interpretations by federal, Puerto Rico or state agencies, (ii) the enactment, introduction or proposal of any federal legislation (if it has a proposed effective date that is on or before the date the Refunding Bonds are to be issued), (iii) the enactment, introduction or proposal of any law, rule or regulation by any other governmental body, department or agency (federal, Puerto Rico or state) (if it has a proposed effective date that is on or before the date the Refunding Bonds are to be issued) or (iv) the handing down of a judgment, ruling or order issued by any court or administrative body, which in each case would prohibit (or have the retroactive effect of prohibiting, if enacted, adopted, passed or finalized) the Underwriters from purchasing or selling the Refunding Bonds to the public or, as to the Commonwealth, would make the issuance, sale or delivery of the Refunding Bonds illegal (or have the retroactive effect of making such issuance, sale or delivery illegal, if enacted, adopted, passed or finalized); provided, however, that such change in law, rule or regulation or judgment, ruling or order shall have become effective or been enacted, introduced, proposed or issued, as the case may be, after the date of this Official Statement.

Events that may occur prior to the issuance of the Refunding Bonds may have significant consequences to persons who have agreed to purchase the Refunding Bonds. The market prices of the Refunding Bonds on the date the Refunding Bonds are issued are unlikely to be the same as the purchase prices therefor, and such differences may be substantial. Several facts may adversely affect such prices, including (but not limited to) a general increase or decrease in market interest rates, any threatened or adopted change in the federal income tax laws affecting the relative benefits of owning tax-exempt securities versus other types of investments, or any adverse development with respect to the Commonwealth's financial condition or prospects or with respect to the ratings on the Commonwealth's indebtedness, including the underlying ratings on the Refunding Bonds. In addition, although the delivery of the approving opinion of Bond Counsel is a condition to the issuance and delivery of the Refunding Bonds and is subject to a number of conditions to be fulfilled at the time of such delivery as described above, changes or proposed changes in federal income tax laws or regulations or interpretations thereof could affect the market value of tax-exempt securities, including the Refunding Bonds, without preventing the delivery of such opinion or the delivery of the Refunding Bonds.

**Sources and Uses of Funds**

| | |
|---|---|
| Sources: | |
| Principal amount of the Bonds | $ 555,295,000 |
| Net original issue premium | 31,828,539 |
| Moneys from Redemption Fund | 1,385,244 |
| Total sources | $ 588,508,783 |
| Uses: | |
| Deposit into the 2003 Public Improvements Fund | $ 446,045,000 |
| Deposit into the Extraordinary Maintenance Fund | 25,000,000 |
| Deposit into the Escrow Fund for Refunded Bonds[(1)] | 104,442,250 |
| Underwriting discount, bond insurance premium and legal, printing, and other financing expenses | 13,021,533 |
| Total uses | $ 588,508,783 |

(1) Will occur on or about April 2, 2003, upon the issuance of the Refunding Bonds.

## THE BONDS

**General**

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

**Book-Entry Only System**

The following information concerning The Depository Trust Company ("DTC"), New York, New York and DTC's book-entry system has been obtained from DTC. Neither the Commonwealth nor the Underwriters take any responsibility for the accuracy thereof.

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

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

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

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

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

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

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

Principal, redemption premium, if any, and interest payments on the Bonds will be made to DTC or to such other nominee as may be requested by DTC. DTC's practice is to credit Direct Participants' accounts on the payable date in accordance with their respective holdings shown on DTC's records unless DTC has reason to believe that it will not receive payment on the payable date. Payments by Participants to Beneficial Owners will be governed by standing instructions and customary practices, as is the case with securities held for the accounts of customers in bearer form or registered in "street name," and will be the responsibility of such Participant and not of DTC, the Commonwealth, or the Registrar, subject to any statutory or regulatory requirements as may be in effect from time to time. Payment of principal of, redemption premium, if any, and interest on the Bonds to DTC is the responsibility of the Commonwealth or the Registrar, disbursement of such payments to Direct Participants shall be the responsibility of DTC, and disbursement of such payments to the Beneficial Owners shall be the responsibility of Direct and Indirect Participants.

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

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

**Payments and Transfers**

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

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

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

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

**Authorization**

Section 2 of Article VI of the Constitution of the Commonwealth provides that the power of the Commonwealth to contract and to authorize the contracting of debts shall be exercised as determined by the Legislature. Pursuant to this power, the Legislature enacted the Acts, which authorize the issuance of the Bonds.

**Redemption**

The Public Improvement Bonds maturing on or prior to July 1, 2022 and the Refunding Bonds are not subject to redemption prior to maturity. The Public Improvement Bonds maturing on or after July 1, 2027 are subject to redemption prior to maturity as described below.

*Optional Redemption.* At the option of the Secretary of the Treasury and upon at least 30 days' notice, the Public Improvement Bonds maturing on or after July 1, 2027 are subject to redemption, from any moneys that may be available for that purpose (other than from moneys set aside in respect of an amortization requirement), prior to maturity, on or after July 1, 2012, either in whole or in part, on any date, as directed by the Secretary of the Treasury, at the principal amount of the Bonds to be redeemed, together with accrued interest to the date fixed for redemption.

*Mandatory Redemption.* The Public Improvement Bonds maturing July 1, 2027 and July 1, 2032 (other than the serial bond maturing July 1, 2032 bearing interest at 4.80%) (the "Term Bonds") are subject to redemption to the extent of the respective amortization requirements therefor set forth below (less the amount applied to the purchase of any such Term Bonds and otherwise subject to adjustment as described below), upon at least 30 days' notice, on July 1, 2023 and on July 1, 2028, respectively, and on July 1 in each year thereafter at a redemption price of par plus accrued interest to the dates fixed for redemption:

| July 1 | Amortization Requirement for Term Bonds due July 1, 2027 | Amortization Requirement for Term Bonds due July 1, 2032 |
|---|---|---|
| 2023 | $20,320,000 | |
| 2024 | 21,335,000 | |
| 2025 | 22,400,000 | |
| 2026 | 23,520,000 | |
| 2027 | 24,695,000† | |
| 2028 | | $25,930,000 |
| 2029 | | 27,230,000 |
| 2030 | | 28,590,000 |
| 2031 | | 30,020,000 |
| 2032 | | 18,520,000† |
| **Average life (years)** | 23.0 | 27.8 |

†Maturity.

If the amount of the Term Bonds purchased or redeemed in a fiscal year exceeds the amount of the amortization requirement for such Bonds for such fiscal year, the amortization requirement for such Bonds may be decreased for such subsequent fiscal years and in such amounts aggregating the amount of such excess as the Secretary of the Treasury shall determine.

**Notice of Redemption; Effect of Redemption or Deposit in Trust**

Any redemption of the Public Improvement Bonds, either in whole or in part, shall be made upon at least thirty days' prior notice by mail to DTC or, if the book-entry only system as described above has been discontinued, by first class mail, postage prepaid, to all registered owners of such Public Improvement Bonds to be redeemed in the manner and under the terms and conditions provided in the Public Improvement Bond Resolution. On the date designated for redemption, notice having been given as provided in the Public Improvement Bond Resolution and moneys for payment of the principal of and accrued interest on the Public Improvement Bonds or portions thereof so called for redemption being held by the Registrar, interest on the Public Improvement Bonds or portions thereof so called for redemption shall cease to accrue.

Subject to certain provisions of the Public Improvement Bond Resolution, Public Improvement Bonds and portions of Public Improvement Bonds which have been duly called for redemption under the provisions of the Public Improvement Bond Resolution, or with respect to which irrevocable instructions to call for redemption or to pay at maturity have been given, and for the payment of the principal of and the accrued interest on which sufficient moneys or investments permitted by law shall be held in separate trust for the owners of the Public Improvement Bonds or portions thereof to be paid or redeemed, shall not be deemed to be outstanding under the Public Improvement Bond Resolution, and the registered owners thereof shall have no rights in respect thereof except to receive payment of the principal thereof and the accrued interest thereon from said separate trust.

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

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

**Security**

*Provision for Payment of Public Debt*

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

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

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

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

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

*Special Fund for General Obligation Debt Service*

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

Act No. 39 of the Legislature of Puerto Rico, approved May 13, 1976, as amended ("Act No. 39"), requires the Secretary of the Treasury to transfer each month from available funds of the Commonwealth to the Redemption Fund such amounts which together with certain funds otherwise deposited therein will be equal to the sum of one-sixth of the interest to be paid in the next six months and one-twelfth of the principal to be paid or required to be amortized within the next twelve months on all bonds and notes of the Commonwealth for which its full faith and credit are pledged as the same become due and all bonds and notes of the Commonwealth for which the guaranty of the Commonwealth has been exercised. Moneys in the Redemption Fund are held in trust by Government Development Bank. Act No. 39 provides that the obligation of the Secretary of the Treasury to make the above transfers is cumulative, and the amount of any deficiency in any month shall be added to the amount of transfers required in future months until such deficiency has been fully paid. On June 30, 2002, the amount on deposit in the Redemption Fund was $236,689,383, which was the required amount.

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

**Payment Record**

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

**Debt Limitation**

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

On December 21, 1995, Puerto Rico Aqueduct and Sewer Authority ("PRASA") issued $400,340,000 Puerto Rico Aqueduct and Sewer Authority Refunding Bonds, guaranteed by the Commonwealth (the "PRASA Guaranteed Bonds"). On January 1, 1997, the Commonwealth began to make payments of debt service on the PRASA Guaranteed Bonds under the full faith and credit guarantee of the Commonwealth. The amount paid by the Commonwealth under the PRASA Guaranteed Bonds will be taken into account for purposes of computing the above described 15% constitutional debt limitation.

A portion of the proceeds of the Commonwealth's Public Improvement Refunding Bonds, Series 2001 and all of the proceeds of the Commonwealth's Public Improvement Refunding Bonds, Series 2002 A were invested in guaranteed investment contracts instead of investment securities that would result in a legal defeasance under Puerto Rico law. Similarly, the proceeds of the Refunding Bonds will be invested in a guaranteed investment contract. Since the bonds refunded with the proceeds of such guaranteed investment contracts are not legally defeased, such bonds are treated (or will be treated, in the case of the Refunded Bonds) as outstanding for purposes of the 15% debt limitation.

After giving effect to the issuance of the Public Improvement Bonds, future maximum annual debt service for the Commonwealth's outstanding general obligation debt is $645,783,892 in the fiscal year ending June 30, 2003. Debt service for the PRASA Guaranteed Bonds paid by the Commonwealth during fiscal 2002 (including for this purpose debt service payments due July 1, 2002) was $33,541,577. The sum of those amounts ($679,325,470) is equal to 9.64% of $7,050,545,000, which is the average of the adjusted internal revenues for the two fiscal years ended June 30, 2001 and June 30, 2002. If the bonds refunded by the Commonwealth's Public Improvement Refunding Bonds, Series 2001 and the Commonwealth's Public Improvement Refunding Bonds, Series 2002 A were treated as not being outstanding (they will be treated as outstanding because they were refunded with the proceeds of guaranteed investment contracts instead of investment securities eligible to be used for legal defeasance ) the percentage referred to in the preceding sentence would be 7.86%.

Upon the issuance of the Refunding Bonds in April 2003, the percentage referred to in the last sentence of the preceding paragraph will be 9.65%. If the Refunded Bonds were deemed not to be outstanding, such percentage would be 7.86%.

**Maturity Limitation**

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

**Bond Insurance**

Concurrently with the issuance of the Insured Bonds, Financial Guaranty will issue its Policy covering the Insured Bonds. The Policy unconditionally guarantees the payment of that portion of the principal of and interest on the Insured Bonds which has become due for payment, but shall be unpaid by reason of nonpayment by the issuer of the Insured Bonds (the "Issuer"). Financial Guaranty will make such payments to State Street Bank and Trust Company, N.A., or its successor as its agent (the "Fiscal Agent"), on the later of the date on which such principal or interest (as applicable) is due or on the business day next following the day on which Financial Guaranty shall have received telephonic or telegraphic notice, subsequently confirmed in writing, or written notice by registered or certified mail, from an owner of Insured Bonds or the Paying Agent of the nonpayment of such amount by the Issuer. The Fiscal Agent will disburse such amount due on any 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 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 or interest (as applicable) shall be vested in Financial Guaranty. The term "nonpayment" in respect of an Insured Bond includes any payment of principal, or interest (as applicable) made to an owner of an 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.

The Policy is non-cancellable and the premium will be fully paid at the time of delivery of the Insured Bonds. The Policy covers failure to pay principal of the Insured Bonds on their respective stated maturity dates or dates on which the same shall have been duly called for mandatory sinking fund redemption, and not on any other date on which the Insured Bonds may have been otherwise called for redemption, accelerated or advanced in maturity, and covers the failure to pay an installment of interest on the stated date for its payment.

This Official Statement contains a section regarding the ratings assigned to the Insured Bonds and reference should be made to such section for a discussion of such ratings and the basis for their assignment to the Insured Bonds. Reference should be made to the description of the Issuer for a discussion of the ratings, if any, assigned to such entity's outstanding parity debt that is not secured by credit enhancement.

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

Financial Guaranty is a wholly-owned subsidiary of FGIC Corporation (the "Corporation"), a Delaware holding company. The Corporation is a subsidiary of General Electric Capital Corporation ("GE Capital"). Neither the Corporation nor GE Capital is obligated to pay the debts of or the claims against Financial Guaranty. Financial Guaranty is a monoline financial guaranty insurer domiciled in the State of New York and subject to regulation by the State of New York Insurance Department. As of March 31, 2002, the total capital and surplus of Financial Guaranty was approximately $1.03 billion. Financial Guaranty prepares financial statements on the basis of both statutory accounting principles and generally accepted accounting principles. Copies of such financial statements may be obtained by writing to Financial Guaranty at 125 Park Avenue, New York, New York 10017, Attention: Communications Department (telephone number: 212-312-3000) or to the New York State Insurance Department at 25 Beaver Street, New York, New York 10004-2319, Attention: Financial Condition Property/Casualty Bureau (telephone number: 212-480-5187).

## PUBLIC SECTOR DEBT OF THE COMMONWEALTH

### Pro Forma Public Sector Debt

The following table presents a summary of the public sector debt of the Commonwealth as of April 30, 2002, as adjusted for the issuance of the Public Improvement Bonds, and as adjusted for the issuance of the Refunding Bonds and the refunding of the Refunded Bonds. The table should be read in conjunction with the information set forth in "Debt" in *Appendix I.*

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

| | April 30, 2002 | As Adjusted by the Issuance of the Public Improvement Bonds | As Adjusted by the Issuance of the Public Improvement Bonds and the Refunding Bonds (2) |
|---|---|---|---|
| Puerto Rico direct debt . . . . . . . . . . . . | $ 6,801,254 (1) | $ 7,261,254 | $ 7,255,804 |
| Municipal debt . . . . . . . . . . . . . . . . . . | 1,751,896 | 1,751,896 | 1,751,896 |
| Public corporations debt | | | |
| Puerto Rico guaranteed debt . . . . . | 610,903 | 610,903 | 610,903 |
| Debt supported by Puerto Rico appropriations or taxes . . . . . . . . | 13,813,673 | 13,813,673 | 13,813,673 |
| Other non-guaranteed debt . . . . . . . | 6,979,457 | 6,979,457 | 6,979,457 |
| Total public corporations debt . . . . | $ 21,404,033 | $21,404,033 | $21,404,033 |
| Total public sector debt . . . . . . . . . . . | $ 29,957,183 | $30,417,183 | $30,411,733 |

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

(1) This amount excludes any Commonwealth general obligation bonds that have been refunded with proceeds that were invested in guaranteed investment contracts even though such bonds will be considered outstanding under their authorizing resolution and for purposes of calculating the Commonwealth's debt limitation. The principal amount of Puerto Rico direct debt, as of July 1, 2002, was $6,642,109.

(2) Adjusted to exclude the Refunded Bonds even though such bonds are being refunded with proceeds that will be invested in a guaranteed investment contract and, therefore, will be considered to be outstanding under their authorizing resolution and for purposes of calculating the Commonwealth's debt limitation.

*Source:* Government Development Bank

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

The following table presents the debt service requirements for (i) Commonwealth general obligation bonds and PRASA bonds for which debt service payments are being made under the Commonwealth guaranty, in each case outstanding on April 30, 2002 (adjusted to exclude debt service on the Refunded Bonds); (ii) debt service on the Public

Improvement Bonds; (iii) debt service on the Refunding Bonds; and (iv) total debt service adjusted for the issuance of the Public Improvement Bonds, the issuance of the Refunding Bonds and the refunding of the Refunded Bonds. The table excludes debt service on Commonwealth general obligation bonds that have been or will be refunded with the proceeds of refunding bonds invested in guaranteed investment contracts, notwithstanding that such bonds will be considered to be outstanding under their authorizing resolution and for purposes of calculating the Commonwealth's debt limitation. See "Commonwealth Guaranteed Debt" in *Appendix I*. With respect to other debt of PRASA, see "Public Corporations" in *Appendix I*. Debt service requirements for each fiscal year, as shown in the following table, include principal and interest due on July 1 immediately following the close of such fiscal year.

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

| Fiscal Year Ending June 30 | Outstanding Bonds Total Debt Service[1] | Outstanding PRASA Bonds Debt Service | Public Improvement Bonds | | Refunding Bonds | | Grand Total[2] |
|---|---|---|---|---|---|---|---|
| | | | Principal | Interest | Principal | Interest | |
| 2003 | $ 453,380 | $ 32,745 | $ 0 | $ 21,369 | $ 0 | $ 1,296 | $ 508,970 |
| 2004 | 451,845 | 30,125 | 0 | 23,817 | 0 | 5,241 | 511,028 |
| 2005 | 451,843 | 30,127 | 0 | 23,817 | 0 | 5,241 | 511,028 |
| 2006 | 451,847 | 30,121 | 0 | 23,817 | 0 | 5,241 | 511,026 |
| 2007 | 451,841 | 30,126 | 0 | 23,817 | 0 | 5,241 | 511,026 |
| 2008 | 451,835 | 30,131 | 9,255 | 23,817 | 0 | 5,241 | 520,279 |
| 2009 | 451,826 | 30,123 | 9,740 | 23,331 | 0 | 5,241 | 520,262 |
| 2010 | 451,965 | 29,984 | 10,250 | 22,820 | 0 | 5,241 | 520,260 |
| 2011 | 414,625 | 29,928 | 10,740 | 22,333 | 35,680 | 5,241 | 518,547 |
| 2012 | 414,436 | 30,127 | 11,300 | 21,769 | 37,630 | 3,279 | 518,541 |
| 2013 | 432,150 | 30,128 | 11,895 | 21,176 | 21,985 | 1,209 | 518,542 |
| 2014 | 457,368 | 30,125 | 12,550 | 20,521 | 0 | 0 | 520,565 |
| 2015 | 457,366 | 30,126 | 13,240 | 19,831 | 0 | 0 | 520,563 |
| 2016 | 457,375 | 30,121 | 13,970 | 19,103 | 0 | 0 | 520,568 |
| 2017 | 457,373 | 30,122 | 14,735 | 18,335 | 0 | 0 | 520,564 |
| 2018 | 457,368 | 30,126 | 15,545 | 17,524 | 0 | 0 | 520,563 |
| 2019 | 457,377 | 30,125 | 16,400 | 16,669 | 0 | 0 | 520,570 |
| 2020 | 487,493 | 0 | 17,305 | 15,767 | 0 | 0 | 520,565 |
| 2021 | 335,691 | 0 | 18,255 | 14,815 | 0 | 0 | 368,761 |
| 2022 | 255,034 | 0 | 19,260 | 13,811 | 0 | 0 | 288,106 |
| 2023 | 210,962 | 0 | 20,320 | 12,752 | 0 | 0 | 244,034 |
| 2024 | 187,455 | 0 | 21,335 | 11,736 | 0 | 0 | 220,526 |
| 2025 | 187,449 | 0 | 22,400 | 10,669 | 0 | 0 | 220,518 |
| 2026 | 178,692 | 0 | 23,520 | 9,549 | 0 | 0 | 211,761 |
| 2027 | 178,691 | 0 | 24,695 | 8,373 | 0 | 0 | 211,760 |
| 2028 | 178,692 | 0 | 25,930 | 7,139 | 0 | 0 | 211,761 |
| 2029 | 178,693 | 0 | 27,230 | 5,842 | 0 | 0 | 211,765 |
| 2030 | 178,693 | 0 | 28,590 | 4,481 | 0 | 0 | 211,764 |
| 2031 | 178,691 | 0 | 30,020 | 3,051 | 0 | 0 | 211,762 |
| 2032 | 0 | 0 | 31,520 | 1,550 | 0 | 0 | 33,070 |
| Total | $10,358,058 | $514,410 | $460,000 | $483,398 | $95,295 | $47,714 | $11,958,875 |

* Totals may not add due to rounding.

(1) Debt service requirements on all general obligation bonds outstanding on April 30, 2002, excluding debt service on any general obligation bonds, including the Refunded Bonds,refunded with proceeds invested in guaranteed investment contracts and, therefore, considered to be outstanding under their authorizing resolution and for purposes of calculating the Commonwealth's debt limitation.

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

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

## TAX MATTERS

### Public Improvement Bonds

In the opinion of Squire, Sanders & Dempsey L.L.P., Bond Counsel, under existing law (i) interest on the Public Improvement 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"), and is not an item of tax preference for purposes of the federal alternative minimum tax imposed on individuals and corporations, and (ii) the Public Improvement Bonds and the interest thereon are exempt from state, Commonwealth and local income taxation. Bond Counsel will express no opinion as to any other tax consequences regarding the Public Improvement Bonds.

The opinion on federal tax matters will be based on and will assume the accuracy of certain representations and certifications, and continuing compliance with certain covenants, of the Commonwealth to be contained in the transcript of proceedings and that are intended to evidence and assure the foregoing, including that the Public Improvement Bonds are and will remain obligations the interest on which is excluded from gross income for federal income tax purposes. Bond Counsel will not independently verify the accuracy of those certifications and representations.

The Code prescribes a number of qualifications and conditions for the interest on state and local government obligations to be and to remain excluded from gross income for federal income tax purposes, some of which require future or continued compliance after issuance of the obligations in order for the interest to be and to continue to be so excluded from the date of issuance. Noncompliance with these requirements by the Commonwealth may cause the interest on the Public Improvement Bonds to be included in gross income for federal income tax purposes and thus to be subject to federal income tax retroactively to the date of issuance of the Public Improvement Bonds. The Commonwealth has covenanted, to the extent permitted by the Constitution and the laws of the Commonwealth, to take the actions required of it for the interest on the Public Improvement Bonds to be and to remain excluded from gross income for federal income tax purposes, and not to take any actions that would adversely affect that exclusion. Bond Counsel is not aware of any provision of the Constitution or laws of the Commonwealth that would prevent the Commonwealth from complying with the requirements of the Code.

Under Code provisions applicable only to certain corporations, a portion of the excess of adjusted current earnings (which includes interest on all tax-exempt obligations, including the Public Improvement Bonds) over other alternative minimum taxable income may be subject to a corporate alternative minimum tax. In addition, interest on the Public Improvement Bonds may be subject to a branch profits tax imposed on certain foreign corporations doing business in the United States and to a tax imposed on excess net passive income of certain S corporations.

Under the Code, the exclusion of interest from gross income for federal income tax purposes may have certain adverse federal income tax consequences on items of income, deduction or credit for certain taxpayers, including financial institutions, certain insurance companies, recipients of Social Security and Railroad Retirement benefits, those that are deemed to incur or continue indebtedness to acquire or carry tax-exempt obligations, and individuals otherwise eligible for the earned income tax credit. The applicability and extent of these or other tax consequences will depend upon the particular tax status or other tax items of the owner of the Public Improvement Bonds. Bond Counsel will express no opinion regarding those consequences.

Ownership of tax-exempt obligations, including the Public Improvement Bonds, may also result in collateral income tax consequences under Puerto Rico law to financial institutions doing business in Puerto Rico.

Purchasers of the Public Improvement Bonds at other than their original issuance at the respective prices indicated on the inside cover of this Official Statement should consult their own tax advisors regarding other tax considerations, such as the consequences of market discount.

**Original Issue Discount and Original Issue Premium**

Certain of the Public Improvement Bonds ("Discount Bonds") as indicated on the inside cover page of this Official Statement may be offered and sold to the public at an original issue discount ("OID"). OID is the excess of the stated redemption price at maturity (the principal amount) over the "issue price" of a Discount Bond. The issue price of a Discount Bond is the initial offering price to the public (other than to bond houses, brokers or similar persons acting in the capacity of underwriters or wholesalers) at which a substantial amount of the Discount Bonds of the same maturity is sold pursuant to that offering. For federal income tax purposes, OID accrues to the owner of a Discount Bond over the period to maturity based on the constant yield method, compounded semiannually (or over a shorter permitted compounding interval selected by the owner). The portion of OID that accrues during the period of ownership of a Discount Bond purchased in the initial offering at the price for such Discount Bond stated on the inside cover page of this Official Statement (i) is interest excludable from the owner's gross income for federal income tax purposes to the same extent, and subject to the same considerations discussed above, as other interest on the Public Improvement Bonds, and (ii) is added to the owner's tax basis for purposes of determining gain or loss on the maturity, redemption, prior sale or other disposition of that Discount Bond. A purchaser of a Discount Bond at its issue price in the initial public offering who holds that Discount Bond to maturity will realize no gain or loss upon the retirement of that Discount Bond.

Certain of the Public Improvement Bonds ("Premium Bonds") as indicated on the inside cover page of this Official Statement may be offered and sold to the public at a price in excess of their stated redemption price (the principal amount) at maturity. That excess constitutes bond premium. For federal income tax purposes, bond premium is amortized over the period to maturity of a Premium Bond, based on the yield to maturity of that Premium Bond (or, in the case of a Premium Bond callable prior to its stated maturity, the amortization period and yield may be required to be determined on the basis of an earlier call date that results in the lowest yield on that Premium Bond), compounded semiannually. No portion of that bond premium is deductible by the owner of a Premium Bond. For purposes of determining an owner's gain or loss on the sale, redemption (including redemption at maturity) or other disposition of a Premium Bond, the owner's tax basis in the Premium Bond is reduced by the amount of bond premium that accrues during the period of ownership. As a result, an owner may realize taxable gain for federal income tax purposes from the sale or other disposition of a Premium Bond for an amount equal to or less than the amount paid by the owner for that Premium Bond. A purchaser of a Premium Bond at its issue price in the initial offering who holds that Premium Bond to maturity (or, in the case of a callable Premium Bond, to its earlier call date that results in the lowest yield on that Premium Bond) will realize no gain or loss upon the retirement of that Premium Bond.

Owners of Discount and Premium Bonds should consult their own tax advisors as to the determination for federal income tax purposes of the amount of OID or bond premium properly accruable in any period with respect to the Discount or Premium Bonds and as to other federal tax consequences and the treatment of OID and bond premium for purposes of state and local taxes on, or based on, income.

**Refunding Bonds**

Assuming no change in existing law, it is expected that an opinion substantially similar to the opinion described above with respect to the Public Improvement Bonds, and subject to the same limitations as described above with respect to the Public Improvement Bonds, will be issued in connection with the issuance of the Refunding Bonds. See "Delayed Delivery of the Refunding Bonds" under *Plan of Financing* and "Forms of Opinions of Bond Counsel" in *Appendix II*.

## LEGAL MATTERS

The proposed forms of opinions of Squire, Sanders & Dempsey L.L.P., Miami, Florida, Bond Counsel, are set forth in *Appendix II* to this Official Statement. Certain legal matters will be passed upon for the Underwriters by Pietrantoni Méndez & Alvarez LLP, San Juan, Puerto Rico.

## LEGAL INVESTMENT

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

## VERIFICATION OF MATHEMATICAL COMPUTATIONS

The Verification Agent will verify, from the information provided to them, the mathematical accuracy as of the date of the closing of the Refunding Bonds of the computations contained in the provided schedules to determine that the anticipated receipts from the investments 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 (see *Plan of Financing*). The Verification Agent will express no opinion on the assumptions provided to them, nor as to the exclusion from gross income for Federal income tax purposes of the interest on the Refunding Bonds.

## UNDERWRITING

The Underwriters have jointly and severally agreed, subject to certain conditions, to purchase the Public Improvement Bonds from the Commonwealth at an aggregate discount of $3,339,938 from the initial offering prices of such bonds. The Underwriters have jointly and severally agreed, subject to certain conditions, to purchase the Refunding Bonds from the Commonwealth at an aggregate discount of $544,206 from the initial offering prices of such bonds. The obligation of the Underwriters to purchase the Public Improvement Bonds is subject to certain conditions precedent, and they will be obligated to purchase all the Public Improvement Bonds, if any such bonds are purchased. The obligation of the Underwriters to purchase the Refunding Bonds is subject to certain conditions precedent and may be terminated as described above in "Delayed Delivery of the Refunding Bonds" under *Plan of Financing*. The Underwriters will be obligated to purchase all the Refunding Bonds if any such bonds are purchased. The Underwriters may offer to sell the Bonds to certain dealers and others at prices lower than the initial public offering prices. The offering prices may be changed, from time to time, by the Underwriters.

Lehman Brothers Inc. , a managing underwriter, has entered into a written agreement with Santander Securities Corporation, pursuant to which Santander Securities Corporation has agreed to provide investment banking services to Lehman Brothers in connection with Lehman Brothers' provision of underwriting and investment banking services to the Commonwealth with respect to the Bonds. Pursuant to this agreement, the existence of which has been disclosed to the Commonwealth and Government Development Bank, Santander Securities Corporation will be entitled to receive a portion of Lehman Brothers' actual net profits, if any, in connection with the underwriting of the Bonds. Other similar agreements with respect to the sharing of underwriting net profits have been entered into and disclosed to the Commonwealth and Government Development Bank by the following Underwriters: Goldman, Sachs & Co. and Firstbank Puerto Rico; ABN Amro Financial Services, Inc. and Prudential Securities Corporation; Banc of America Securities LLC and Oriental Financial Services Corporation; Morgan Stanley & Co. Incorporated and Popular Securities, Inc; and Wachovia Bank, National Association and Doral Securities, Inc.

## GOVERNMENT DEVELOPMENT BANK FOR PUERTO RICO

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

## RATINGS

Moody's and Standard & Poor's have given the Bonds ratings of "Baa1" and "A-" , respectively. These ratings do not reflect the Policy. Moody's and Standard & Poor's are expected to give the Insured Bonds ratings of "Aaa" and "AAA", respectively, based on the expected issuance by Financial Guaranty of the Policy covering the Insured Bonds. Ratings reflect only the respective views of the rating agencies and an explanation of the significance of each rating may be obtained only from the respective rating agency.

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

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

## CONTINUING DISCLOSURE

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

1. to file within 305 days after the end of each fiscal year commencing with the fiscal year ending June 30, 2002 (June 30, 2003 with respect to the Refunding Bonds), with each NRMSIR and with any Commonwealth state information depository ("SID"), core financial information and operating data for the prior fiscal year, including (i) the Commonwealth's audited financial statements, prepared in accordance with generally accepted accounting principles in effect from time to time, and (ii) material historical quantitative data (including financial information and operating data) on the Commonwealth and its revenues, expenditures, financial operations and indebtedness, in each case generally found in this Official Statement; and

2. to file, in a timely manner, with each NRMSIR or with the MSRB and with any Commonwealth SID, notice of any failure of the Commonwealth to comply with paragraph 1 above and of the occurrence of any of the following events with respect to the Bonds, if material:

    a. principal and interest payment delinquencies;
    b. non-payment related defaults;
    c. unscheduled draws on debt service reserves reflecting financial difficulties;
    d. unscheduled draws on credit enhancements reflecting financial difficulties;
    e. substitution of credit or liquidity providers, or their failure to perform;
    f. adverse opinions or events affecting the tax-exempt status of the Bonds;
    g. modifications to rights of the holders (including Beneficial Owners) of the Bonds;
    h. Bond calls;
    i. defeasances;
    j. release, substitution, or sale of property securing repayment of the Bonds; and
    k. rating changes.

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 Bonds do not provide for "debt service reserves." For a description of the Bonds, see *The Bonds*. In addition, with respect to the following events:

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

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

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

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 J.J. Kenny Repository, 55 Water Street, 45th Floor, New York, New York 10041; FT Interactive Data, Attn: NRMSIR, 100 William Street, New York, New York 10038; and DPC Data Inc., One Executive Drive, Fort Lee, New Jersey 07024.

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

The Commonwealth acknowledges that its undertaking pursuant to the Rule described above is intended to be for the benefit of the Beneficial Owners of the Bonds, and shall be enforceable by any such Beneficial Owners; provided that the right to enforce the provisions of its undertaking shall be limited to a right to obtain specific enforcement of the Commonwealth's obligations thereunder.

No Beneficial Owner may institute any suit, action or proceeding at law or in equity ("Proceeding") for the enforcement of the foregoing covenants (the "Covenants") or for any remedy for breach thereof, unless such Beneficial Owner shall have filed with the Commonwealth written notice of any request to cure such breach, and the Commonwealth shall have refused to comply within a reasonable time. All Proceedings shall be instituted only in a Commonwealth court located in the Municipality of San Juan, Puerto Rico for the equal benefit of all Beneficial Owners of the outstanding Bonds benefitted by the Covenants, and no remedy shall be sought or granted other than specific performance of any of the Covenants at issue. Moreover, Proceedings filed by Beneficial Owners against the Commonwealth may be subject to the sovereign immunity provisions of Section 2 of Act No. 104, approved June 29, 1955, as amended (32 L.P.R.A. §3077 and §3077a), which governs the scope of legal actions against the Commonwealth, substantially limits the amount of monetary damages that may be awarded against the Commonwealth and provides certain notice provisions, the failure to comply with which may further limit any recovery.

The Covenants may only be amended if:

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

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

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

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

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

## MISCELLANEOUS

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

Appended to and constituting a part of this Official Statement are the Commonwealth Report (*Appendix I*), the proposed forms of opinions of Bond Counsel *(Appendix II*), and a specimen of the Policy to be issued by Financial Guaranty *(Appendix III)*.

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

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

**COMMONWEALTH OF PUERTO RICO**

By: /s/ Juan A. Flores Galarza

Secretary of the Treasury

**APPENDIX I**

COMMONWEALTH OF PUERTO RICO
Financial Information and Operating Data Report
May 10, 2002

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**COMMONWEALTH OF PUERTO RICO**

**Financial Information and Operating Data Report**
**May 10, 2002**

# 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. Generally, a portion of the federal excise taxes imposed on shipments of alcoholic beverages from Puerto Rico and other rum producing countries and other taxes on shipments of tobacco products from Puerto Rico to the mainland are returned to the Treasury Department of Puerto Rico. On March 6, 2002, Congress extended, until January 2004, the December 31, 2001 expiration of the current $13.25 per proof gallon cover over of excise taxes on distilled spirits. See "Major Sources of General Fund Revenues - Other Taxes and Revenues" under *Puerto Rico Taxes, Other Revenues and Expenditures*.

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 Labor Secretary, 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 1996 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 3, 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.

Juan Agosto Alicea, President of Government Development Bank for Puerto Rico ("Government Development Bank" or "GDB"), took office on January 2, 2001. He obtained a Bachelor's degree in Business Administration from the University of Puerto Rico and has been a licensed certified public accountant since 1966. He has worked as an auditor for Arthur Andersen & Co., Puerto Rico Industrial Development Company, Peat Marwick & Mitchell, and the Federal Department of Housing and Urban Development. From 1985 to 1988 he served as Secretary of the Treasury, and was chairman of the Board of Directors of Government Development Bank. From 1995 to 1996, he was Administrator of the Municipality of San Juan. He is a former president of the Puerto Rico College of CPAs and the Board of Directors of United Way of Puerto Rico.

**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 by political party is as follows:

| | **Senate** | **House** |
|---|---|---|
| Popular Democratic Party | 19 | 29 |
| New Progressive Party | 8 | 20 |
| Puerto Rico Independence Party | 1 | 1 |
| Independent | - | 1 |
| | 28 | 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 service sectors of the economy and expanding and modernizing the island's infrastructure. Domestic and foreign investment has been stimulated by selective tax exemption, development loans, and other financial and tax incentives. Infrastructure expansion and modernization have been to a large extent financed by bonds and notes issued by the Commonwealth, its public corporations and municipalities. Economic progress has been aided by significant increases in the levels of education and occupational skills of the island's population.

The economy of Puerto Rico operates as a region within the United States. During fiscal year 2001 (July 2000 through June 2001), approximately 88% of Puerto Rico's exports went to the United States mainland, which was also the source of approximately 54% of Puerto Rico's imports. In fiscal year 2001, Puerto Rico experienced a $17.8 billion positive merchandise trade balance.

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

*Fiscal Years 1997 to 2001*

Puerto Rico's almost two decades-long economic expansion continued throughout the five-year period from fiscal year 1997 through fiscal year 2001. Almost every sector of the economy participated, and record levels of employment were achieved. Factors behind this expansion included government-sponsored economic development programs, periodic declines in the exchange value of the United States dollar, increases in the level of federal transfers, the relatively low cost of borrowing and low oil prices.

Gross product in fiscal year 1997 was $32.3 billion ($31.4 billion in 1996 prices) and gross product in fiscal year 2001 was $44.2 billion ($35.3 billion in 1996 prices). This represents an increase in gross product of 36.7% from fiscal year 1997 to 2001 (12.6% in 1996 prices). Since fiscal year 1985, personal income, both aggregate and per capita, has increased consistently each fiscal year. In fiscal year 2001, aggregate personal income was $41.5 billion ($37.2 billion in 1996 prices)[*] and personal income per capita was $10,816 ($9,713 in 1996 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 Puerto Rico than in any state. Transfer payments to individuals in fiscal year 2001 were $8.6 billion, of which $6.3 billion, or 72.7%, represented entitlements

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[*] Different price deflators are used for gross product and personal income statistics.

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.

According to the Labor Department's Household Employment Survey, average employment increased from 1,128,300 in fiscal year 1997 to 1,157,850 in fiscal year 2001. Average unemployment decreased from 13.1% in fiscal year 1997 to 10.5% in fiscal year 2001.

The following table shows the gross product for the five fiscal years ended June 30, 2001.

**Commonwealth of Puerto Rico**

**Gross Product**

| | Fiscal Year Ended June 30 | | | | |
|---|---|---|---|---|---|
| | **1997** | **1998** | **1999** | **2000** | **2001**(1) |
| Gross product - $ millions | $ 32,343 | $ 35,111 | $ 38,281 | $ 41,442 | $ 44,211 |
| Real gross product - $ millions (1996 prices) | 31,390 | 32,410 | 33,723 | 34,733 | 35,341 |
| Annual percentage increase in real gross product (1996 prices) | 3.4% | 3.2% | 4.1% | 3.0% | 1.7% |
| U.S. annual percentage increase in real gross product (1996 prices) | 4.0% | 4.3% | 4.0% | 4.4% | 2.8% |

(1) Preliminary.

*Sources:* Planning Board and Data Resources Inc.

Since the 1950s, the Planning Board has prepared a complete set of macroeconomic measures like those prepared for the United States by the Bureau of Economic Analysis ("BEA") of the Department of Commerce. 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 2001 are preliminary until the revised figures are released.

*Fiscal Year 2002*

According to the Labor Department's Household Employment Survey, during the first ten months of fiscal year 2002, total monthly employment averaged 1,167,100 compared to 1,161,500 in the same period of fiscal year 2001, an increase of 0.5%. As a result of the small increase in average monthly employment and a higher labor participation rate, the unemployment rate increased from 10.2% during the first ten months of fiscal year 2001 to 11.9% during the first ten months of fiscal year 2002. Total employment for April 2002 was 1,191,000, an increase of 48,000 compared to the same period in 2001. The Planning Board's gross product forecast for fiscal year 2002 and fiscal year 2003, made in March 2002, projected an increase of 0.3% for fiscal year 2002 and an increase of 2.7% for fiscal year 2003. The Planning Board's forecast for fiscal year 2002 could be classified as a growth recession.

The performance of the economy during fiscal year 2002 was affected primarily by the performance of the United States economy, the level of transfer payments, and the level of oil prices and interest rates. In the past, Puerto Rico has been heavily dependent on oil imports for its energy needs.

**Economic Development Program**

The Commonwealth's current economic development program is based on the following four initiatives: (i) the enactment of laws in Puerto Rico providing tax benefits that will promote foreign 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 amendment of Section 956 of the United States Internal Revenue Code of 1986 (the "Code") to incorporate new Federal income tax benefits that enhance the attractiveness of establishing operations in Puerto Rico.

*Puerto Rico Legislation*

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 recently enacted legislation extending certain benefits of its most recent tax incentive law, Act No. 135 of December 2, 1997 (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 recently 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 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 shares of 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 received by financial institutions in connection with guaranteeing the payment of debt issued to finance tourism development projects; (v) granting 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 for financial institutions for charges collected on obligations issued for the financing of tourism projects; (vii) granting tax exemption for the investments in infrastructure made by housing developers; and (viii) rehabilitating urban centers through the development of housing projects, community areas, commercial areas, parks and recreational spaces, construction and reparation of structures and the development of bare or under-developed sites.

Legislation has also been enacted to grant tax credits to Puerto Rico businesses that acquire products manufactured in Puerto Rico for exportation.

*Acceleration and Simplification of Local Permitting Process*

Another of the government's initiatives to promote economic activity is to simplify the regulatory process for obtaining government permits in order to accelerate the granting of permits and reduce the costs of the permitting process. As part of this initiative, the government has established a multi-agency center that will handle in a coordinated way the permitting process and allow the filing of a single application for all government permits required for a project. When public hearings are required by various government agencies, the government is also developing a procedure to allow them to be conducted simultaneously by the various government agencies.

*Reduction of the Costs of Doing Business*

The government 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.

The high cost of energy in Puerto Rico has been identified as one of the costs of doing business that particularly affects the manufacturing industry. The government has sought to lower this cost by reducing Puerto Rico's dependence on oil for energy production through the development of the cogeneration plants mentioned below. In addition, Puerto Rico Electric Power Authority has commenced a hedging program with respect to oil prices to lessen the impact of the volatility of oil prices on the cost of electricity.

*Federal Legislative Proposal*

In order to enhance the attractiveness for United States companies of establishing operations in Puerto Rico, the Commonwealth government is seeking to have Section 956 of the Code amended to provide a new and permanent tax regime applicable to U.S. based businesses that have operations in the Commonwealth or other U.S. possessions. This proposed regime is 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. For a discussion of the bill which has been introduced in the U.S. Congress incorporating the Commonwealth's proposed amendment, see "Proposed New U.S. Tax Regime for Companies Doing Business in Puerto Rico - Section 956 of the Code" under "Tax Incentives" below.

## Employment and Unemployment

The number of persons employed in Puerto Rico during fiscal year 2001 averaged 1,157,850. Unemployment, although at relatively low historical levels, remains above the United States average. Average unemployment decreased from 13.1% in fiscal year 1997 to 10.5% in fiscal year 2001, the lowest level since 1970, as a result of a moderate increase in employment and a drop in the labor participation rate. During the first ten months of fiscal year 2002, however, the unemployment rate increased to 11.9%, as a result of an increase in the labor participation rate which offset a small increase in total employment.

The following table presents annual statistics of employment and unemployment for fiscal year 1997 through fiscal year 2001, and monthly statistics for July to April 2002.

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

| Fiscal Years Ended June 30 | Labor Force[(1)] | Employed[(1)] | Unemployed[(1)] | Unemployment Rate[(2)] |
|---|---|---|---|---|
| | | (Annual Average) | | |
| 1997 | 1,298 | 1,128 | 170 | 13.1% |
| 1998 | 1,317 | 1,137 | 179 | 13.6 |
| 1999 | 1,310 | 1,147 | 163 | 12.5 |
| 2000 | 1,303 | 1,159 | 143 | 11.0 |
| 2001 | 1,293 | 1,158 | 135 | 10.5 |
| **Fiscal Year 2002** | | (Seasonally Adjusted) | | |
| July | 1,276 | 1,135 | 140 | 11.0% |
| August | 1,311 | 1,149 | 162 | 12.4 |
| September | 1,317 | 1,155 | 162 | 12.3 |
| October | 1,313 | 1,152 | 161 | 12.3 |
| November | 1,319 | 1,172 | 147 | 11.1 |
| December | 1,309 | 1,167 | 141 | 10.8 |
| January | 1,328 | 1,183 | 145 | 10.9 |
| February | 1,361 | 1,182 | 179 | 13.2 |
| March | 1,348 | 1,185 | 164 | 12.2 |
| April | 1,361 | 1,191 | 170 | 12.5 |

(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**

Puerto Rico has a diversified economy. During the period between fiscal year 1997 and 2001, the manufacturing and services sectors generated the largest portion of gross domestic product. Three sectors of the economy provide the most employment: manufacturing, services and government.

The following table presents annual statistics of gross domestic product by sector and gross product for the five fiscal years ended June 30, 2001.

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

| | Fiscal Year Ended June 30 | | | | |
|---|---|---|---|---|---|
| | **1997** | **1998** | **1999** | **2000** | **2001**(1) |
| Manufacturing | $19,302 | $22,994 | $23,312 | $23,375 | $27,099 |
| Services(2) | 18,956 | 20,682 | 22,435 | 24,814 | 26,785 |
| Government(3) | 5,220 | 5,251 | 5,530 | 5,478 | 6,011 |
| Transportation, communication and public utilities | 3,751 | 3,978 | 4,032 | 4,312 | 4,704 |
| Agriculture, forestry and fisheries | 466 | 437 | 336 | 527 | 487 |
| Construction(4) | 1,257 | 1,482 | 1,668 | 1,833 | 1,977 |
| Statistical discrepancy | (765) | (739) | 529 | 706 | 835 |
| Total gross domestic product(5) | 48,187 | 54,086 | 57,841 | 61,045 | 67,897 |
| Less: net payment abroad | (15,844) | (18,976) | (19,560) | (19,603) | (23,686) |
| Total gross product(5) | $32,343 | $35,110 | $38,281 | $41,442 | $44,211 |

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

*Source:* Planning Board

The following table presents annual statistics of average employment by sector for the five fiscal years ended June 30, 2001.

**Commonwealth of Puerto Rico**
**Non-Farm Payroll Employment by Economic Sector(1)**
**(thousands of persons)**

| | Fiscal Year Ended June 30 | | | | |
|---|---|---|---|---|---|
| | **1997** | **1998** | **1999** | **2000** | **2001(2)** |
| Manufacturing | 153 | 150 | 146 | 142 | 140 |
| Services(3) | 432 | 444 | 459 | 480 | 491 |
| Government(4) | 319 | 310 | 302 | 286 | 280 |
| Transportation, communication and public utilities | 26 | 27 | 29 | 35 | 34 |
| Construction(5) | 58 | 59 | 66 | 71 | 74 |
| Total(6) | 987 | 990 | 1,002 | 1,014 | 1,019 |

(1) The figures presented in this table are based on the Current Employment Statistics Survey (Establishment Survey) prepared by the Bureau of Labor and Statistics of Puerto Rico Labor and Human Resource Department. There are numerous conceptual and methodological differences between the Current Population Survey (Household Survey) and the Establishment Survey. The Establishment 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 Establishment Survey excludes the self-employed and agriculture employment. In Puerto Rico, self-employment represents around 14% of total employment.
(2) Preliminary.
(3) Includes wholesale and retail trade, finance, insurance and real estate, hotels and related services, and other services.
(4) Includes the Commonwealth, its municipalities and the federal government; excludes public corporations.
(5) Includes mining.
(6) Totals may not add due to rounding.

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

*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 2001 manufacturing generated $27.1 billion, or 39.9% of gross domestic product. The manufacturing sector employed 137,770 workers as of March 2001 (as reported in the Department of Labor and Human Resources - Benchmark on Employment Hours and Earnings). During the first nine months of fiscal year 2002, the manufacturing sector employed 131,130 workers, a decrease of 6.7% compared with the same period for fiscal year 2001, 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 semifinished 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 January 2002, the average hourly manufacturing wage rate in Puerto Rico was 67.3% of the average mainland United States rate.

Manufacturing in Puerto Rico is now more diversified than during the earlier phases of the industrial development program. In the last 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 heavy investment in the pharmaceuticals, scientific instruments, computers, and electrical products industries in Puerto Rico over the last decade.

The following table sets forth gross domestic product by manufacturing sector for the five fiscal years ended June 30, 2001.

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

| | Fiscal Year Ended June 30 | | | | |
|---|---|---|---|---|---|
| | **1997** | **1998** | **1999** | **2000** | **2001**(1) |
| Pharmaceuticals | $10,354 | $13,192 | $12,913 | $12,654 | $15,296 |
| Machinery and metal products: | | | | | |
| Machinery, except electrical | 925 | 1,131 | 1,847 | 2,049 | 2,702 |
| Electrical machinery | 1,496 | 1,506 | 1,410 | 1,451 | 1,915 |
| Professional and scientific instruments | 1,334 | 1,596 | 1,697 | 1,834 | 1,911 |
| Other machinery and metal products | 300 | 351 | 377 | 400 | 394 |
| Food products | 2,086 | 2,073 | 1,910 | 1,852 | 1,949 |
| Other chemical and allied products | 590 | 941 | 898 | 815 | 601 |
| Apparel | 622 | 610 | 609 | 639 | 648 |
| Other(2) | 1,595 | 1,595 | 1,651 | 1,683 | 1,684 |
| Total gross domestic product of manufacturing sector(3) | $19,302 | $22,994 | $23,312 | $23,375 | $27,099 |

(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 sets forth manufacturing employment by industry group as of March 31 for the last five years.

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

| Industry Group | As of March 31 1997 | 1998 | 1999 | 2000 | 2001 |
|---|---|---|---|---|---|
| Apparel and related products | 21,750 | 19,039 | 18,349 | 16,770 | 15,304 |
| Food and related products | 19,949 | 17,816 | 16,852 | 15,182 | 14,877 |
| Electrical machinery, equipment and supplies | 24,671 | 22,728 | 20,254 | 19,394 | 18,883 |
| Chemicals and related products (includes pharmaceuticals) | 27,235 | 27,524 | 26,899 | 28,714 | 29,169 |
| Professional and scientific instruments | 14,914 | 15,105 | 14,542 | 14,818 | 15,068 |
| Machinery, except electrical and transportation equipment | 3,755 | 3,068 | 3,790 | 3,593 | 3,457 |
| Petroleum refining and related industries; rubber and miscellaneous plastic products | 5,768 | 5,994 | 5,970 | 6,197 | 5,690 |
| Leather and leather products | 6,566 | 5,834 | 4,749 | 3,982 | 2,884 |
| Paper and related products; printing, publishing and related industries | 7,441 | 8,698 | 9,418 | 9,536 | 9,078 |
| Metal products | 5,683 | 6,159 | 6,390 | 6,719 | 7,672 |
| Stone, clay and glass products | 4,972 | 5,217 | 5,509 | 5,929 | 5,888 |
| Lumber and wood products; furniture and fixtures | 3,352 | 3,538 | 3,446 | 3,343 | 3,597 |
| Textile mill products | 3,627 | 3,282 | 2,827 | 2,010 | 2,081 |
| Tobacco products | 1,206 | 1,285 | 1,297 | 1,254 | 1,438 |
| Miscellaneous manufacturing industries | 2,384 | 3,558 | 3,125 | 3,114 | 2,684 |
| Total | 153,273 | 148,845 | 143,417 | 140,555 | 137,770 |

*Sources:* Department of Labor and Human Resources, Census of Manufacturing, except for March 1999, 2000 and 2001, which information was derived from the "benchmark" on Employment, Hours and Earnings

While total employment in the manufacturing sector decreased by 15,503 from March 1997 to March 2001, other indicators of the manufacturing sector suggest that manufacturing production increased. Average weekly hours worked increased 4.4% from fiscal year 1997 to fiscal year 2001. 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 productivity. Most of the decreases in employment have been concentrated in labor intensive industries, particularly apparel, textiles, tuna canning, leather products and electro-mechanical manufacturing.

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

| Employment 2,500 and over | Product |
|---|---|
| American Home Products | Pharmaceuticals |
| Baxter International | Pharmaceuticals |
| Bristol Myers Squibb Corp. | Pharmaceuticals |
| Coach Inc. | Apparel |
| Eaton Corp. | Electronic Instruments |
| General Electric Co. | Electronic Instruments |
| ICN Pharmaceuticals Inc. | Pharmaceuticals |
| Johnson and Johnson | Pharmaceuticals |
| Pfizer | Pharmaceuticals |

| Employment 1,000 to 2,499 | Product |
|---|---|
| Abbott Laboratories Inc. | Pharmaceuticals |
| Bumble Bee Seafoods | Food |
| Cardinal Health Inc. | Packages Products |
| Hewlett-Packard | Computers |
| Hubell Incorporated | Electrical Instruments |
| MacAndrews & Forbes Holdings | Tobacco Products |
| Medtronics | Surgical and Medical Instruments |
| Merck & Co | Chemicals |
| Monsanto | Pharmaceuticals |
| Ocular Science-American Hydron | Ophthalmic Products |
| Propper International | Apparel |
| Schering Plough Corp. | Pharmaceuticals |
| Sensormatic-Electronics | Electronic Components |
| U.S. Surgical Corp. | Scientific Instruments |

| Employment 500 to 999 | Product |
|---|---|
| Allergan Inc. | Pharmaceuticals |
| Aramark | Apparel |
| Astra Zeneca Group PLC | Pharmaceuticals |
| B. Braun Medical Systems | Medical Equipment |
| Becton-Dickinson & Co. | Scientific Instruments |
| Conagra | Food |
| Eli Lilly and Co. | Pharmaceuticals |
| Guidant Corp. | Medical Instruments |
| Hamilton Sundstrand Corp. | Electrical Instruments |
| Ingersoll-Rand Co. | Electrical Instruments |
| Novartis-Holding AG | Ophthalmic Products |
| Nypro | Medical Devices |
| Pharmacia Up-John Co. | Pharmaceuticals |
| Procter & Gamble Co. | Pharmaceuticals |
| R.J.R. Nabisco | Food and Cigarettes |
| SmithKline Beecham | Pharmaceuticals |
| Solectron Corp. | Electronic Components |
| Storage Technology Corp. | Electronic |
| Suiza Foods | Food |
| Timberland Company (The) | Leather |

| Employment 200 to 499 | Product |
|---|---|
| Aiken | Electronic Components |

| Employment 200 to 499 | Product |
|---|---|
| Amgen Manufacturing Co. | Pharmaceuticals |
| Atlantron Inc. | Communications |
| Aventis Pharmaceuticals | Pharmaceuticals |
| Avon Products Inc. | Costume Jewelry |
| Bacardí Limited | Beverages |
| Biovail Corporation Intl. | Pharmaceuticals |
| Block Drug Co. | Pharmaceuticals |
| C.R. Bard | Surgical Instruments |
| Carolina Underwear Co. | Apparel |
| Checkpoint Systems Inc. | Electronic |
| Coca Cola Company (The) | Food |
| Colgate-Palmolive Co. | Consumer Products |
| Corning Cable Systems LLC | Electronic Connectors |
| Curtis Instruments | Medical Instruments |
| Dana Corp. | Motor Vehicle Parts |
| Dexter Shoe | Footwear |
| Dooney & Bourke | Leather |
| Eagle Work Clothes | Apparel |
| Emerson Electric | Electronic Instruments |
| ESCO | Filters |
| Essilor International | Ophthalmic Products |
| Ferrero S.P.A. | Plastics Products |
| Impress Metal Packaging | Metal Products |
| ICI Omicron B.V. | Chemicals |
| Ivax Corporation | Medical Equipment |
| Jostra Med Izintechnick AG | Surgical and Medical Instruments |
| Lawson Mardon Wheaton | Glass and Plastics |
| Loctite Corp. | Chemicals |
| Lutron Electronics Co. | Electronic |
| Matsushita Electric Industrial | Electrical Instruments |
| Millipore Corp. | Scientific Instruments |
| Northrop Grumman Corp. | Electrical Instruments |
| Owens Illinois | Glass and Plastics |
| Pall Corp. | Filters |
| Praxair | Chemicals |
| PepsiCo | Food |
| Pillsbury International | Food |
| Rocky Shoes & Boots | Footwear |
| Schein Pharmaceutical | Pharmaceuticals |
| Siemens AG | Electrical Instruments |
| Signal Transformer Co. | Electrical Equipment |
| St. Jude Medical Inc. | Medical Instruments |
| Standard Mfg. Co. | Apparel |
| Standard Motor Products | Motor Vehicle Parts |
| Sun Co. | Oil Refining |
| Symmetricom Inc. | Electronic Equipments |
| Thomas & Betts | Electronic Equipments |
| TYCO Health Care | Medical Instruments |
| Unilever PLC | Consumers and Medicals |

*Source:* PRIDCO, Office of Economic Research (as of March 2002)

*Services*

Puerto Rico has experienced significant growth in the services sector (including finance, insurance, real estate, wholesale and retail trade, hotels and related services 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 1997 and 2001, the gross domestic product in this sector increased at an annual average rate of 9.0%, while employment increased at an annual average rate of 3.3%. The development of the services sector has shown a strong interaction among the following important sectors: manufacturing, tourism, construction, and agriculture. The services sector in Puerto Rico has a diversified base.

The high degree of knowledge, skills, and expertise in professional and technical services available in Puerto Rico places 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 2001, services generated $26.8 billion of gross domestic product, or 39.4% of the total. Service employment grew from 432,100 in fiscal year 1997 to 491,200 in fiscal year 2001, a cumulative increase of 13.7%, which increase was greater than the 3.3% cumulative growth in total employment over the same period. Wholesale and retail trade, finance, insurance and real estate experienced significant growth in fiscal years 1997 to 2001, as measured by gross domestic product. Gross domestic product in wholesale and retail trade increased from $6.7 billion in fiscal year 1997 to $8.7 billion in fiscal year 2001. In finance, insurance and real estate, gross domestic product increased from $6.9 billion in fiscal year 1997 to $11.2 billion in fiscal year 2001. There are sixteen commercial banks and trust companies currently operating in Puerto Rico. Total assets of these institutions as of December 31, 2001 were $61.6 billion.

The following tables set forth gross domestic product and employment for the services sector for the five fiscal years ended June 30, 2001.

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

| | Fiscal Year Ended June 30 | | | | |
|---|---|---|---|---|---|
| | **1997** | **1998** | **1999** | **2000** | **2001[1]** |
| Wholesale and retail trade | $ 6,724 | $ 7,287 | $ 8,112 | $ 8,421 | $ 8,717 |
| Finance, insurance and real estate | 6,917 | 7,672 | 8,183 | 9,903 | 11,181 |
| Other services[2] | 5,314 | 5,723 | 6,140 | 6,489 | 6,887 |
| Total[3] | $18,955 | $20,682 | $22,435 | $24,814 | $26,785 |

(1) Preliminary.
(2) Includes hotel and related services.
(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 Year Ended June 30 | | | | |
|---|---|---|---|---|---|
| | **1997** | **1998** | **1999** | **2000** | **2001**[1] |
| Wholesale and retail trade | 196 | 200 | 205 | 217 | 222 |
| Finance, insurance and real estate | 46 | 47 | 48 | 49 | 48 |
| Other services[2] | 190 | 197 | 205 | 215 | 221 |
| Total | 432 | 444 | 459 | 480 | 491 |

(1) Preliminary.
(2) Includes hotels and related services.

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

### *Hotels and Related Services - Tourism*

Total visitors' expenditures accounted for 4.0% of the island's gross domestic product in fiscal year 2001, compared to 3.9% in fiscal year 2000. Visitors' expenditures and the number of visitors to the island had grown consistently from 1985 to 1998. In fiscal year 1999, however, the number of visitors to the island and visitors' expenditures decreased, due in part to the effect of Hurricane Georges, which struck the island in September 1998. During fiscal year 2000, the number of visitors to the island increased to 4.6 million and visitors' expenditures increased to $2.4 billion. In fiscal year 2001, the number of visitors to the island increased to 4.9 million and visitors' expenditures increased to $2.7 billion, an increase of 7.5% and 14.2%, respectively, compared to fiscal year 2000.

The number of persons registered in tourist hotels during fiscal year 2001 increased 10.9% over the number registered during fiscal year 2000. The average occupancy rate in tourist hotels during fiscal year 2001 was 70.0% compared to 74.2% in fiscal year 2000. The average number of rooms rented in tourist hotels increased 1.7% during fiscal year 2001 compared with fiscal year 2000. These increases are due in part to increased marketing by the Commonwealth, trends in the U.S. economy and increased hotel usage by Puerto Rico residents.

During the first eight months of fiscal year 2002, the number of persons registered in tourist hotels was 983,200, a decrease of 2.0% over the number registered during the same period of fiscal year 2001. The average occupancy rate in tourist hotels during the first eight months of fiscal year 2002 was 61.1% compared to 68.3% in the same period of fiscal year 2001. The average number of rooms rented in tourist hotels decreased 7.3% during the first eight months of fiscal year 2002 compared with the same period of fiscal year 2001. The average number of rooms available in tourist hotels increased 3.4% during the first eight months of fiscal year 2002 compared with the same period of fiscal year 2001. The government's implementation of new initiatives is expected to help the tourism sector in Puerto Rico.

San Juan is the largest homeport for cruise ships in the Caribbean and the fourth largest homeport 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, 2001.

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

| | Number of Visitors | | | | |
|---|---|---|---|---|---|
| **Fiscal Year Ended June 30** | **Tourist Hotels**[(2)] | **Cruise Ship** | **Other**[(3)] | **Total** | **Total Visitors' Expenditures (in millions)** |
| 1997 | 906,706 | 1,107,913 | 2,335,068 | 4,349,687 | 2,046.3 |
| 1998 | 1,030,500 | 1,274,700 | 2,365,600 | 4,670,800 | 2,232.9 |
| 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)] | 1,186,800 | 1,354,600 | 2,364,400 | 4,907,800 | 2,728.1 |

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

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

*Government*

The government sector of Puerto Rico plays an important role in the economy. In fiscal year 2001, government accounted for $6.0 billion of Puerto Rico's gross domestic product, or 8.9% of the total. The government is also a significant employer, providing jobs for 280,300 workers, or 27.5% of total employment in fiscal year 2001. Government sector employment does not include employment by public corporations, which is included in the employment statistics of other sectors. These public corporations include significant employers such as the Electric Power Authority and the Aqueduct and Sewer Authority. The government's (including the central government, the public corporations and the municipalities) share of payroll employment, measured according to the payroll survey, has diminished from 34.9% in fiscal year 1981, to 33.6% in fiscal year 1990, and to 26.5% in fiscal year 2000.

On February 25, 1998, legislation was enacted permitting the unionization of government employees (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; annual salary increases are limited; 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-six United States and international airlines. At present, there is daily direct service between San Juan and New York, Chicago, Dallas, Los Angeles, Miami, Atlanta, Boston, and numerous other destinations within the United States. There is also regularly scheduled service between Puerto Rico and other Caribbean islands and major Latin American and European cities. A major United States airline uses San Juan as a hub for its intra-Caribbean 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, 2001, totaled approximately 4,607 miles. The highway system comprises 228 miles of primary urban system highways, 379 miles of primary rural system highways and 4,000 miles of secondary and tertiary highways and roads.

The Commonwealth is conducting a request for proposal process to select a private company to develop, construct and operate a world class transshipment facility in the south coast of Puerto Rico, to be called the Port of the Americas. This state-of-the-art facility will handle Post-Panamax vessels with a capacity of more than 6,000 TEUs (Twenty-Foot Equivalent Unit cargo trailers), which currently are the latest generation of cargo ships. In December 2001 and January 2002 the preliminary environmental impact statements for this project were filed. Construction is projected to start in June 2004. In addition, legislation is under consideration in the Legislature of Puerto Rico to establish the Port of the Americas Authority, which will have the full decision-making power to negotiate and select the best candidate to develop and operate the project. GDB has provided a $10 million credit line earmarked for the initial environmental and feasibility studies. The Legislature is expected to appropriate $38.7 million in fiscal year 2003 to start the off-site infrastructure construction and improvement of the facilities needed to operate the project.

*Construction*

The construction industry has experienced substantial real growth since fiscal year 1987. Although it represents a relatively small segment of the economy compared to other sectors, it has made significant contributions to the growth of economic activity.

During the period from fiscal year 1997 through fiscal year 2000, construction investment increased 44.9%, and in fiscal year 2001, it remained at $6.8 billion. The total value of construction permits increased 25.3% over the same five year period. The strength of public investment has been an important component in the significant expansion of construction investment. During fiscal year 2001, approximately 36.7% of the total investment in construction was related to public projects. While sales of locally produced cement for fiscal year 2001 decreased 2.0% in comparison with fiscal year 2000, the government believes that total sales of cement for fiscal year 2001 increased slightly from fiscal year 2000 because of an offsetting increase in sales of imported cement. In fiscal year 2001, the average employment in the construction sector was 72,700, an increase of 4.2% over fiscal year 2000.

During the first eight months of fiscal year 2002, the total value of construction permits decreased 38.0%, compared with the same period in fiscal year 2001. Total sales of locally produced cement decreased 4.7% during the first seven months of fiscal year 2002 in comparison with the same period of fiscal year 2001, which decrease was offset by increases in imported cement. The average employment in the construction sector during the first nine months of fiscal year 2002 was 71,413.

For the current fiscal year, the latest survey of construction investment anticipates a decline in private investment and a significant increase of 24% in public investment compared with fiscal year 2001. According to the survey, the growth in public investment will come primarily from housing, hotels, new schools (and school reconstruction programs), water projects and other infrastructure projects to be undertaken by Puerto Rico Highway and Transportation Authority ("PRHTA") and GDB. For fiscal year 2003, approximately $1.2 billion is expected to be invested for public improvements.

*Agriculture*

The Department of Agriculture and related agencies have directed their efforts at increasing and improving local agricultural production, increasing efficiency and quality of produce, and stimulating the consumption of locally produced agricultural products. During fiscal year 2001, gross income from agriculture was $716.1 million, a decrease of 0.7% in comparison with fiscal year 2000. 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. Recently, non-traditional crops and livestock and poultry 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 are expected to be implemented to promote employment and income generated by the agricultural sector. The policy initiatives being considered include a restructuring of the Department of Agriculture, an increase in government purchases of local agricultural products, and a new system of agricultural credits and subsidies for new projects.

**Higher Education**

During the four decades from 1950 to 1990, 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. Since the 1980s, college attendance has remained relatively stable as a percentage of the college age population, generally following the trend in the United States.

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

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

| Academic Year | Commonwealth of Puerto Rico: Population 18-24 Years of Age(1) | Commonwealth of Puerto Rico: Higher Education Enrollment | Commonwealth of Puerto Rico: Percent(2) | Mainland United States: Population 18-24 Years of Age(1) | Mainland United States: Higher Education Enrollment(2) | Mainland United States: Percent |
|---|---|---|---|---|---|---|
| 1970 | 341,448 | 57,340 | 16.8% | 23,714,000 | 8,580,887 | 36.2% |
| 1980 | 397,839 | 130,105 | 32.7 | 30,022,000 | 12,096,895 | 40.3 |
| 1990 | 417,636 | 156,147 | 37.4 | 26,961,000 | 13,819,000 | 51.3 |
| 2000(3) | 470,660 | 174,550 | 37.1 | 26,748,000 | 15,072,000 | 56.3 |

(1) Based on enumerated population as of April 1.
(2) Number of persons of all ages enrolled in institutions of higher education as percent of population 18-24 years of age.
(3) Estimated.

*Sources:* United States Bureau of the Census (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, includes eleven campuses located throughout the island. Total enrollment of the University was 69,773 students during academic year 2000-2001. The Commonwealth is legally bound to appropriate annually for the University 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 37 private institutions of higher education located in Puerto Rico. Such institutions have current enrollment in excess of 100,000 students and provide programs of study in liberal arts, education, business, natural sciences, technology, secretarial and computer sciences, nursing, medicine, and law. Degrees are offered by these institutions at the associate, bachelor, master, and doctoral levels.

## Tax Incentives

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 attracting and retaining foreign 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 which 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. In addition, it provides certain tax credits for qualifying investments in hotel development projects.

As part of the incentives to promote the tourism industry, the Commonwealth established the Tourism Development Fund as a subsidiary of GDB with the authority to make investments in or provide financing to entities that contribute to the development of the tourism industry. The Fund was initially capitalized with $50,000,000 and was authorized to provide financial guarantees for financing hotel development projects. To date the Fund has provided financial guarantees to private entities issuing bonds or borrowing funds to finance the development of thirteen hotel projects that provided approximately 3,000 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 will be 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, a large number of 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 of 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 Section 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. The recent increase in Commonwealth revenues attributable to withholding taxes on royalty payments suggests that a significant share of the net income previously reported by corporations operating under the profit split method of Section 936 has been transferred to CFCs.

*Proposed New U.S. Tax Regime for Companies Doing Business in Puerto Rico - Section 956 of the Code*

One of the elements of the Commonwealth's new economic development plan involves amending the Code to provide a new tax regime applicable to U.S.-based businesses that have operations in Puerto Rico or other U.S. possessions. A proposal to amend the Code in this regard put forth by the Governor of Puerto Rico has broad bi-partisan support in both the U.S. Senate and the House of Representatives.

The proposal would amend the Code as follows: (i) Sections 30A and 936 would be allowed to expire according to their terms; (ii) Section 956 would be amended to exclude from current U.S. tax 90% of the otherwise taxable investments in certain U.S. property made by a "Qualified CFC" out of its "Qualified Income"; (iii) as an alternative to the Section 956 exclusion, Section 245 would be amended to allow an 85% dividends received deduction with respect to dividends paid out of Qualified Income by the Qualified CFC; and (iv) the investment in U.S. properties by the Qualified CFC out of its Qualified Income will not be subject to the imputation of interest nor to treatment as a constructive dividend.

A "Qualified CFC" would be defined under the Code as a controlled foreign corporation which is created or organized under the laws of the Commonwealth or a possession of the United States. "Qualified Income" would be limited to that portion of the CFCs foreign source income that is derived from the active conduct by the CFC of a trade or business in Puerto Rico (or a possession of the United States) or from the sale or exchange of substantially all the assets used by the CFC in the active conduct of such a trade or business. The proposed Section 956 exclusion would be applicable only to income that is eligible for deferral under general U.S. tax principles. Thus, for example, passive income received by the CFC could not be converted from income that is currently taxable under Subpart F of the Code into income eligible for deferral by the investment of such amounts in U.S. property pursuant to the proposed amendment to Section 956.

The legislative process for consideration of this proposal is in the early stages and, thus, it is not possible at this time to determine whether the proposal will be enacted into law or what amendments, if any, may be made to it.

## 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. 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.

The following table presents a summary of public sector debt as of March 31, 2002. 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, except as otherwise noted in footnote 4 to the table below. Also excluded from the table is debt the inclusion of which would reflect double counting, including, but not limited to, $958,285,000 of bonds outstanding by the Municipal Finance Agency to finance its purchase of bonds of Puerto Rico municipalities, and $1,277,422,000 of obligations of GDB issued to purchase certain Commonwealth public sector debt and for other purposes, of which $267,000,000 is guaranteed by the Commonwealth.

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

| | March 31, 2002 |
|---|---|
| Puerto Rico direct debt[(1)] | $ 6,714,600 |
| Municipal debt | 1,722,889 |
| Public corporations debt | |
| Puerto Rico guaranteed debt[(2)] | 610,903 |
| Debt supported by Puerto Rico appropriations or taxes[(3)] | 13,793,651 |
| Other non-guaranteed debt[(4)] | 7,167,837 |
| Total public corporations debt | 21,572,391 |
| Total public sector debt | $30,009,880 |

(1) Includes $57,630,000 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"). Does not include the issuance of the Public Improvement Refunding Bonds, Series 2002, which closed on April 4, 2002 in the amount of $501,565,000 (the "2002 Forward Refunding Bonds").

(2) Consists of $491,093,000 bonds issued by the Aqueduct and Sewer Authority and $119,810,000 of State Revolving Fund Loans, incurred under various federal water laws. Excludes $1,493,562,000 of Public Buildings Authority bonds and notes, which are primarily payable from Commonwealth appropriations and $267,000,000 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 Public Buildings Authority, the Public Finance Corporation, the Infrastructure Financing Authority and the Housing Finance Authority and notes of the Health Facilities and Services Administration which were assumed by the Department of Health. This amount does not include the issuance of Transportation Revenue Refunding Bonds (Series F) of Highway and Transportation Authority issued on April 3, 2002 in the amount of $118,615,000.

(4) Includes $1,081,550,000 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, and $397,005,000 of The Children's Trust Fund bonds which are payable solely from a portion of 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 (A) Commonwealth general obligation bonds outstanding as of March 31, 2002 (including the 2002 Forward Refunding Bonds); and (B) bonds of the Aqueduct and Sewer Authority which were outstanding on March 31, 2002 for which debt service payments are being made under the Commonwealth guaranty.

The table excludes debt service on certain general obligation bonds, notwithstanding that such bonds will be considered to be outstanding under their respective authorizing resolutions and for purposes of calculating the Commonwealth's Constitutional debt limitation because, pending the redemption of said bonds on July 1, 2002 and July 1, 2004, the proceeds of general obligation refunding bonds used to effect such redemption are invested in guaranteed investment contracts rather than in United States Treasury obligations. 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[1]
## (in thousands)

| Fiscal Year Ending June 30 | Outstanding Bonds[2] Principal | Interest | Total Debt Service | PRASA Bonds Debt Service | Grand Total |
|---|---|---|---|---|---|
| 2002 | $ 159,145 | $ 278,763 | $ 437,908 | $ 33,542 | $ 471,449 |
| 2003 | 98,006 | 356,759 | 454,765 | 32,745 | 487,510 |
| 2004 | 102,608 | 354,778 | 457,386 | 30,125 | 487,511 |
| 2005 | 168,955 | 288,429 | 457,384 | 30,127 | 487,511 |
| 2006 | 152,824 | 304,564 | 457,388 | 30,121 | 487,509 |
| 2007 | 136,443 | 320,939 | 457,382 | 30,126 | 487,509 |
| 2008 | 164,208 | 293,169 | 457,376 | 30,131 | 487,507 |
| 2009 | 194,250 | 263,118 | 457,367 | 30,123 | 487,491 |
| 2010 | 206,335 | 251,171 | 457,506 | 29,984 | 487,490 |
| 2011 | 218,267 | 239,299 | 457,566 | 29,928 | 487,494 |
| 2012 | 235,820 | 221,545 | 457,365 | 30,127 | 487,493 |
| 2013 | 249,005 | 208,359 | 457,364 | 30,128 | 487,492 |
| 2014 | 242,198 | 215,171 | 457,368 | 30,125 | 487,493 |
| 2015 | 253,675 | 203,692 | 457,366 | 30,126 | 487,492 |
| 2016 | 266,030 | 191,344 | 457,375 | 30,121 | 487,495 |
| 2017 | 278,897 | 178,476 | 457,373 | 30,122 | 487,494 |
| 2018 | 292,395 | 164,973 | 457,368 | 30,126 | 487,494 |
| 2019 | 323,386 | 133,991 | 457,377 | 30,125 | 487,501 |
| 2020 | 378,710 | 108,783 | 487,493 | 0 | 487,493 |
| 2021 | 246,945 | 88,746 | 335,691 | 0 | 335,691 |
| 2022 | 178,850 | 76,184 | 255,034 | 0 | 255,034 |
| 2023 | 143,650 | 67,312 | 210,962 | 0 | 210,962 |
| 2024 | 127,310 | 60,145 | 187,455 | 0 | 187,455 |
| 2025 | 133,850 | 53,599 | 187,449 | 0 | 187,449 |
| 2026 | 132,050 | 46,642 | 178,692 | 0 | 178,692 |
| 2027 | 138,785 | 39,906 | 178,691 | 0 | 178,691 |
| 2028 | 145,965 | 32,727 | 178,692 | 0 | 178,692 |
| 2029 | 153,540 | 25,153 | 178,693 | 0 | 178,693 |
| 2030 | 161,695 | 16,998 | 178,693 | 0 | 178,693 |
| 2031 | 169,980 | 8,711 | 178,691 | 0 | 178,691 |
| | $5,352,210 | $4,883,800 | $10,236,010 | $ 547,952 | $11,495,174 |

(1) Totals may not add due to rounding.
(2) Includes $501,565,000 Commonwealth of Puerto Rico Public Improvement Refunding Bonds, Series 2002, issued on April 4, 2002.

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

### Commonwealth Guaranteed Debt

As of March 31, 2002, $2,099,993,241 of Commonwealth guaranteed bonds of the Public Buildings Authority was outstanding. Maximum annual debt service on these bonds is $172,857,749 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 March 31, 2002, $267,000,000 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 March 31, 2002, the Commonwealth had guaranteed the outstanding Series 1995 revenue bonds of the Aqueduct and Sewer Authority in the aggregate principal amount of $347,515,000. 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 extended guaranty will also cover any additional bonds and loans that may be issued until June 30, 2005. As of March 31, 2002, aggregate principal amounts outstanding on these obligations were $143,578,000 and $119,810,000, respectively. No payments under the Commonwealth guaranty have been required to date for these obligations of the Aqueduct and Sewer Authority.

### Trends of Public Sector Debt

Historically, the Commonwealth has maintained a fiscal policy that provides for a prudent relationship between the growth of public sector debt and the growth of the economic base required to service that debt. During fiscal years 1996, 1997 and 1998, however, public sector debt increased at a greater rate than the growth of gross product due to an increase in the amount of debt incurred to finance certain key infrastructure projects that were important to the development of the economy and were expected to produce long-term economic benefits, and debt incurred to refinance outstanding debt, enabling Puerto Rico to benefit from historically low levels of interest rates and realize debt service savings. During fiscal years 1999 and 2000, the growth of public sector debt was below the growth of gross product. Public sector debt increased by 12.1% during fiscal year 2001, compared to a 6.7% increase in gross product for the same year. The increase in the rate of growth of public sector debt during fiscal year 2001 was due to the issuance during such fiscal year of $1,092,550,000 of bonds of the Infrastructure Financing Authority and $397,005,000 of bonds of the Children’s Trust Fund, both of which are payable from sources other than Commonwealth appropriations or taxes or revenues of public corporations derived from services or products. Excluding these bond issues, the rate of growth of public sector debt for fiscal year 2001 would have been 5.9%.

As of March 31, 2002, outstanding short-term debt, relative to total debt, was 7.6%.

The following table shows the trends in gross product (in current dollars) and public sector debt for the five fiscal years ended June 30, 2001 and the first nine months of fiscal year 2002.

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

| | Public Sector Debt | | | | | Gross Product[2] | |
|---|---|---|---|---|---|---|---|
| June 30 | Long Term | Short Term[3] | Short Term as % of Total | Total[1] | Rate of Increase | Amount | Rate of Increase |
| 1997……………….. | $17,865 | $1,642[4] | 8.4% | $19,507 | 10.7% | $32,343 | 6.5% |
| 1998……………….. | 20,759 | 1,563[4] | 7.0 | 22,322 | 14.4 | 35,111 | 8.6 |
| 1999……………….. | 20,905 | 1,772[4] | 7.8 | 22,677 | 1.6 | 38,281 | 9.0 |
| 2000……………….. | 21,620 | 2,202[4] | 9.2 | 23,822 | 5.0 | 41,442 | 8.3 |
| 2001……………….. | 23,833 | 2,871[5] | 10.8 | 26,704 | 12.1 | 44,211 | 6.7 |
| March 31, 2002 | 27,733 | 2,277 | 7.6 | 30,010 | 12.4 | N/A | N/A |

(1) Totals may not add due to rounding.
(2) In current dollars.
(3) Obligations (other than bonds) issued with an original maturity of three years or less and lines of credit with a remaining maturity of three years or less are considered short-term debt.
(4) Does not include the tax and revenue anticipation notes that were outstanding at the close of the indicated fiscal years because prior to the end of said fiscal years sufficient funds had been set aside for the payment of such notes in full.
(5) Includes a $164 million line of credit from Government Development Bank to the Secretary of the Treasury whose proceeds were applied to pay debt service on general obligation bonds in lieu of funds available therefor in the General Fund.

*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, 2001 and for the first nine months of fiscal year 2002.

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

| | Commonwealth | | | Municipalities | | | Public Corporations[2] | | | Total[1] | | Grand Total[1] |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| June 30 | Long Term | Short Term[3] | Total[1] | Long Term | Short Term[3] | Total[1] | Long Term | Short Term[3] | Total[1] | Long Term | Short Term[3] | |
| 1997 | 4,512 | 0[4] | 4,512[5] | 843 | 51 | 894 | 12,509 | 1,590 | 14,100 | 17,865 | 1,642[4] | 19,507[5] |
| 1998 | 4,819 | 0[4] | 4,819[5] | 973 | 57 | 1,030 | 14,967 | 1,506 | 16,473 | 20,759 | 1,563[4] | 22,322[5] |
| 1999 | 5,097 | 0[4] | 5,097[5] | 1,215 | 60 | 1,275 | 14,593 | 1,713 | 16,306 | 20,905 | 1,772[4] | 22,678[5] |
| 2000 | 5,349 | 0[4] | 5,349[5] | 1,396 | 68 | 1,464 | 14,875 | 2,133 | 17,008 | 21,620 | 2,202[4] | 23,822[5] |
| 2001 | 5,674 | 164[6] | 5,838[5] | 1,468 | 164 | 1,632 | 16,691 | 2,543 | 19,234 | 23,833 | 2,871 | 26,704[5] |
| March 31, 2002 | 5,914 | 800 | 6,714 | 1,553 | 170 | 1,723 | 20,266 | 1,307 | 21,573 | 27,733 | 2,277 | 30,010 |

(1) Totals may not add due to rounding.
(2) Includes Commonwealth guaranteed debt.
(3) Obligations (other than bonds) issued with an original maturity of three years or less and lines of credit with a remaining maturity of three years or less are considered short-term debt.
(4) Does not include the tax and revenue anticipation notes 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.
(5) Includes the Transferred CRUV Debt.
(6) Includes a $164 million line of credit from Government Development Bank to the Secretary of the Treasury whose proceeds were applied to pay debt service on general obligation bonds in lieu of funds available therefor in the General Fund.

*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 March 31, 2002 ("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 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 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
## March 31, 2002
## (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 | $ 491,093 | $ 0 | $ 491,093 | $ 119,810 | $ 14,393[1] | $ 134,203 | $ 610,903 | $ 14,393[1] | $ 625,296 |
| Electric Power Authority | 0 | 4,711,346 | 4,711,346 | 0 | 125,000 | 125,000 | 0 | 4,836,346 | 4,836,346 |
| Health Facilities and Services Administration[2] | 0 | 0 | 0 | 0 | 561,293 | 561,293 | 0 | 561,293 | 561,293 |
| Highway and Transportation Authority | 0 | 4,519,404 | 4,519,404 | 0 | 300,000 | 300,000 | 0 | 4,819,404 | 4,819,404 |
| Housing Finance Authority | 0 | 484,640 | 484,640 | 0 | 158,367 | 158,367 | 0 | 643,007 | 643,007 |
| Industrial Development Company | 0 | 167,703 | 167,703 | 0 | 69,525 | 69,525 | 0 | 237,228 | 237,228 |
| Infrastructure Financing Authority | 0 | 2,042,870[3] | 2,042,870 | 0 | 10,035 | 10,035 | 0 | 2,052,905 | 2,052,905 |
| Public Finance Corporation | 0 | 3,933,683[4] | 3,933,683 | 0 | 0 | 0 | 0 | 3,933,683[4] | 3,933,683 |
| Ports Authority | 0 | 95,230 | 95,230 | 0 | 264,608 | 264,608 | 0 | 359,838 | 359,838 |
| Public Buildings Authority | 2,099,993 | 0 | 2,099,993 | 0 | 0 | 0 | 2,099,993 | 0 | 2,099,993 |
| Sugar Corporation | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| University of Puerto Rico | 0 | 469,728 | 469,728 | 0 | 631 | 631 | 0 | 470,359 | 470,359 |
| Others | 0 | 390,170[5] | 390,170[5] | 0 | 542,869 | 542,869 | 0 | 933,039 | 933,039 |
| Total[6] | $2,591,086[7] | $16,814,774 | $19,405,860 | $ 119,810 | $2,046,721 | $2,166,531 | $2,710,896[7] | $18,861,495 | $21,572,391 |

(1) Principal of and interest on this debt is reimbursed from Commonwealth appropriations.
(2) This is debt incurred by the Health Facilities and Services Administration prior to its dissolution on June 30, 1999, which debt was assumed by the Department of Health.
(3) $1,092.6 million of this amount is payable from interest earnings on $1.2 billion deposited in the Puerto Rico Infrastructure Development Fund which represents a portion of the proceeds received by the Commonwealth from the sale of its controlling interest in the Puerto Rico Telephone Company in 1999.
(4) Payable primarily from Commonwealth appropriations.
(5) On November 15, 2000, the Children's Trust issued its Tobacco Settlement Asset-Backed Bonds, Series 2000, in the total principal amount of $397,005,000. Said bonds will be repaid from payments made by certain tobacco companies under a master settlement agreement. See "Other Public Corporations" below.
(6) Does not include accretion of interest from the respective issuance dates on capital appreciation bonds.
(7) Authorization for Commonwealth guarantee of debt as of March 31, 2002 was $3,891,000,000.

*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 March 31, 2002, $1,215,075,000 of bonds and notes of GDB were outstanding. As of said date, GDB also had $2,253,983,000 in loans to local 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 $550,000,000, may be guaranteed by the Commonwealth, of which $267,000,000 were outstanding as of March 31, 2002.

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 needed 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 of such housing units. The Federal Housing Administration has insured mortgages on certain of the housing units. As of March 31, 2002, $1,250,208,051 of bonds of Housing Finance Corporation was outstanding. In August 2001, the Housing Finance Corporation issued $127,075,000 of its Home Mortgage Revenue Bonds and Notes.

As of March 31, 2002, the Authority also had outstanding $484,640,000 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, and (iv) refund bonds originally issued by the Urban Renewal and Housing Corporation to carry out activities related to the provision of low-cost housing for moderate income families, federally aided public housing for low-income families, and urban renewal, housing and related activities. These bonds are payable principally from appropriations in substantially the amount that the Commonwealth would otherwise have been bound to appropriate for such purposes.

*Tourism Development Fund* was created in November 1993 to promote the hotel and tourism industry of Puerto Rico, 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 March 31, 2002, the Tourism Development Fund had outstanding guarantees with respect to the financing of thirteen hotel projects totaling $607,455,000. On June 25, 2001, the owner of one of these projects with a guaranty for $84,740,000 filed for bankruptcy. The Tourism Development Fund has commenced foreclosure proceedings in another project for which the guaranty is $27,130,000. The Tourism Development Fund is currently paying the debt service on these two projects from its own funds.

*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 April 30, 2002, the Corporation had $3.6 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 for Commonwealth appropriations. Said debt includes debt of the Maritime Shipping Authority, debt of the Secretary of the Treasury relating to advances made by the Secretary to the municipalities to settle certain property tax claims, debt which had been incurred by the Office for the Improvement of Public Schools in connection with its public schools repair and improvement program, indebtedness of Health Facilities and Services Administration ("AFASS"), and debt of Aqueduct and Sewer Authority relating to the construction of the North Coast Superaqueduct (discussed below).

In December 2001, the Corporation issued $96,835,000 of qualified zone academy bonds to fund, in part, the rehabilitation and repair of some of the Commonwealth's public schools. The bonds are payable from escrow funds segregated for such purpose.

A description of certain other affiliates of GDB is provided in "Other Public Corporations."

**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 has embarked on an extensive capital improvement program for the five-year period ending June 30, 2005 that is estimated to cost approximately $1.7 billion. 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 debt issued by PRASA. In addition, Act No. 45 was amended in 2000 to extend the payment guaranty of the Commonwealth to all of the outstanding bonds issued by the Authority to the United States Department of Agriculture, Rural Development, and to all of the outstanding loans granted by the Clean Water and Drinking Water State Revolving Funds for the benefit of the Authority. The extended guaranty will cover any additional issuance of these obligations until June 30, 2005.

PRASA has reported net losses of $94.9 million, $130 million and $100.7 million during fiscal years 1998, 1999 and 2000, respectively. The net loss for fiscal 2001 was only $510,000, due to the ability under new government accounting rules to treat government grants as revenues rather than capital contributions. Without such favorable treatment of government grants, PRASA's net loss would have been $169.6 million in fiscal 2001. These losses reflect the continuing financial and operating difficulties that PRASA has experienced in recent years. The total debt of PRASA, including bonds and loans, was $625.4 million as of March 31, 2002.

On May 26, 1995, PRASA and Professional Services Group, Inc. entered into a five-year agreement, which expires in June 2002, for the operations, management, repair and maintenance of PRASA's systems. A new agreement to manage, operate, maintain, repair and, as and when necessary or appropriate, replace the PRASA systems was entered into on May 2, 2002 with Ondeo Puerto Rico, Inc., an affiliate of Ondeo Suez ("Ondeo"). This 10-year agreement has as its major objectives the elimination of PRASA's operating deficit, the elimination of unaccounted-for-water, the achievement of environmental compliance, the improvement in the planning and implementation of capital projects and the general improvement of the service available to the residents of Puerto Rico.

Ondeo will be compensated through a service fee component (the "SFC") which consists of a fixed part and a variable part. The SFC may be adjusted for additions and/or deletions of components to PRASA's systems (new plants, pumping stations, etc.), for uncontrollable circumstances and for inflation. With respect to inflation, the agreement may be adjusted only during the last five years by the difference between an inflation index and 4.5%. The SFC includes all operating expenses (regardless of the actual amount of such expenses) with the exception of electricity and insurance, which are treated as pass-through costs. The SFC also includes the replacement of any system component as required during the life of the agreement. The replacement requirement applies to all system components in operation with the exception of pipelines, where the requirement is for the annual replacement of at least 0.5% of the pipes.

The agreement also provides for a variable compensation component (the "VCC") which may not exceed 20% of total compensation. The VCC includes incentives for increasing PRASA revenues, reducing electricity consumption, achieving general performance improvements and reducing PRASA operating costs.

The agreement contains a number of operating commitments to ensure that its objectives are met. The commitments include reduction of unaccounted-for-water, existing pipeline rehabilitation, pipe repair to control leaks, improvement in customer service and achievement of environmental compliance.

The agreement contains a number of events of default for operator nonperformance with the agreement's standards. The agreement may be cancelled without cause by PRASA after 5 years upon payment of a termination fee. PRASA's monetary obligations under the agreement are unconditionally guaranteed by GDB.

PRASA entered into an agreement with Thames-Dick Superaqueduct Partners, Inc. for the planning, design, construction, operation and maintenance of the North Coast Superaqueduct to supply additional potable water to certain municipalities, mainly in the San Juan Metropolitan Area. The total cost of the North Coast Superaqueduct was approximately $390 million. Permanent financing for this project was provided in August 2001 through the issuance of $390,000,000 of bonds of Public Finance Corporation, payable from Commonwealth appropriations. The North Coast Superaqueduct started operations on September 1, 2000.

*Economic Development Bank* was created in July 1985 to engage primarily in granting small direct loans, providing loan guarantees to private enterprises, and making equity investments in such enterprises. Its initial capital was provided by a transfer of loans in the principal amount of $15,000,000 previously administered by a now inactive subsidiary of GDB. As of March 31, 2002, Economic Development Bank had outstanding debt (not including deposits) of $13,605,000.

*Electric Power Authority* owns and operates the island's electric system. The Capital Improvement Program for the five-year period ending June 30, 2006, is estimated to cost approximately $2.0 billion and is 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 March 31, 2002, the Authority had $4,711,346,000 in bonds outstanding (not including accretion of interest from the respective issuance dates on capital appreciation bonds). As a means of reducing its dependency on oil, the Authority has entered into power purchase contracts relating to the construction of certain cogeneration plants that will use fuels other than oil. These two cogeneration projects consist of EcoElectrica's 507 megawatts liquefied natural gas plant at Guayanilla and a 454 megawatts clean coal facility at Guayama to be built and operated by an affiliate of Applied

Energy Systems ("AES"). EcoElectrica's plant started commercial operations in March 2000. Construction of AES' plant began in November 1999, and the plant is expected to be in service during calendar year 2002. It is expected that these two cogeneration plants will initially provide approximately one-third of the Authority's energy needs.

*Health Facilities and Services Administration* was created by Act No. 26 of November 13, 1975, as amended, for the principal purpose of developing and operating public hospitals and other health facilities and providing health services. In connection with the revamping of the island's public health system and as part of a health reform program that has the effect of changing the public health system from one in which the government provides health services to low income persons to one in which medical services are provided by the private sector and the government provides comprehensive health insurance cover to such persons, the Administration was dissolved on June 30, 1999, and its administrative responsibilities, agreements and claims were transferred to the Department of Health. As part of the health reform, the government sold to private companies several of the public health facilities that were operated by the Administration.

The operations of the Administration had been funded substantially by Commonwealth appropriations and lines of credit provided by GDB. Aggregate outstanding indebtedness to GDB as of March 31, 2002, relating to such lines of credit was $561,293,000. Such indebtedness is scheduled to be restructured and financed by bonds to be issued by Public Finance Corporation, which bonds will be paid from funds to be appropriated annually by the Legislature of Puerto Rico. In addition to that debt, there are other debts associated with the Administration currently outstanding.

*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 1.7 million persons were covered by the system as of June 30, 2001.

The cost to the General Fund of the health insurance program for fiscal year 2002 will be $1,237 million, compared to $1,302 million for fiscal year 2001. This cost exceeds the amount budgeted for fiscal year 2002 by $238 million. The fiscal year 2003 recommended budget estimates the cost of the health insurance program to be $1,247.9 million.

*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 Puerto Rico 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 March 31, 2002, the Authority had $4,519,404,000 in bonds outstanding.

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 $1.9 billion, which cost will be financed by Federal Transit Administration grants, other federal funding sources and the Authority's own resources. On August 4, 2000, the Authority entered into a loan agreement with the United States Department of Transportation Federal Transit Administration evidencing a long-term loan to the Authority in the amount of $300,000,000. This loan was used by the Authority to pay a portion of the costs related to the first phase of this project. An extension of the first phase of Tren Urbano to serve the area of Minillas Government Center is currently in the planning stage.

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

*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 March 31, 2002, the Company had $167,703,000 in bonds outstanding.

*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 March 31, 2002, $3,332,612,126 of the Authority's bonds were outstanding.

*Infrastructure Financing Authority* was created in June 1988 by virtue of Act No. 44 of June 21, 1988, as amended ("Act No. 44"), 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. Act No. 44 also established the Puerto Rico Infrastructure Fund, funded in the amount of $30 million during fiscal year 1989 and $40 million for each of the following twenty-nine fiscal years with the first proceeds of federal excise taxes imposed on rum and other articles produced in Puerto Rico and sold in the United States which are transferred to Puerto Rico pursuant to the United States Internal Revenue Code of 1986, as amended. On July 7, 1997, Act No. 44 was amended to increase to $60 million for fiscal year 1998 and $70 million for each subsequent year until fiscal year 2028 the amount of federal excise taxes transferred to the Authority. The increased level of appropriations is used by the Authority to provide financial support to aqueduct and sewer projects. The Authority had $2,042,870,000 in bonds outstanding as of March 31, 2002.

In January 1998, the Authority expanded the assistance given to Aqueduct and Sewer Authority to include assistance covering the design and construction of various strategic regional water and sewer projects intended to provide improved services to targeted regions throughout the island, the implementation of an immediate action plan to address a number of small water and sewer rehabilitation projects, and legal and technical assistance in achieving compliance with certain environmental laws and in establishing a prioritized capital program. The Authority is undertaking such projects at the request of the Aqueduct and Sewer Authority.

In June 1998, Act No. 44 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 ("PRTC"). 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. On October 11, 2000, the Authority issued $1,092,550,000 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. On March 3, 1995, the assets and operations of the Maritime Shipping Authority were acquired by an investor group headed by BTIP, a subsidiary of Bankers Trust New York Corporation, under the terms and conditions approved by the Legislature of Puerto Rico and signed by the Governor on September 27, 1994. The remaining debt of the Authority was refinanced, as allowed under Act No. 113 of September 27, 1994, through the issuance of bonds by Public Finance Corporation, a subsidiary of GDB. The aggregate principal amount of such bonds as of March 31, 2002, was $265,553,974 (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 March 31, 2002, the Agency had $958,285,000 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. The Authority reported net losses during the fiscal years ended June 30, 1998 and 1999 of $28.8 million and $6.5 million, respectively. The Authority reported net income of $15.3 million for fiscal year 2000 and net income of $28.2 million for fiscal year 2001. As of March 31, 2002, the Authority had $95,230,000 in bonds outstanding.

*Public Buildings Authority* is authorized to construct, purchase or lease office, school, health, and social welfare 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 Act No. 17 of 1968, as amended, to have outstanding at any one time up to $2,100,000,000 of bonds guaranteed by the Commonwealth. As of March 31, 2002, $2,099,993,241 of such bonds of the Authority was outstanding (not including accretion of interest from the respective issuance dates on capital appreciation bonds). On January 30, 2002, the Authority issued PBA Bonds in the amount of $789,022,892.30 to finance a portion of its current construction program, to refinance certain outstanding bonds of the Authority and to repay all interim financing with GDB.

The Authority is undertaking a program to construct additional correctional facilities to be completed by July 2002 at an estimated cost of $187,000,000. The Authority has previously issued $126,972,552 in bonds to finance the construction of three correctional facilities, which are being operated by private companies.

At present, several officers of the Commonwealth are defendants in a lawsuit filed in the United States District Court in which they are charged with violating the constitutional rights of correctional system inmates as a result of severe overcrowding in the island's correctional system. Fines to assure compliance with minimum space standards have been assessed in the past against the defendants, such fines being paid by the Commonwealth. Most of these fines have been earmarked for improving the conditions of inmates but not for construction of additional correctional facilities to alleviate prison overcrowding. The Commonwealth can give no assurance that additional fines will not be levied in connection with this lawsuit.

*Sugar Corporation* was created in 1973 to consolidate ownership and management of the Commonwealth's interests in Puerto Rico's sugar industry. Until February 27, 1998, Sugar Corporation owned or leased and operated virtually all the sugar production facilities on the island. Sugar Corporation bought all cane grown by private growers, processed the cane, and sold crude and refined sugar and molasses. For many years, its operations produced substantial operating deficits.

On September 5, 1996, the Governor of Puerto Rico signed into law Act No. 189, as amended, which authorized the transfer, for a nominal sum, of certain assets and liabilities of the Corporation to entities created by the sugar cane growers. Pursuant thereto, as of December 31, 2000, the Commonwealth transferred the operations of the Corporation to certain entities formed by sugar cane growers. The Corporation retained substantially all its liabilities. During fiscal year 2002, the debt of the Corporation was restructured and refinanced by bonds issued by Public Finance Corporation, which bonds will be paid from funds to be appropriated annually by the Legislature of Puerto Rico.

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

On March 2, 1999, the Telephone Authority sold a controlling interest in PRTC to a consortium led by GTE International Telecommunications Incorporated, which was substantially 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. On January 2002, Verizon exercised its option to purchase an additional 15% of PRTC stock. The Government retains a 28% stock participation in PRTC. The proceeds from the Verizon option exercise were applied to reduce the unfunded pension benefits obligations of the Employees Retirement System of the Commonwealth and its instrumentalities.

*University of Puerto Rico* (the "University"), with 69,773 students during academic year 2000-2001, 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 of which $469,728,000 was outstanding as of March 31, 2002.

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 of sufficient amounts to pay debt service on said bonds as they become due.

*Children's Trust Fund* (the "Trust") is a not-for-profit corporate entity created by the Commonwealth under Act No. 173 of July 30, 1999. The Trust is a public instrumentality of the Commonwealth. Pursuant to Act No. 173, the Commonwealth has transferred to the Trust all of its rights, title and interest under the tobacco litigation Master Settlement Agreement ("MSA"), including the Commonwealth's right to receive initial, annual and strategic contribution fund payments to be made by the participating cigarette manufacturers under the MSA.

The Trust issued $397,005,000 aggregate principal amount of Tobacco Settlement Asset-Backed Bonds, Series 2000 on November 15, 2000. The Series 2000 Bonds and any other additional series of senior bonds will be secured by a statutory pledge of certain tangible and intangible assets of the Trust, including its right to receive 50% of Puerto Rico's portion of the initial payments, annual payments, and strategic contribution fund payments under the MSA.

*Public corporations*, in addition to those mentioned above, have outstanding debt in the aggregate amount of $383,577,000 as of March 31, 2002. Debt service on $140,660,000 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, 2001 the total number of active members of the three systems was as follows: Employees Retirement System, 151,060; Teachers Retirement System, 48,342, and Judiciary Retirement System, 346. The three systems are financed by contributions made by employers (the Commonwealth, public corporations, or municipalities), employees, and investment income. The central government is responsible for approximately 66% of total employer contributions to the Employees Retirement System, and the other 34% 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 statute. Required contributions to the systems by employers are determined by statute with respect to the Teachers Retirement System and, with respect to the Employees and Judiciary Retirement Systems, by the Administrators of the Systems.

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, 2000, the total pension benefit obligation for the Employees Retirement System and Judiciary Retirement System was $9,459,300,000 and $135,800,000, respectively. The unfunded pension benefit obligation of the Employees Retirement System and Judiciary Retirement System for the same period was $7,417,500,000 and $53,000,000, respectively, representing a funding ratio of 22% and 61%, respectively. 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.

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. On June 13, 2001, the Legislature approved a law providing another 3% increase, effective as of January 1, 2001, in post-retirement annuity payments granted on or prior to January 1, 1998. Subsequent increases will depend upon the explicit approval of the System's Board of Trustees and the Legislature. 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.

On February 1, 1990, the Legislature of Puerto Rico enacted Act No. 1 amending the organic act of the Employees Retirement System 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.

Act No. 305 of September 24, 1999 further amended the organic act of the Employees Retirement System 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 Government 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 do 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 Government. Instead, Government contributions will now be used completely to reduce the unfunded accumulated 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 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 and purchased an additional 15% of the stock of PRTC for $172 million. The proceeds of the sale were deposited into the Employees Retirement System.

The Employees Retirement System expects its disbursements of benefits during fiscal year 2002 to exceed the expected contributions and investment income for such year. The Employees Retirement System proposes to finance the cash shortfall with a short-term loan from a private bank, which is expected to be repaid from the proceeds of the sale of the 15% stock ownership to Verizon upon its exercise of its stock option described above.

According to the most recent actuarial valuation of the Teachers Retirement System submitted by a firm of independent consulting actuaries, as of June 30, 2000, the accrued actuarial liability of the system was $3,204,824,362, the value of assets amounted to $2,283,554,000, representing a funding ratio of 78.30%, and the resulting unfunded accrued liability was $695,334,362. 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 is 20 years. The actuarial valuation assumed an investment return of 8% per year and salary increases of 5% per year. Act No. 43 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, 1999, June 30, 2000, and June 30, 2001. The investment income figures presented in the table for fiscal years 1999, 2000 and 2001 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, 1999** | | | |
| Income: | | | |
| Employers' contributions | $274,658 | $ 5,744 | $ 91,155 |
| Employee contributions | 217,179 | 2,115 | 67,807 |
| Investment income | 244,025 | 7,489 | 242,198 |
| Total | 735,862 | 15,348 | 401,160 |
| Expenses: | | | |
| Benefit payments | 515,993 | 7,099 | 206,397 |
| Administrative and other expenses | 33,956 | 1,074 | 16,469 |
| Total | 549,949 | 8,173 | 222,866 |
| Net Income | $185,913 | $ 7,175 | $178,294 |
| **Fiscal Year Ending June 30, 2000** | | | |
| Income: | | | |
| Employers' contributions | $309,097 | $ 5,222 | $ 86,246 |
| Employee contributions | 218,342 | 2,094 | 68,864 |
| Investment income | 296,842 | 11,075 | 286,507 |
| Total | 824,281 | 18,391 | 441,617 |
| Expenses: | | | |
| Benefit payments | 605,465 | 7,705 | 219,886 |
| Administrative and other expenses | 28,651 | 1,372 | 31,755 |
| Total | 634,116 | 9,077 | 251,641 |
| Net Income | $190,165 | $ 9,312 | $189,976 |
| **Fiscal Year Ended June 30, 2001** | | | |
| Income: | | | |
| Employers' contributions | $356,978 | $5,394 | $ 116,134 |
| Employee contributions | 245,221 | 2,240 | 94,295 |
| Special Contribution-PRTA Holdings | 701,000 | 0 | 0 |
| Investment income | (225,636) | (10,707) | 37,332 |
| Total | $1,077,563 | $(3,073) | $247,761 |
| Expenses: | | | |
| Benefit payments | 655,418 | 8,262 | 240,761 |
| Administrative and other expenses | 29,492 | 1,049 | 22,507 |
| Total | 684,910 | 9,311 | 263,268 |
| Net Income | $ 392,653 | $(12,384) | $ (15,507) |

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

## COMMONWEALTH FINANCIAL STATEMENTS

Since fiscal year 1990, the complete financial statements of the Commonwealth have been audited. For fiscal year 2001, such financial statements were audited by KPMG LLP, whose report thereon is dated January 21, 2002. Preparation of the audited financial statements of the Commonwealth involves the collection and combination of audited financial statements from fifty separate reporting entities.

The Comprehensive Annual Financial Report of the Commonwealth for fiscal year 2001 prepared by the Department of the Treasury, which includes the general purpose financial statements of the Commonwealth for fiscal year 2001, has been filed by the Commonwealth with each nationally recognized municipal securities information repository.

## 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 was incorporated into the General Fund commencing in fiscal year 1993.

The General Fund is the primary operating fund of the Commonwealth. General Fund revenues are broadly based and include revenues raised internally as well as those from non-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 Commonwealth revenues and expenditures of the General Fund on a cash basis for fiscal year 1998 through fiscal year 2001 and the Commonwealth's estimated revenues and budgeted expenditures for fiscal year 2002. The information through fiscal year 2001 is based on actual fiscal year-end results. The information relating to fiscal year 2002 is based on (i) revised revenue estimates made by the Secretary of the Treasury in February 2002 and (ii) expenditures included in the approved budget for fiscal year 2002, adjusted upward by the Office of Management and Budget in March 2002 to incorporate the revised costs of the health insurance program as determined after completion of negotiations with the health insurance companies.

To improve the presentation of the following table, the Department of the Treasury has eliminated the use of line items identified as "Operating Transfers In" and "Operating Transfers Out" in the financial statements of the Commonwealth and has assigned the amounts previously listed under these two categories to the following revenue and expenditure line items according to the purpose and amount of each transfer: "Other Income," "Other Expenditures," "Capital Outlays and Other Debt Service" and "Transfers to Agencies." 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. 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)

| | 1999 | 2000 | 2001 | 2002(e) | 2003[1] |
|---|---|---|---|---|---|
| Beginning cash balance | $ 340,771 | $ 474,759 | $ 287,055 | $ 125,154 | $ 11,960 |
| Revenues from internal sources: | | | | | |
| Income Taxes: | | | | | |
| Individuals | 2,244,376 | 2,352,066 | 2,259,090 | 2,464,000 | 2,775,000 |
| Corporations | 1,653,762 | 1,781,862 | 1,696,766 | 1,735,000 | 1,846,000 |
| Partnerships | 2,087 | 2,339 | 3,026 | 3,000 | 3,000 |
| Withheld from non-residents | 369,384 | 557,276 | 696,835 | 670,000 | 561,000 |
| Tollgate taxes | 114,533 | 111,130 | 49,511 | 36,000 | 36,000 |
| Interest | 10,666 | 11,674 | 14,782 | 15,000 | 16,000 |
| Dividends | 38,996 | 39,664 | 58,580 | 40,000 | 43,000 |
| Total income taxes | 4,433,804 | 4,856,011 | 4,778,590 | 4,963,000 | 5,280,000 |
| Commonwealth excise taxes | | | | | |
| Alcoholic beverages | 243,464 | 236,374 | 237,512 | 242,000 | 326,000 |
| Cigarettes | 119,105 | 115,157 | 119,135 | 119,000 | 170,000 |
| Motor vehicles | 411,573 | 389,995 | 406,252 | 429,000 | 504,000 |
| Other excise taxes | 699,685 | 668,820 | 579,050 | 661,000 | 746,000 |
| Total Commonwealth excise taxes | 1,473,827 | 1,410,346 | 1,341,949 | 1,451,000 | 1,746,000 |
| Property taxes | 2,214 | 1,131 | 287 | - | - |
| Inheritance and gift taxes | 1,811 | 3,109 | 7,475 | 2,000 | 2,000 |
| Licenses | 70,848 | 73,801 | 76,338 | 79,000 | 84,000 |
| Other: | | | | | |
| Lottery | 59,206 | 63,779 | 57,482 | 62,000 | 70,000 |
| Electronic Lottery | 53,013 | 70,209 | 70,211 | 61,000 | 87,000 |
| Miscellaneous non-tax revenues | 176,669 | 169,246 | 299,758 | 527,000 | 232,000 |
| Total other | 288,888 | 303,234 | 427,451 | 650,000 | 389,000 |
| Total revenues from internal sources | 6,271,392 | 6,647,632 | 6,632,090 | 7,145,000 | 7,501,000 |
| Revenues from non-Commonwealth sources: | | | | | |
| Federal excise taxes | 217,296 | 245,750 | 286,890 | 280,000 | 295,000 |
| Customs | 61,355 | 50,231 | 43,154 | 40,000 | 40,000 |
| Total revenues from non-Commonwealth sources | 278,651 | 295,981 | 330,044 | 320,000 | 335,000 |
| Sub-total revenues | 6,550,043 | 6,943,613 | 6,962,134 | 7,465,000 | 7,836,000 |
| Proceeds from Special Funds | - | - | - | - | - |
| Total Revenues | 6,550,043 | 6,943,613 | 6,962,134 | 7,465,000 | 7,836,000 |
| Other Income (refunds)[2] | 2,570 | 64,325 | 84,878 | 159,917 | - |
| (Transfers) to Redemption Fund [3] | (320,240) | (410,046) | (245,814) | (314,636) | (375,889) |
| Proceeds of notes and other borrowings[4] | 600,000 | 778,863 | 825,703 | 1,072,007 | - |
| Repayment of notes and other borrowings[5] | (611,410) | (787,155) | (686,024) | (1,201,084) | - |
| Adjusted revenues | 6,220,963 | 6,589,600 | 6,940,577 | 7,181,204 | 7,460,111 |
| Expenditures: | | | | | |
| Grants and subsidies | 2,392,018 | 2,864,215 | 3,078,505 | 2,902,780 | 2,647,965 |
| Personal services | 2,470,456 | 2,737,159 | 2,779,989 | 3,347,676 | 3,851,574 |
| Other services | 723,563 | 745,194 | 778,236 | 795,615 | 783,569 |
| Materials and supplies | 99,404 | 109,081 | 106,072 | 178,014 | 147,963 |
| Equipment purchases | 52,993 | 56,404 | 48,326 | 37,099 | 29,040 |
| Capital outlays and other debt service | 166,841 | 101,178 | 33,235 | 33,012 | - |
| Transfers to agencies | 181,700 | 164,073 | 280,415 | - | - |
| Other expenditures | - | - | - | - | - |
| Total expenditures | 6,086,975 | 6,777,304 | 7,102,778 | 7,294,396 | 7,460,111 |
| Adjusted revenues less expenditures | 133,988 | (187,704) | (161,901) | (113,194) | - |
| Ending cash balance | $ 474,759 | $ 287,055 | $ 125,154 | $ 11,960 | $ 11,960 |

(e) Estimated.
(1) Budget, as recommended.
(2) Consists of reimbursement of certain advances to agencies to cover expenses, revenue from the General Fund's non budgetary funds and 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

*Projected Fiscal Year 2003 Compared to Estimated Fiscal Year 2002*

It is projected that General Fund total revenues for fiscal year 2003 (excluding proceeds from special funds) will be $7,836 million, representing an increase of $371 million, or 5.0%, from budgeted fiscal year 2002 revenues. The major changes from fiscal year 2002 are expected to be: (i) projected increases in income taxes from individuals of $311 million and in corporate income taxes of $111 million; (ii) a projected increase in Commonwealth excise taxes of $295 million; and (iii) a projected decrease in miscellaneous revenues of $295 million and in income taxes withheld from non-residents of $109 million.

The projected General Fund revenues for fiscal year 2003 assume a 6.8% nominal, 2.7% real growth in gross national product, and additional revenues of $596 million from new legislative measures, most of which have been enacted. Projected revenues do not take into consideration the result of a lawsuit filed by one of the eight air cargo carriers that service Puerto Rico. In the lawsuit, this air cargo carrier seeks to prevent the Treasury Department from implementing a local regulation that precludes the carrier from delivering goods brought into the island prior to the consignee evidencing the payment of the excise tax on such goods. Recently, the court entered a permanent injunction in favor of the carrier. The Government is appealing the decision. The total amount of excise taxes collected annually in recent years by the eight air cargo carriers that service Puerto Rico has been approximately $53 million.

*Estimated Fiscal Year 2002 Compared to Actual Fiscal Year 2001*

As of February 2002, it was projected that General Fund total revenues for fiscal year 2002 (excluding proceeds from special funds) will be $7,465 million, representing an increase of $503 million, or 7.2%, from fiscal year 2001 revenues. The major changes from fiscal year 2001 are expected to be: (i) projected increases in income taxes from individuals of $205 million and in corporate income taxes of $38 million; (ii) a projected increase in Commonwealth excise taxes of $109 million; (iii) a projected increase in miscellaneous revenues of $227 million; and (iv) a projected decrease in income taxes withheld from non-residents, tollgate taxes and dividend taxes totaling $59 million.

The revenue estimates for fiscal year 2002 were based on the following assumptions: (i) the economy of Puerto Rico would continue a moderate growth pattern until at least the fourth calendar quarter of 2002 (nominal growth of the economy during fiscal year 2002 was expected to be between 4% and 5%); (ii) tax collections would continue to grow in excess of the 2% growth registered in fiscal year 2001, which was an election year and a year in which the last phase of a previously legislated tax rate reduction became effective; (iii) the price of crude oil would average $25 per barrel; (iv) rum excise tax collections would increase as a result of an extension of the effective date of the legislation maintaining the amount of rum excise tax returned to Puerto Rico at $13.25 per proof gallon; and, (v) there would be some income tax revenue reductions as a result of the recently enacted local tax legislation designed to stimulate economic activity.

One of the largest components of the expected increase in tax collections, totaling $280 million, is the result of special administrative actions which have enabled the Treasury Department to collect $151 million during the first ten months of fiscal year 2002. These actions include stronger enforcement in the collection of excise taxes and an aggressive campaign to collect past due income taxes.

For the first ten months of fiscal year 2002 (July 2001 through April 2002), General Fund revenues were $5,767.5 million, which is $235.8 million or 4.3% higher than General Fund revenues during the first ten months of fiscal year 2001, but $177.5 million or 3.0% less than budgeted revenues for this period. The Commonwealth government has identified other revenues and other funding sources to cover the estimated revenue shortfall, including tapping certain reserves, the sale of certain municipal receivables to Government Development Bank, and additional excise tax revenues from recently enacted legislation.

Expenditures for the full fiscal year 2002 are projected to be $7,597.1 million, which is $131.4 million or 1.8% higher than the $7,465.7 million budgeted. The principal reasons for the difference are (i) health reform costs that are projected to be approximately $125 million higher than budgeted; (ii) payroll and other costs of education that are projected to be approximately $64.9 million higher than budgeted; and (iii) public safety costs that are projected to be approximately $66.5 million higher than budgeted, offset by lower projected expenditures in other areas of approximately $125 million. The Government expects to cover these additional expenditures with reserve funds from the Commonwealth's Budgetary Fund and from unused funds from certain agencies that have operating surpluses.

The ending cash balance for the General Fund for fiscal 2002 is estimated to be $12 million, a decrease of $113 million from fiscal year 2001. This decrease resulted principally from the repayment during fiscal year 2002 from General Fund moneys of short term borrowings incurred in fiscal year 2001 and not yet repaid in said fiscal year.

*Fiscal Year 2001 Compared to Fiscal Year 2000*

General Fund total revenues for fiscal year 2001 were $6,962 million, an increase of approximately $18.5 million from fiscal year 2000. The major changes from fiscal year 2000 are: a decrease of $85 million in corporate income taxes; a decrease of $93 million on individual income taxes; a decrease of $62 million in tollgate taxes; a decrease of $89 million in other excise taxes; an increase in income tax withheld from non-residents of $140 million; and an increase in federal excise taxes of $41 million. The decrease in corporate income taxes was due to the effects of the economic slowdown in the United States and Puerto Rico. The reduction in tollgate taxes and the increase in withholding taxes to non-residents are the result of continuing conversions of corporations to controlled foreign corporation tax status and the payment of withholding taxes on royalties paid to U.S. affiliates. The reduction in local excise taxes allocated to the General Fund was attributable principally to a reduction in the tax on crude oil (which varies inversely with the price of crude oil) and a transfer of certain excise taxes from the General Fund to other funds of the Commonwealth as required by recent Commonwealth legislation. Federal excise tax revenues rose due to growing exports of rum products. Commencing in fiscal year 2000 the amount of the rum excise tax returned to the Treasury of Puerto Rico increased from $10.50 to $13.25 per gallon. See "Major Sources of General Fund Revenues" below.

Total expenditures for fiscal year 2001 were $7,103 million, an increase of $325 million, or 4.8%, over fiscal year 2000. Expenditures grew primarily in the areas of education, health and public safety. This growth is attributable in part to the rising cost of services and expanding programs. For a comparison of budgeted expenditures and actual expenditures, see "Fiscal Year 2002 Budget" in *Budget of the Commonwealth of Puerto Rico*. The ending cash balance for the General Fund for fiscal year 2001 was $125 million, a decrease of $162 million from fiscal year 2000. This decrease, together with moneys raised by the Commonwealth from short-term borrowings that were not repaid in full prior to the end of fiscal year 2001, enabled the Commonwealth to cover expenses in said year in excess of the amount budgeted therefor and in the face of a decline in General Fund Revenues. General Fund deposits to the Redemption Fund in fiscal year 2001 were $113 million less than in fiscal year 2000 because the last four monthly deposits in fiscal year 2001 were made from the proceeds of a short-term loan from GDB which loan was repaid in early fiscal year 2002 from the proceeds of general obligation bonds issued in June 2001.

In lieu of issuing tax and revenue anticipation notes in fiscal year 2001 to meet seasonal differences in the timing of revenues and expenses, the Commonwealth obtained a loan from the GDB in the amount of $661.4 million. This loan has been repaid.

*Fiscal Year 2000 Compared to Fiscal Year 1999*

General Fund total revenues for fiscal year 2000 were $6,944 million, an increase of $394 million, or 6.0%, over fiscal year 1999. The major changes were: an increase in revenues obtained from income taxes of $422 million and a decrease in Commonwealth excise taxes of $63 million.

Total expenditures for fiscal year 2000 were $6,777 million, an increase of $690 million, or 11.3%, over fiscal year 1999. The ending cash balance for the General Fund for fiscal year 2000 was $287 million, a decrease of $188 million from fiscal year 1999.

**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, 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 on January 1, 2001, and 6%, 9%, 14% and 27% for the taxable years commencing on and after January 1, 2002. However, legislation was approved to delay the January 1, 2002 date to January 1, 2004. Dividend income from Puerto Rico corporations and certain qualifying foreign corporations is taxed at a rate of 10%. A recent amendment to the PR Code provides an income tax exemption for REITs and imposes a 17% tax on taxable dividends distributed by such entities during the first ten taxable years of the REIT.

Gains realized from the sale or exchange of a capital asset by resident individuals, if held for more than six months, are taxed at a rate of 20% or 10% if the capital asset consists of certain property located or deemed located in Puerto Rico sold or exchanged after December 31, 2000. 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 December 31, 2000 are subject to a special capital gains rate of 7%. Legislation has been introduced to extend the eligibility date from December 31, 2000 to December 31, 2007.

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.

*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 $275,000. 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. The special tax rate applicable to dividend distributions of REIT's also applies to dividends 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%.

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 continues to be 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 with respect to dividends paid from profits invested in certain eligible instruments for specified periods of time.

Payments in excess of $1,000 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. Legislation has been introduced which will increase the withholding tax to 10% in the case of individuals.

*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. Effective May 16, 2002, the excise tax on cigarettes and sport utility vehicles will increase. The excise tax on distilled spirits will also increase effective on June 13, 2002.

*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 alcoholic beverages 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 alcoholic beverages from Puerto Rico and other rum producing countries is $13.50 per gallon. Of this amount, $13.25 per gallon was and will be returned to the Treasury of Puerto Rico during the period from October 1, 1999 to December 31, 2003. Effective on January 1, 2004, the amount returned will be $10.50 per gallon.

*Property Taxes*

Personal property, which accounts for approximately 53% of total collections of taxable property, is self-assessed. Real property taxes are assessed at 1958 values. No real property reassessment has been made since 1958, and construction taking place after that year has been assessed on the basis of what the value of the property would have been in 1958. Accordingly, the overall assessed valuation of real property for taxation purposes is substantially lower than the actual market value. Also, an exemption on the first $15,000 of assessed valuation in owner-occupied residences is available.

On August 30, 1991, legislation was adopted in Puerto Rico providing a municipal reform program, which also involved the creation of the Municipal Revenues Collection Center ("CRIM") to collect property taxes. The program transferred the previous functions of the Department of the Treasury with respect to real and personal property tax assessment, notification, determination, and collection to the CRIM, as of July 1, 1993. The 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 continues to be 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, 1997 through 2001.

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

| Fiscal Year Ended June 30 | Assessed Valuations(1) | Taxes Levied | Collections of Current Year | Collections of Previous Years | Total |
|---|---|---|---|---|---|
| 1997 | $17,499,974 | $533,362 | $438,415 | $82,435 | $519,613 |
| 1998 | 19,272,428 | 619,343 | 510,999 | 90,311 | 601,310 |
| 1999 | 20,042,738 | 642,555 | 523,886 | 47,309 | 571,198 |
| 2000 | 20,514,014 | 704,568 | 594,151 | 64,812 | 658,963 |
| 2001 | 21,575,063 | 736,667 | 614,411 | 70,496 | 684,908 |

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

*Source:* Municipal Revenues Collection Center

During 1997, legislation was enacted authorizing the CRIM to sell past-due property taxes on residential, commercial and industrial properties to persons who, after payment of the purchase price to the CRIM, would then be responsible for collecting such taxes from the delinquent property taxpayers. Pursuant to this legislation, in February 1999 CRIM sold certain of these past due property tax debts to Public Finance Corporation, which financed the purchase price by issuing non-recourse bonds payable solely from the collection of such past due property taxes. The proceeds of the sale of these bonds were paid to the CRIM for the benefit of the Commonwealth and the municipalities of the Commonwealth. As a result of a series of transactions that concluded in April 2002, these bonds were either re-purchased by PFC and retired or paid in full.

## 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 (a) improving the methods by which delinquent taxpayers are identified, primarily through the use of computer analyses, (b) computerizing the processing of tax returns, and (c) identifying and eliminating taxpayer abuses of the existing tax laws.

## Transfers to General Obligation 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 the Health Facilities and Services Administration 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. 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.

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

| | Fiscal Year Ending June 30 | | | | |
|---|---|---|---|---|---|
| | 1998 | 1999 | 2000 | 2001[2] | 2002[2] |
| Education | $ 504,296 | $ 571,758 | $ 676,018 | $ 642,082 | $ 725,685 |
| Social Services | 1,592,402 | 1,548,876 | 1,571,480 | 1,665,248 | 1,705,067 |
| Health | 399,790 | 362,905 | 353,487 | 356,028 | 364,804 |
| Labor and Human Resources[3] | 161,272 | 308,699 | 180,477 | 339,772 | 398,146 |
| Crime | 25,726 | 27,552 | 20,666 | 16,965 | 13,328 |
| Housing[4] | 224,787 | 232,359 | 268,782 | 336,175 | 375,195 |
| Drug and Justice | 10,909 | 9,841 | 14,710 | 17,524 | 11,176 |
| Agriculture and Natural Resources | 6,771 | 6,898 | 6,427 | 5,341 | 8,824 |
| Contributions to Municipalities | 64,911 | 58,865 | 58,865 | 56,809 | 59,191 |
| Other | 6,337 | 5,914 | 5,568 | 5,559 | 7,311 |
| **TOTAL** | $2,997,201 | $3,133,667 | $3,156,480 | $3,441,503 | $3,668,727 |

(1) Federal grants to public corporations, including but not limited to the Highway and Transportation Authority, are not included in this table.
(2) Estimated.
(3) Amounts include grants to the Right to Work Administration and to the Occupational Development and Human Resources Council.
(4) Amounts include grants to the Public Housing Administration.

*Source:* Office of Management and Budget

## BUDGET OF THE COMMONWEALTH OF PUERTO RICO

## Office of Management and Budget

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 to supervise its administration in Executive Branch agencies. 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, follow-up of agencies compliance with the Government program and regulatory policies. In each of these areas OMB's role is to help improve administrative management, to develop better performance measures and coordinating mechanisms, and to 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 budge. 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 and various departments and other recipients of such grants. Revenue and federal grant estimates are under continuous review and, if necessary, are revised at least quarterly during the fiscal year. Fiscal control over expenditures is exercised 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 Act), 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. The Budgetary Fund Act was amended in 1994 to require that an annual legislative appropriation equal to 0.33% of the total budgeted appropriations for each fiscal year be deposited in the Budgetary Fund. In 1997, the Budgetary Fund Act was further amended to increase the annual legislative appropriation to be deposited in the Budgetary Fund to 1% of the total revenues of the preceding fiscal year, beginning in fiscal year 2000. In addition, other income (not classified as revenues) that is not assigned by law to a specific purpose is also required to be deposited in the Budgetary Fund. The maximum balance of the Budgetary Fund may not exceed 6% of the total appropriations included in the budget for the preceding fiscal year. As of June 30, 2002, the un-encumbered balance in the Budgetary Fund is expected to be $51.2 million. As of March 21, 2002, the Budgetary Fund balance was $175.7 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 year.

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 and police fire protection. The central government provides significant annual grants to the University of Puerto Rico, Aqueduct and Sewer Authority and to the municipalities. In the summaries, 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 in included in current expenses for debt service. Debt services 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 25.2% 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, and rental payments to the Public Buildings Authority, among others, including debt service on direct debt of the Commonwealth.

### Fiscal Year 2003 Proposed Budget

On February 12, 2002, the Governor of Puerto Rico submitted a proposed budget for fiscal year 2003 to the Legislature of Puerto Rico. This budget is expected to be approved before June 30, 2002. The following table presents a summary of the Commonwealth's central government proposed budget for the fiscal year ending June 30, 2003.

**Commonwealth of Puerto Rico**
**Summary of Central Government Annual Budget**
**Fiscal Year Ending June 30, 2003**
**(in thousands)**

| | General Fund[2] | Bond Fund | Special Funds | Total |
|---|---|---|---|---|
| Revenues from internal sources: | | | | |
| Property taxes | $ - | | $ 104,412 | $ 104,412 |
| Personal income taxes | 2,715,000 | - | - | 2,715,000 |
| Retained non-resident income tax | 561,000 | - | - | 561,000 |
| Corporate income taxes | 1,846,000 | - | - | 1,846,000 |
| Partnership income taxes | 3,000 | - | - | 3,000 |
| Tollgate taxes | 36,000 | - | - | 36,000 |
| 17% withholding tax on interest | 16,000 | - | - | 16,000 |
| 10% withholding tax on dividends | 43,000 | - | - | 43,000 |
| Inheritance and gift taxes | 2,000 | - | - | 2,000 |
| Excise taxes: | | | | |
| Alcoholic beverages | 367,000 | - | - | 367,000 |
| Motor vehicles and accessories | 499,000 | - | - | 499,000 |
| Cigarettes | 194,000 | - | - | 194,000 |
| Special excise tax on certain petroleum products | 28,000 | - | - | 28,000 |
| General 5% excise tax | 558,000 | - | - | 558,000 |
| Other | 160,000 | - | 146,453 | 306,453 |
| Licenses | 84,000 | - | - | 84,000 |
| Miscellaneous non-tax revenues: | | | | |
| Contributions from lottery fund | 70,000 | - | - | 70,000 |
| Electronic lottery | 87,000 | - | - | 87,000 |
| Registration and document certification fees | 154,000 | - | - | 154,000 |
| Other | 78,000 | - | 182,818 | 260,818 |
| Total revenues from internal sources | 7,501,000 | - | 433,683 | 7,934,683 |
| Revenues from non-Commonwealth sources: | | | | |
| Federal excise taxes on off-shore shipments | 295,000 | - | - | 295,000 |
| Federal grants | - | - | 3,668,727[1] | 3,668,727 |
| Customs | 40,000 | - | - | 40,000 |
| Total revenues from non-Commonwealth sources | 335,000 | - | 3,668,727 | 4,003,727 |
| Total revenues | 7,836,000 | - | 4,102,410 | 11,938,410 |
| Other: | | | | |
| Other Income | - | - | - | - |
| Balance from previous year | - | - | 440,545 | 440,545 |

| | General Fund[2] | Bond Fund | Special Funds | Total |
|---|---|---|---|---|
| Bonds authorized | - | 500,000 | - | 500,000 |
| Total other sources | - | 500,000 | 440,545 | 940,545 |
| Total resources | 7,836,000 | 500,000 | 4,542,955 | 12,878,955 |
| Appropriations: | | | | |
| Current expenses: | | | | |
| General government | 756,828 | - | 48,302 | 805,130 |
| Education | 2,446,471 | - | 795,493 | 3,241,964 |
| Health | 1,276,888 | - | 330,970 | 1,607,858 |
| Welfare | 400,268 | - | 2,176,622 | 2,576,890 |
| Economic development | 184,720 | - | 66,904 | 251,624 |
| Public safety and protection | 1,414,261 | - | 56,604 | 1,470,865 |
| Transportation and communications | 77,390 | - | 17,081 | 94,471 |
| Housing | 22,728 | - | 194,817 | 217,554 |
| Contributions to municipalities | 354,837 | - | 2,095 | 356,932 |
| Special pension contributions | 101,227 | - | - | 101,227 |
| Debt service | 375,889 | - | 104,412 | 480,301 |
| Other debt service | 424,493 | - | 19,000 | 443,493 |
| Total appropriations-current expenses | 7,836,000 | - | 3,812,300 | 11,648,300 |
| Capital improvements | - | 500,000 | 165,019 | 665,019 |
| Total appropriations | 7,836,000 | 500,000 | 3,977,319 | 12,313,319 |
| Year-end balance | - | - | 565,636 | 565,636 |
| Total appropriations and year-end balance | $7,836,000 | $500,000 | $4,542,955 | $12,878,955 |

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

*Sources*: Department of the Treasury and Office of Management and Budget, as reported on March 20, 2002

In the fiscal year 2003 budget proposal revenues and other resources of all budgetary funds total $11,938,410,000 excluding balances from the previous fiscal year and general obligation bonds authorized. The estimated net increase in General Fund revenues in fiscal year 2003 are accounted mainly by personal income taxes (up $140,000,000), alcoholic beverages (up $125,000,000), corporation income taxes (up $122,000,000), cigarettes (up $75,000,000), motor vehicles and accessories (up $70,000,000), electronic lottery ($26,000,000), federal excise taxes on off-shore shipments (up $15,000,000) and decrease in income tax withheld from non-residents (down $109,000,000).

Current expenses and capital improvements of all budgetary funds total $12,313,319,000, an increase of $395,294,000 from fiscal 2002. The major changes in General Fund expenditures by program in fiscal 2003 are: education (up $120,268,000), public safety and protection (up $119,535,000), health (up $88,453,000), debt service (up $63,715,000), special pension contributions (up $31,686,000), welfare (up $16,282,000), contributions to municipalities (up $10,744,000), housing (up $1,088,000) and transportation and communications (up $283,000), and decrease in economic development (down $2,912,000), general government (down $18,937,000), other debts (down $59,911,000).

The general obligation bond authorization for the fiscal 2003 budget is $500,000,000.

### Fiscal Year 2002 Budget

The following table presents a summary of the Commonwealth's central government budget for the fiscal year ending June 30, 2002.

**Commonwealth of Puerto Rico**
**Summary of Central Government Annual Budget**
**Fiscal Year Ending June 30, 2002**
**(in thousands)**

| | General Fund | Bond Fund | Special Funds | Total |
|---|---|---|---|---|
| Revenues from internal sources: | | | | |
| Property taxes | $ - | $ - | $ 104,412 | $ 104,412 |
| Personal income taxes | 2,575,000 | - | - | 2,575,000 |
| Retained non-resident income tax | 670,000 | - | - | 670,000 |
| Corporate income taxes | 1,724,000 | - | - | 1,724,000 |
| Partnership income taxes | 3,000 | - | - | 3,000 |
| Tollgate taxes | 36,000 | - | - | 36,000 |
| 17% withholding tax on interest | 15,000 | - | - | 15,000 |
| 10% withholding tax on dividends | 40,000 | - | - | 40,000 |
| Inheritance and gift taxes | 2,000 | - | - | 2,000 |
| Excise taxes: | | | | |
| Alcoholic beverages | 242,000 | - | - | 242,000 |
| Motor vehicles and accessories | 429,000 | - | - | 429,000 |
| Cigarettes | 119,000 | - | - | 119,000 |
| Special excise tax on certain petroleum products | 26,000 | - | - | 26,000 |
| General 5% excise tax | 555,000 | - | - | 555,000 |
| Other | 80,000 | - | 146,453 | 226,453 |
| Licenses | 79,000 | - | - | 79,000 |
| Miscellaneous non-tax revenues: | | | | |
| Contributions from lottery fund | 62,000 | - | - | 62,000 |
| Electronic lottery | 61,000 | - | - | 61,000 |
| Registration and document certification fees | 143,000 | - | - | 143,000 |
| Other | 70,000 | - | 182,818 | 252,818 |
| Total revenues from internal sources | 6,931,000 | - | 433,683 | 7,364,683 |
| Revenues from non-Commonwealth sources: | | | | |
| Federal excise taxes on off-shore shipments | 280,000 | - | - | 280,000 |
| Federal grants | - | - | 3,668,727[1] | 3,668,727 |
| Customs | 40,000 | - | - | 40,000 |
| Total revenues from non-Commonwealth sources | 320,000 | - | 3,668,727 | 3,988,727 |
| Total revenues | 7,251,000 | - | 4,102,410 | 11,353,410 |
| Other: | | | | |
| Other Income | 214,706 | | - | 214,706 |
| Balance from previous year | - | - | 465,239 | 465,239 |
| Bonds authorized | - | 475,000 | - | 475,000 |
| Total other sources | 214,706 | 475,000 | 465,239 | 1,154,945 |
| Total resources | $7,465,706 | $475,000 | $4,567,649 | $12,508,355 |

| | General Fund | Bond Fund | Special Funds | Total |
|---|---|---|---|---|
| Appropriations: | | | | |
| Current expenses: | | | | |
| General government | 775,765 | - | 48,302 | 824,067 |
| Education | 2,326,203 | - | 795,493 | 3,121,696 |
| Health | 1,188,435 | - | 330,970 | 1,519,405 |
| Welfare | 383,986 | - | 2,176,622 | 2,560,608 |
| Economic development | 187,632 | - | 66,904 | 254,536 |
| Public safety and protection | 1,294,726 | - | 56,604 | 1,351,330 |
| Transportation and communications | 77,107 | - | 17,081 | 94,188 |
| Housing | 21,640 | - | 194,817 | 216,457 |
| Contributions to municipalities | 344,093 | - | 2,095 | 346,188 |
| Special pension contributions | 69,541 | - | - | 69,541 |
| Debt service | 312,174 | - | 104,412 | 416,586 |
| Other debt service | 484,404 | - | 19,000 | 503,404 |
| Total appropriations-current expenses | 7,465,706 | - | 3,812,300 | 11,278,006 |
| Capital improvements | - | 475,000 | 165,019 | 640,019 |
| Total appropriations | 7,465,706 | 475,000 | 3,977,319 | 11,918,025 |
| Year-end balance | - | - | 590,330 | 590,330 |
| Total appropriations and year-end balance | $7,465,706 | $475,000 | $4,567,649 | $12,508,355 |

(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 as reported on March 20, 2002

In the fiscal 2002 budget projected revenues and other resources of all budgetary funds total $11,568,116,000 excluding balances from the previous fiscal year and general obligation bonds authorized. General Fund projected revenues increased by $299.1 million as compared with fiscal year 2001. The estimated net increase in general fund revenues in fiscal year 2002 are accounted mainly by personal income taxes (up $226,817,000), general excise taxes of 5% (up $46,028,000), corporation income taxes (up $27,234,000), special excise tax on certain petroleum products (up $24,100,000), motor vehicles and accessories (up $22,748,000), contributions from lottery fund (up $4,518,000), alcoholic beverages (up $4,488,000), licenses (up $2,662,000), and decrease in customs (down $3,154,000), federal excise taxes on off-shore shipments (down $6,890,000), electronic lottery (down $9,211,000), tollgate taxes (down $13,511,000), interest on dividend 10% (down $18,580,000), and retained non-resident income tax (down $26,835,000).

Current expenses and capital improvements, of all budgetary funds total $11,918,025,000, an increase of $379,692,000 from fiscal 2001. The major changes in General Fund expenditures by program in fiscal 2002 are: debt service (up $66,360,000), general government (up $5,860,000), other debts (up $47,819,000), contributions to municipalities (up $43,628,000), special pension contributions (up $23,131,000), economic development (up $10,564,000), public safety and protection (up $4,446,000), and decrease in housing (down $1,185,000), transportation and communications (down $2,188,000), welfare (down $13,729,000), education (down $14,126,000), and health (down $89,349,000).

The general obligation bond authorization for the fiscal year 2002 budget was $475,000,000.

In September 2001, the government announced that, based on negotiations with several insurance companies that provide health insurance coverage to low income individuals, the projected cost of health insurance of $300 million for fiscal 2002 that was included in the budget will not be achieved. However, the government expects to achieve savings due to eligibility audits and additional discounts from pharmaceutical manufacturers. In addition, the Government has reallocated revenues from the Emergency Fund and other moneys obtained from refinancing debt at lower interest rates to cover the cost of health insurance. In addition, in fiscal year 2003, the Government expects to achieve savings of $65 million per year with the implementation of a smart card that is expected to improve health services. See "Summary and Management Discussion of General Fund Results – Estimated Fiscal 2002 Compared to Actual Fiscal 2001" in *Puerto Rico Taxes, Other Revenues and Expenditures*.

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

Revenue and expenditures, as reported by the Department of the Treasury in its General Purpose Financial Statements, may differ substantially from resources and appropriations in the annual budget for a number of reasons, including the following.

(i) The budgetary accounts are on a cash basis, while 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, 2001, the Commonwealth included in its financial statements reported liabilities of approximately $138 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 a lawsuit alleging violations of civil rights. Preliminary hearings and discovery proceedings are in progress. The amounts claimed exceed $3 billion; however, the ultimate liability cannot be presently determined. It is the opinion of the Commonwealth that the claim is excessive and exaggerated. 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 in excess of amounts provided, 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.

## FORMS OF OPINIONS OF BOND COUNSEL

*Upon delivery of the Public Improvement Bonds, Squire, Sanders & Dempsey L.L.P. is prepared to render its final opinion with respect to the Public Improvement Bonds in substantially the following form:*

August __, 2002

Hon. Juan A. Flores Galarza
Secretary of the Treasury of Puerto Rico
San Juan, Puerto Rico

Dear Sir:

We have served as bond counsel in connection with the issuance by the Commonwealth of Puerto Rico of its $460,000,000 principal amount of Public Improvement Bonds of 2003, Series A (the "Bonds"). The Bonds are dated, mature on July 1 of the years and in such principal amounts and bear interest at the rates, all as set forth in the Resolution referred to hereinbelow. The Bonds are issuable as fully registered Bonds without coupons, in authorized denominations of $5,000 and integral multiples thereof, in the manner and in accordance with the terms and conditions of the Resolution.

In our capacity as bond counsel, we have examined the transcript of the proceedings (the "Transcript") of the Commonwealth of Puerto Rico relating to the issuance of the Bonds, including, without limitation, Act No. 100 of the Legislature of Puerto Rico, approved July 12, 2002 (the "Act") and a resolution adopted on July 18, 2002 by the Secretary of the Treasury of Puerto Rico and approved by the Acting Governor of Puerto Rico (the "Resolution"), and such other documents as we have deemed necessary to render this opinion.

We have also examined a copy of one of the Bonds as executed and authenticated. We assume that all other Bonds have been similarly executed and authenticated.

From such examination, we are of the opinion that:

1. The Act is valid.

2. Said proceedings have been validly and legally taken.

3. The Act and said proceedings show lawful authority for the issuance and sale of the Bonds, and the Bonds constitute valid and binding general obligations of the Commonwealth of Puerto Rico for the prompt payment of the principal of and the interest on which the good faith, credit and taxing power of the Commonwealth of Puerto Rico are pledged.

4. The interest on the 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"), and is not an item of tax preference for purposes of the federal alternative minimum tax imposed on individuals and corporations. The Bonds and the interest thereon are exempt from state, Commonwealth of Puerto Rico and local income taxation. We express no opinion as to any other tax consequences regarding the Bonds.

Under the Code, portions of the interest on the Bonds earned by certain corporations (as defined for federal income tax purposes) may be subject to a corporate alternative minimum tax and interest on the Bonds may be subject to a branch profits tax imposed on certain foreign corporations doing business in the United States and to a tax imposed on excess net passive income of certain S corporations.

In giving the opinion set forth in numbered paragraph 4. hereof, we have relied upon and assumed continuing compliance with the Commonwealth of Puerto Rico's covenants and the accuracy, which we have not independently verified, of the representations and certifications of the Commonwealth of Puerto Rico contained in the Transcript. The accuracy of those representations and certifications, and the Commonwealth of Puerto Rico's compliance with those covenants, may be necessary for the interest on the Bonds to be and to remain excluded from gross income for federal income tax purposes. Failure to comply with certain of those covenants subsequent to issuance of the Bonds could cause interest on the Bonds to be included in gross income for federal income tax purposes retroactively to the date of issuance of the Bonds. The Commonwealth of Puerto Rico has covenanted to comply with the requirements of the Code to the extent permitted by the Constitution and laws of the Commonwealth. We are not aware of any provisions of the Constitution or laws of the Commonwealth of Puerto Rico that would prevent the Commonwealth from complying with the requirements of the Code.

In rendering the opinions set forth herein, we have assumed the accuracy and truthfulness of all public records and of all certifications, documents and other proceedings examined by us that have been executed or certified by public officials acting within the scope of their official capacities and have not verified the accuracy or truthfulness thereof. We have also assumed the genuineness of the signatures appearing upon such public records, certifications, documents and proceedings. As to questions of fact material to our opinion, we have relied on representations of the Commonwealth of Puerto Rico furnished to us, without undertaking to verify such representations by independent investigation.

It is to be understood that the rights of the holders of the Bonds and the enforceability of the Resolution and the Bonds may be subject to judicial discretion and valid bankruptcy, insolvency, reorganization, moratorium and other laws affecting creditors' rights generally, and subject to general principles of equity (regardless of whether considered in a proceeding in equity or at law).

Respectfully submitted,

[To be signed "Squire, Sanders & Dempsey L.L.P."]

*Assuming among other matters, no Change in Law as described in the Official Statement under "Delayed Delivery of the 2002 Refunding Bonds" in* Plan of Financing, *upon delivery of the Refunding Bonds, Squire, Sanders & Dempsey L.L.P. is prepared to render its final opinion with respect to the Refunding Bonds in substantially the following form:*

April __, 2003

Hon. Juan A. Flores Galarza
Secretary of the Treasury of Puerto Rico
San Juan, Puerto Rico

Dear Sir:

We have served as bond counsel in connection with the issuance by the Commonwealth of Puerto Rico of its $95,295,000 principal amount of Public Improvement Refunding Bonds, Series 2003 (the "Bonds"). The Bonds are dated, mature on July 1 of the years and in such principal amounts and bear interest at the rates, all as set forth in the Resolution referred to hereinbelow. The Bonds are issuable as fully registered Bonds without coupons, in authorized denominations of $5,000 and integral multiples thereof, in the manner and in accordance with the terms and conditions of the Resolution.

In our capacity as bond counsel, we have examined the transcript of the proceedings (the "Transcript") of the Commonwealth of Puerto Rico relating to the issuance of the Bonds, including, without limitation, Act No. 33 of the Legislature of Puerto Rico, approved December 7, 1942 (the "Act") and a resolution adopted on July 18, 2002 by the Secretary of the Treasury of Puerto Rico and approved by the Acting Governor of Puerto Rico (the "Resolution"), and such other documents as we have deemed necessary to render this opinion.

We have also examined a copy of one of the Bonds as executed and authenticated. We assume that all other Bonds have been similarly executed and authenticated.

From such examination, we are of the opinion that:

1. The Act is valid.

2. Said proceedings have been validly and legally taken.

3. The Act and said proceedings show lawful authority for the issuance and sale of the Bonds, and the Bonds constitute valid and binding general obligations of the Commonwealth of Puerto Rico for the prompt payment of the principal of and the interest on which the good faith, credit and taxing power of the Commonwealth of Puerto Rico are pledged.

4. The interest on the 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"), and is not an item of tax preference for purposes of the federal alternative minimum tax imposed on

individuals and corporations. The Bonds and the interest thereon are exempt from state, Commonwealth of Puerto Rico and local income taxation. We express no opinion as to any other tax consequences regarding the Bonds.

Under the Code, portions of the interest on the Bonds earned by certain corporations (as defined for federal income tax purposes) may be subject to a corporate alternative minimum tax and interest on the Bonds may be subject to a branch profits tax imposed on certain foreign corporations doing business in the United States and to a tax imposed on excess net passive income of certain S corporations.

In giving the opinion set forth in numbered paragraph 4. hereof, we have relied upon and assumed compliance with the Commonwealth of Puerto Rico's covenants and the accuracy, which we have not independently verified, of the representations and certifications of the Commonwealth of Puerto Rico contained in the Transcript. The accuracy of those representations and certifications, and the Commonwealth of Puerto Rico's compliance with those covenants, may be necessary for the interest on the Bonds to be and to remain excluded from gross income for federal income tax purposes. Failure to comply with certain of those covenants subsequent to issuance of the Bonds could cause interest on the Bonds to be included in gross income for federal income tax purposes retroactively to the date of issuance of the Bonds. The Commonwealth of Puerto Rico has covenanted to comply with the requirements of the Code to the extent permitted by the Constitution and laws of the Commonwealth. We are not aware of any provisions of the Constitution or laws of the Commonwealth of Puerto Rico that would prevent the Commonwealth of Puerto Rico from complying with the requirements of the Code.

In rendering the opinions set forth herein, we have assumed the accuracy and truthfulness of all public records and of all certifications, documents and other proceedings examined by us that have been executed or certified by public officials acting within the scope of their official capacities and have not verified the accuracy or truthfulness thereof. We have also assumed the genuineness of the signatures appearing upon such public records, certifications, documents and proceedings. As to questions of fact material to our opinion, we have relied on representations of the Commonwealth of Puerto Rico furnished to us, without undertaking to verify such representations by independent investigation.

It is to be understood that the rights of the holders of the Bonds and the enforceability of the Resolution and the Bonds may be subject to judicial discretion and valid bankruptcy, insolvency, reorganization, moratorium and other laws affecting creditors' rights generally, and subject to general principles of equity (regardless of whether considered in a proceeding in equity or at law).

Respectfully submitted,

[To be signed "Squire, Sanders & Dempsey L.L.P."]

FGIC

Financial Guaranty Insurance
Company
115 Broadway
New York, NY 10006
(212) 312-3000
(800) 352-0001

*A GE Capital Company*

# 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 State Street Bank and Trust Company, N.A., 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

Financial Guaranty Insurance
Company
115 Broadway
New York, NY 10006
(212) 312-3000
(800) 352-0001

*A GE Capital Company*

FGIC

# Municipal Bond
# New Issue Insurance Policy

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 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.

**President**

**Effective Date:** **Authorized Representative**

State Street Bank and Trust Company, N.A., acknowledges that it has agreed to perform the duties of Fiscal Agent under this Policy.

**Authorized Officer**

Financial Guaranty Insurance
Company, doing business in California
as FGIC Insurance Company
115 Broadway
New York, NY 10006
(212) 312-3000
(800) 352-0001

*A GE Capital Company*

FGIC

# Endorsement
## To Financial Guaranty Insurance Company Insurance Policy

**Policy Number:** **Control Number:** 0010001

SPECIMEN

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**
**State Street Bank and Trust Company, N.A., as Fiscal Agent**