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

In the opinion of Bond Counsel, under the provisions of the Acts of Congress now in force, (i) subject to continuing compliance with certain tax covenants, interest on the Bonds will not be includable in gross income for federal income tax purposes, and (ii) the Bonds and interest thereon will be exempt from state, Commonwealth and local taxation under existing law. However, see "Tax Exemption" for a description of alternative minimum tax consequences with respect to interest on the Bonds and other tax considerations.

$440,460,000
COMMONWEALTH OF PUERTO RICO
Public Improvement Bonds of 2005, Series A
(General Obligation Bonds)

Dated: Date of Delivery **Due: July 1, as shown on the inside cover**

The Bonds are issuable as registered bonds without coupons in denominations of $5,000 and whole multiples thereof. Interest on the Bonds will accrue from their date of issuance and will be payable semi-annually on each January 1 and July 1, commencing on January 1, 2005. The Bonds are subject to redemption prior to maturity as set forth herein, the earliest possible date of redemption being July 1, 2014.

Concurrently with the issuance of the Bonds, the Commonwealth is issuing its $93,790,000 Public Improvement Bonds of 2005, Series B. The Series B Bonds are being offered for sale solely in the Commonwealth pursuant to a separate Official Statement.

The scheduled payment of principal of and interest on the Bonds maturing on July 1, 2014, 2015, 2016, 2017 and 2018 will be insured by Financial Security Assurance Inc., as indicated on the inside cover of this Official Statement.

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

The Bonds are offered for delivery when, as and if issued and accepted by the Underwriters, subject to the approval of legality by Sidley Austin Brown & Wood LLP, New York, New York, 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 the Bonds will be available for delivery through the facilities of The Depository Trust Company on or about October 7, 2004.

Morgan Stanley **Banc of America Securities LLC** **Citigroup**

Goldman Sachs & Co. **JP Morgan** **Lehman Brothers**

Merrill Lynch & Co. **Raymond James & Associates, Inc.**

Samuel A. Ramírez & Co. Inc. **UBS Financial Services, Inc.**

Wachovia Bank, National Association

September 24, 2004

$440,460,000
COMMONWEALTH OF PUERTO RICO
Public Improvement Bonds of 2005, Series A
(General Obligation Bonds)

Maturity July 1,	Amount	Interest Rate	Yield
2014*	$ 8,560,000	5.00%	3.44%
2015*	12,945,000	5.00	3.55
2016*	13,595,000	5.00	3.63
2017*	14,275,000	5.00	3.71
2018*	14,985,000	5.00	3.79
2019	15,735,000	5.25	4.18
2020	16,560,000	5.25	4.25
2021	17,430,000	5.25	4.32
2022	18,345,000	5.25	4.40
2023	19,310,000	5.25	4.44
2024	20,325,000	5.00	4.61
2025	21,340,000	5.00	4.68

$ 96,570,000 5.00% Term Bonds due July 1, 2029 -Yield 4.78%
$150,485,000 5.00% Term Bonds due July 1, 2034 -Yield 4.82%

* Insured by Financial Security Assurance Inc.

Commonwealth of Puerto Rico

Governor

SILA M. CALDERÓN

Members of the Cabinet

CÉSAR MIRANDA
Chief of Staff

JOSÉ M. IZQUIERDO
Secretary of State

WILLIAM VÁZQUEZ IRIZARRY
Secretary of Justice

JUAN A. FLORES GALARZA
Secretary of the Treasury

CÉSAR REY
Secretary of Education

ROMÁN M. VELASCO GONZÁLEZ
Secretary of Labor and Human Resources

JOHNNY RULLÁN
Secretary of Health

LUIS RIVERO CUBANO
Secretary of Agriculture

FERNANDO E. FAGUNDO
Secretary of Transportation and Public Works

MILTON SEGARRA
Secretary of Economic Development and Commerce

YOLANDA ZAYAS SANTANA
Secretary of Family Affairs

ILEANA ECHEGOYEN
Secretary of Housing

LUIS E. RODRÍGUEZ
Secretary of Natural and Environmental Resources

NOEMA GIRALT ARMADA
Secretary of Consumer Affairs

JORGE L. ROSARIO
Secretary of Sports and Recreation

MIGUEL A. PEREIRA
Secretary of Corrections and Rehabilitation

Legislative Officers

ANTONIO FAS ALZAMORA
President, Senate

CARLOS VIZCARRONDO
Speaker, House of Representatives

Fiscal Officers

MELBA ACOSTA
Director, Office of Management and Budget

ANTONIO FARÍA
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.

Other than with respect to information concerning Financial Security Assurance Inc. ("FSA") contained under the caption *Bond Insurance* and the insurance policy specimen appearing in *Appendix III*, none of the information in this Official Statement has been supplied or verified by FSA, and FSA makes no representation or warranty, expressed or implied, as to (i) the accuracy or completeness of such information, (ii) the validity of the Bonds, or (iii) the tax exempt status of interest on the Bonds.

Table of Contents

$440,460,000
COMMONWEALTH OF PUERTO RICO
Public Improvement Bonds of 2005, Series A
(General Obligation Bonds)

INTRODUCTORY STATEMENT

This Official Statement of the Commonwealth of Puerto Rico (the "Commonwealth" or "Puerto Rico") provides certain information in connection with the sale of $440,460,000 Commonwealth of Puerto Rico Public Improvement Bonds of 2005, Series A (the "Bonds"). Concurrently with the issuance of the Bonds, the Commonwealth is issuing its $93,790,000 Public Improvement Bonds of 2005, Series B (the "Series B Bonds" and, together with the Bonds, the "2005 Bonds"). The Series B Bonds are being offered for sale solely in the Commonwealth pursuant to a separate Official Statement.

The 2005 Bonds are being issued under the provisions of Act No. 216 of the Legislature of Puerto Rico, approved on August 19, 2004 ("Act 216"), and pursuant to a resolution authorizing the issuance of the 2005 Bonds (the "Bond Resolution") adopted in accordance with Act 216 by the Secretary of the Treasury of the Commonwealth of Puerto Rico (the "Secretary of the Treasury") and approved by the Governor of Puerto Rico on September 24, 2004.

The Bonds maturing on July 1, 2014, 2015, 2016, 2017 and 2018 (the "Insured Bonds") will be insured by a municipal bond insurance policy (the "Policy") issued by Financial Security Assurance Inc. ("FSA").

Under Act 216, 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 2005 Bonds. The Constitution of Puerto Rico provides that public debt of the Commonwealth, which includes the 2005 Bonds, constitutes a first claim on available Commonwealth revenues.

This Official Statement includes the Commonwealth of Puerto Rico Financial Information and Operating Data Report dated August 1, 2004 (the "Commonwealth Report") attached hereto as *Appendix I* and the Comprehensive Annual Financial Report of the Commonwealth for the fiscal year ended June 30, 2003, prepared by the Department of the Treasury of the Commonwealth (the "Commonwealth's Annual Financial Report"), which is incorporated by reference herein.

The Commonwealth Report attached hereto as *Appendix I* includes important information about the Commonwealth, including information about the economy, historical revenues and expenditures of the Commonwealth's General Fund, the year-end results of the fiscal year 2004 budget, the approved budget for fiscal year 2005, and the debt of the Commonwealth's public sector, and should be read in its entirety.

The Commonwealth's Annual Financial Report includes the basic financial statements of the Commonwealth for the fiscal year ended June 30, 2003, together with the independent auditor's report thereon, dated June 9, 2004, of KPMG LLP, certified public accountants. The Commonwealth's Annual Financial Report has been filed by the Commonwealth with each nationally recognized municipal securities information repository ("NRMSIR"). KPMG LLP did not audit the financial statements of the Public Buildings Authority's capital project fund (a major fund), and certain activities, funds and component units separately identified in its report. Those financial statements were audited by other auditors whose reports have been furnished to KPMG LLP, and its opinion as to the basic financial statements, insofar as it relates to the amounts included in the basic financial statements pertaining to such activities, funds and component units, is based solely on the reports of the other auditors.

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

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

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

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

Puerto Rico has a diversified economy with manufacturing and services comprising its principal sectors. Puerto Rico's economy is closely linked to the United States economy. In fiscal year 2003 (which ended on June 30, 2003), the Commonwealth's gross product (preliminary, in current dollars) was $47.4 billion, and personal income per capita (preliminary, in current dollars) was $11,279.

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

Fiscal responsibility for the Commonwealth is shared among the Department of the Treasury, the Office of Management and Budget and Government Development Bank for Puerto Rico ("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.

Additional information about the Commonwealth can be found in the Commonwealth Report attached hereto as *Appendix I*, including information about the economy, historical revenues and expenditures of the Commonwealth's General Fund, the year-end results of the fiscal year 2004 budget, the approved budget for fiscal year 2005, and the debt of the Commonwealth's public sector. The Commonwealth Report should be read in its entirety.

RECENT DEVELOPMENTS

Tropical Storm Jeanne

On September 15, 2004, Tropical Storm Jeanne passed directly over Puerto Rico causing significant damage throughout the island. The island was declared an emergency zone by President George W. Bush, thus making it eligible for emergency assistance from the Federal Emergency Management Agency ("FEMA"). Most losses to government and private property are expected to be covered by private insurance, FEMA emergency aid and local government assistance programs.

The day after the tropical storm struck, much of the island was without water and 100% of the Electric Power Authority's customers did not have electricity. The Commonwealth has been able to restore these utility services at a faster pace than had been experienced during prior hurricane recovery programs. To date, water service has been restored to more than 97% of the Aqueduct and Sewer Authority customers and electrical power has been restored to more than 99.4%.

The Commonwealth is currently in the process of determining the total impact of Tropical Storm Jeanne on the Commonwealth's economy. While some sectors of the economy, like agriculture, suffered more than others, it is expected that its general impact will not be material.

Proposal for Tax Restructuring

The Commonwealth is evaluating a revenue-positive tax restructuring which includes the imposition of a consumption tax and a lowering of the current income tax rates applicable to middle income taxpayers. This restructuring is intended to expand the taxpayer base significantly. The

Commonwealth expects that, if adopted, this tax restructuring will represent a net increase in tax revenues, beginning in fiscal year 2006.

On September 15, 2004, the Governor signed legislation that establishes the principles and objectives that will guide the evaluation and implementation of this future tax restructuring. According to this legislation, the adoption of any tax restructuring legislation by the Legislature of Puerto Rico shall aim to alleviate the tax burden of the middle class taxpayer by significantly reducing current income tax rates without hindering economic growth, control effectively tax evasion and expand the taxpayer base, simplify the current tax system in an effort to make it easy to understand and administrate, and provide the necessary resources in order to achieve balanced economic growth.

This proposed tax restructuring is subject to the drafting and passage of new legislation by the Legislature of Puerto Rico. Despite the adoption of legislation establishing the objectives of the proposed tax restructuring, it remains subject to significant political and implementation risks. Therefore, no assurance can be given that the proposed tax restructuring will be implemented.

Change in Moody's Outlook on the Commonwealth's Outstanding Debt

On September 21, 2004, Moody's Investors Service, Inc. ("Moody's") announced that it was changing its ratings outlook on the Commonwealth's outstanding debt to negative from stable. This outlook change reflects Moody's concern over the Commonwealth's financial performance, particularly the balancing of General Fund operations with loans from Government Development Bank of $250 million and $233 million for fiscal years 2003 and 2004, respectively, the structural imbalance in the fiscal year 2005 budget which will require a loan from Government Development Bank of $550 million, and the 17% funding ratio of the Employees Retirement System of the Commonwealth and its instrumentalities (the "Employees Retirement System"). See "Retirement Systems" in the Commonwealth Report (*Appendix I*). The Commonwealth currently plans on addressing the structural imbalance referenced above with the expected additional net tax revenues resulting from the proposed tax restructuring discussed above, the normal annual increases in General Fund revenues, and new and existing initiatives to reduce expenditures and is evaluating alternatives to improve the funding ratio of the Employees Retirement System.

Unfunded Pension Benefit Obligation of the Retirement System

The Employees Retirement System expects to receive during October 2004 a new actuarial valuation of its pension benefit obligation from its independent consulting actuaries. Based on a preliminary indication from such actuaries, the Employees Retirement System expects that, as of June 30, 2003, its total unfunded pension benefit obligation, as estimated by the actuaries, is approximately $11 billion, resulting in a funding ratio of 15%. The Employees Retirement System is discussing some of the assumptions utilized by the actuaries to determine the pension benefit obligation that, if revised, could reduce the final actuarial value of such obligation.

During fiscal year 2004 the disbursement of benefits by the Employees Retirement System exceeded the contributions and investment income which it received, resulting in a need to liquidate some assets to make benefit payments. Failure to address this cash flow imbalance will result in additional reductions in the assets of the Employees Retirement System and an increase in its unfunded pension benefit obligation. The Employees Retirement System is currently evaluating alternatives to reduce its unfunded pension benefit obligation and increase its revenues. See "Retirement Systems" in the Commonwealth Report (*Appendix I*).

PLAN OF FINANCING

The net proceeds of the Bonds will be deposited in the 2005 Public Improvements Fund established under Act 216. Except for $27.5 million which is required to be used for transfer to the Extraordinary Maintenance Fund established under Act No. 66 of the Legislature of Puerto Rico, approved August 14, 1991, the proceeds of the Bonds will be used to carry out certain capital improvements programs authorized by the Legislature in Act 216.

Sources and Uses of Funds

Sources:

Principal amount of the Bonds	$440,460,000.00
Original Issue Premium	18,307,818.45
Total sources	$458,767,818.45

Uses:

Deposit into the 2005 Public Improvements Fund	$453,500,000.00
Underwriting discount, bond insurance premium and legal, printing, and other financing expenses	5,267,818.45
Total uses	$458,767,818.45

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 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 Bonds, each in the aggregate principal amount of such maturity, and will be deposited with DTC.

DTC, the world's largest depository, is a limited-purpose trust company organized under the New York Banking Law, a "banking organization" within the meaning of the New York Banking Law, a member of the Federal Reserve System, a "clearing corporation" within the meaning of the New York Uniform Commercial Code, and a "clearing agency" registered pursuant to the provisions of Section 17A of the Securities Exchange Act of 1934. DTC holds and provides asset servicing for over 2 million issues of U.S. and non-U.S. equity issues, corporate and municipal debt issues, and money market instruments from over 85 countries that DTC's participants ("Direct Participants") deposit with DTC. DTC also facilitates the post-trade settlement among Direct Participants of sales and other securities transactions in deposited securities, through electronic computerized book-entry transfers and pledges between Direct Participants' accounts. This eliminates the need for physical movement of securities. Direct Participants include both U.S. and non-U.S. securities brokers and dealers, banks, trust companies, clearing corporations, and certain other organizations. DTC is a wholly-owned subsidiary of The Depository Trust & Clearing Corporation ("DTCC"). DTCC, in turn, is owned by a number of Direct Participants of DTC and Members of the National Bonds Clearing Corporation, Government Bonds Clearing Corporation, NBS Clearing Corporation, and Emerging Markets Clearing Corporation, (NSCC, GSCC, MBSCC, and EMCC, also subsidiaries of DTCC), as well as by the New York Stock Exchange, Inc., the American Stock Exchange LLC, and the National Association of Securities Dealers, Inc. Access to the DTC system is also available to others such as both U.S. and non-U.S. securities brokers and dealers, banks, trust companies, and clearing corporations that clear through or maintain a custodial relationship with a Direct Participant, either directly or indirectly ("Indirect Participants"). DTC has the highest rating issued by Standard & Poor's Ratings Services, a division of the McGraw-Hill Companies ("Standard & Poor's"): "AAA." The DTC Rules applicable to its Participants are on file with the Securities and Exchange Commission. More information about DTC can be found at www.dtcc.com.

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

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

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

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

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

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

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

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

Payments and Transfers

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

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

Discontinuance of the Book-Entry Only System

In the event that the book-entry only system is discontinued, the following provisions will apply: principal of and redemption premium, if any, on the Bonds shall be payable in lawful money of the United States of America at the principal office of the Registrar in San Juan, Puerto Rico. Interest on the Bonds will be payable by check mailed to the respective addresses of the registered owners determined as of the record date thereof provided in the Bond Resolution 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 Act 216, which authorizes the Secretary of the Treasury to issue the Bonds pursuant to one or more resolutions adopted by the Secretary of the Treasury and approved by the Governor. In accordance with Act 216, the Secretary of the Treasury adopted and the Governor approved the Bond Resolution.

Redemption

The Bonds maturing on or after July 1, 2015 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 Bonds maturing on or after July 1, 2015 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 and after July 1, 2014, either in whole or in part, on any date, (and if in part, in such order of maturity 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, without premium.

Mandatory Redemption. The Bonds maturing July 1, 2029 and July 1, 2034 (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, 2026 and July 1, 2030, respectively, and on July 1 in each year thereafter at a redemption price of par plus accrued interest to the dates fixed for redemption:

Amortization Requirements for the Term Bonds Due

Year	July 1, 2029	July 1, 2034
2026	$22,405,000	
2027	23,525,000	
2028	24,700,000	
2029	25,940,000*	
2030		$27,235,000
2031		28,595,000
2032		30,025,000
2033		31,525,000
2034		33,105,000*
Average Life	23.294 years	27.831 years

* 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

Any redemption of the Bonds, either in whole or in part, shall be made upon at least a 30-day prior notice by mail to DTC or, if the book-entry only system described above has been discontinued, by first class mail, postage prepaid, to all registered owners of the Bonds to be redeemed in the manner and under the terms and conditions provided in the Bond Resolution. On the date designated for redemption, notice having been given as provided in the Bond Resolution and moneys for payment of the principal of and accrued interest on the Bonds or portions thereof so called for redemption being held by the Registrar, interest on the Bonds or portions thereof so called for redemption shall cease to accrue.

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

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

Security

Provision for Payment of Public Debt

Act 216 provides that the good faith, credit and taxing power of the Commonwealth are irrevocably pledged for the prompt payment of the principal of and interest on the bonds issued under the provisions of Act 216. The Secretary of the Treasury is authorized and directed under Act 216 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. Act 216 provides that the provisions contained therein with respect to the payment of the principal of and interest on the Bonds shall be considered to be a continuous appropriation for the Secretary of the Treasury to make such payments, even though no specific appropriations are made for such purposes. The payments under Act 216 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 year 1989, the Commonwealth has pledged to Puerto Rico Infrastructure Financing Authority certain federal excise taxes imposed on alcoholic beverages and tobacco products produced in Puerto Rico and sold in the United States, which taxes are returned to the Commonwealth. The amounts so pledged, however, are subject to first being applied to payment of the principal of and interest on the Commonwealth public debt, but only if and to the extent that all other available revenues of the Commonwealth are insufficient for that purpose. The Commonwealth has never 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 the Bonds (General Obligation) Debt Service

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

Act No. 39 of the Legislature of Puerto Rico, approved on May 13, 1976, as amended ("Act No. 39"), requires the Secretary of the Treasury to transfer each month from available funds of the Commonwealth to the Redemption Fund such amounts which, together with certain other funds deposited therein, will be equal to the sum of one-sixth of the interest to be paid in the next six months and one-twelfth of the principal to be paid or required to be amortized within the next twelve months on all bonds and notes of the Commonwealth for which its full faith and credit are pledged as the same become due and all bonds and notes of the Commonwealth for which the guaranty of the Commonwealth has been exercised. Moneys in the Redemption Fund are held in trust by Government Development Bank. Act No. 39 provides that the obligation of the Secretary of the Treasury to make the above transfers is cumulative, and the amount of any deficiency in any month shall be added to the amount of transfers required in future months until such deficiency has been fully paid. On September 7, 2004, the amount on deposit in the Redemption Fund was $72,908,568, 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"), of which $318,050,000 are currently outstanding. 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 is taken into account for purposes of computing the above described 15% constitutional debt limitation.

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

Upon the enactment of legislation currently pending that will expressly authorize the Commonwealth to enter into interest rate exchange agreements with respect to the Commonwealth's $447,875,000 Public Improvement Refunding Bonds, Series 2004 B (the "Series 2004 B Bonds"), which were issued as variable rate bonds, the Commonwealth will be permitted to calculate the constitutional debt limitation using (i) the fixed rate it is required to pay under any interest rate exchange agreement entered into by the Commonwealth in connection with the Series 2004 B Bonds, and (ii) the lesser of (A) the maximum interest rate allowed by law, and (B) the maximum interest rate set forth in the resolution approving the bonds, if any, in connection with the Commonwealth's $279,240,000 Public Improvement Refunding Bonds, Series 2004 A (the "Series 2004 A Bonds") and any Series 2004 B Bonds for which no interest rate exchange agreement is executed. The Commonwealth expects to enter into two interest rate exchange agreements with respect to the Series 2004 B Bonds.

After giving effect to the issuance of the 2005 Bonds, future maximum annual debt service for the Commonwealth's outstanding general obligation debt is $711,522,695.42 in the fiscal year ending June 30, 2006 (based on the assumption that the Series 2004 A Bonds bear interest at their actual rate per annum through July 1, 2012 and thereafter at 12% per annum and the Series 2004 B Bonds bear interest at the fixed rate paid by the Commonwealth under the interest rate exchange agreements to be executed in connection with such bonds). Debt service for the PRASA Guaranteed Bonds paid by the Commonwealth during fiscal year 2004 (including for this purpose debt service payments due

July 1, 2004) was $30,125,458. The sum of those amounts ($741,648,152.92) is equal to 9.97% of $7,439,000,000, which is the average of the adjusted internal revenues for the two fiscal years ended June 30, 2003 and June 30, 2004. If the bonds refunded with non-eligible investments described in the preceding paragraph were treated as not being outstanding, the percentage referred to in the preceding sentence would be 9.23%.

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

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

The FSA Bond Insurance Policy

Concurrently with the issuance of the Bonds, FSA will issue the Policy for the Insured Bonds. The Policy guarantees the scheduled payment of principal of and interest on the Insured Bonds when due as set forth in the form of the Policy included as *Appendix III* to this Official Statement.

The Policy is not covered by any insurance security or guaranty fund established under New York, California, Connecticut or Florida insurance law.

FSA. FSA is a New York domiciled financial guaranty insurance company and a wholly owned subsidiary of Financial Security Assurance Holdings Ltd. ("Holdings"). Holdings is an indirect subsidiary of Dexia, S.A., a publicly held Belgian corporation, and of Dexia Credit Local, a direct wholly-owned subsidiary of Dexia, S.A. Dexia, S.A., through its bank subsidiaries, is primarily engaged in the business of public finance, banking and asset management in France, Belgium and other European countries. No shareholder of Holdings or FSA is liable for the obligations of FSA.

At June 30, 2004, FSA's total policyholders' surplus and contingency reserves were approximately $2,212,545,000 and its total unearned premium reserve was approximately $1,501,280,000 in accordance with statutory accounting practices. At June 30, 2004, FSA's total shareholders' equity was approximately $2,438,206,000 and its total net unearned premium reserve was approximately $1,255,708,000 in accordance with generally accepted accounting principles.

The financial statements included as exhibits to the annual and quarterly reports filed by Holdings with the Securities and Exchange Commission are hereby incorporated herein by reference. Also incorporated herein by reference are any such financial statements so filed from the date of this Official Statement until the termination of the offering of the Bonds. Copies of materials incorporated by reference will be provided upon request to Financial Security Assurance Inc., 350 Park Avenue, New York, New York 10022, Attention: Communications Department (telephone (212) 826-0100).

The Policy does not protect investors against changes in market value of the Insured Bonds, which market value may be impaired as a result of changes in prevailing interest rates, changes in applicable ratings or other causes. FSA makes no representation regarding the Insured Bonds or the advisability of investing in the Insured Bonds. FSA makes no representation regarding this Official

Statement, nor has it participated in the preparation thereof, except that FSA has provided to the Commonwealth the information presented under this caption for inclusion in this Official Statement.

PUBLIC SECTOR DEBT OF THE COMMONWEALTH

Public Sector Debt

The following table presents a summary of the public sector debt of the Commonwealth as of June 30, 2004. The table also shows the public sector debt as further adjusted by the following bond issuances and events that have occurred after June 30, 2004: (i) the expected issuance by the Commonwealth in October 2004 of $800,000,000 principal amount of Tax and Revenue Anticipation Notes, Series 2005 (the "2005 TRANS"), (ii) the issuance by Electric Power Authority of $136,105,000 Power Revenue Refunding Bonds, Series OO and $88,595,000 Power Revenue Refunding Bonds, Series PP (the "PREPA Bonds"), and (iii) the issuance of the 2005 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)

	June 30, 2004	As Adjusted(1)
Puerto Rico direct debt(2)	$ 8,519,327	$ 9,853,577
Municipal debt	2,046,043	2,046,043
Public corporations debt		
Puerto Rico guaranteed debt	652,490	652,490
Debt supported by Puerto Rico appropriations or taxes	14,970,726	14,970,726
Other non-guaranteed debt	7,754,058	7,742,763
Total public corporations debt	23,377,274	23,365,979
Total public sector debt	$33,942,644	$35,265,599

* For a complete recital of all notes to this table, see "Public Sector Debt" under "Debt" in *Appendix I*.
(1) Adjusted to include the issuance of the 2005 TRANS, the PREPA Bonds and the 2005 Bonds.
(2) Includes general obligation bonds, tax and revenues anticipation notes, and lines of credit provided by Government Development Bank. The amount excludes certain Commonwealth general obligations that have been refunded with proceeds that were invested in non-eligible investments, even though such bonds will be considered outstanding under their respective authorizing resolutions and for purposes of calculating the Commonwealth's constitutional debt limitation.

Source: Government Development Bank

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

The following table presents the debt service requirements for (i) Commonwealth general obligation bonds and PRASA Guaranteed Bonds for which debt service payments are being made under the Commonwealth guaranty, in each case outstanding on July 1, 2004; (ii) debt service on the 2005 Bonds; and (iii) total debt service adjusted for the issuance of the 2005 Bonds. The table excludes debt service on Commonwealth general obligation bonds that have been refunded with the proceeds of refunding bonds invested in non-eligible investments, notwithstanding that such bonds will be considered to be outstanding under their authorizing resolution and for purposes of calculating the Commonwealth's debt limitation. Debt service requirements for each fiscal year, as shown in the following table, include principal and interest due on July 1 immediately following the close of such fiscal year.

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

Fiscal Year Ending June 30	Outstanding Bonds Total Debt Service[1]	Outstanding PRASA Guaranteed Bonds Debt Service	The 2005 Bonds Principal	The 2005 Bonds Interest	Grand Total[2]
2005	$ 464,892	30,127	6,745	18,709	520,473
2006	527,314	30,121	9,325	25,380	592,140
2007	527,191	30,126	9,550	25,156	592,024
2008	536,929	30,131	9,825	24,884	601,769
2009	532,600	30,123	10,130	24,575	597,428
2010	532,783	29,984	10,485	24,220	597,472
2011	530,404	29,928	10,885	23,822	595,039
2012	530,255	30,127	11,320	23,386	595,088
2013	530,318	30,128	11,790	22,916	595,152
2014	532,414	30,125	12,295	22,410	597,244
2015	532,679	30,126	12,945	21,813	597,563
2016	532,941	30,121	13,595	21,166	597,823
2017	533,323	30,122	14,275	20,486	598,206
2018	534,708	30,126	14,985	19,773	599,591
2019	535,348	30,125	15,735	19,023	600,231
2020	565,802	0	16,560	18,197	600,560
2021	413,903	0	17,430	17,328	448,661
2022	324,051	0	18,345	16,413	358,809
2023	280,253	0	19,310	15,450	315,013
2024	256,970	0	20,325	14,436	291,731
2025	257,275	0	21,340	13,420	292,035
2026	248,914	0	22,405	12,353	283,672
2027	249,178	0	23,525	11,233	283,935
2028	249,456	0	24,700	10,056	284,212
2029	249,725	0	25,940	8,821	284,486
2030	249,897	0	27,235	7,524	284,656
2031	250,014	0	28,595	6,163	284,772
2032	71,405	0	30,025	4,733	106,163
2033	38,435	0	31,525	3,232	73,191
2034	0	0	33,105	1,655	34,760
Total	$11,619,377	$451,540	$534,250	$ 498,733	$ 13,103,900

* Totals may not add due to rounding.

(1) Debt service requirements on all general obligation bonds outstanding on July 1, 2004, adjusted to exclude debt service on all general obligation bonds refunded with proceeds invested in non-eligible investments, notwithstanding that such bonds will be considered to be outstanding under their authorizing resolution and for purposes of calculating the Commonwealth's debt limitation. Interest on the Series 2004 A Bonds is calculated at their actual rate per annum through July 1, 2012 and thereafter at 4.28% per annum for the Series 2004 A Bonds due on July 1, 2030, and 3.88% per annum for the Series 2004 A Bonds due on July 1, 2031. Interest on the Series 2004 B Bonds is calculated using the respective fixed interest rates to be paid by the Commonwealth under the respective interest rate exchange agreements executed in connection with the Series 2004 B Bonds.

(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 2005 Bonds.

Sources: Government Development Bank and Department of the Treasury

TAX EXEMPTION

The Internal Revenue Code of 1986, as amended (the "Code"), includes requirements regarding the use, expenditure and investment of bond proceeds and the timely payment of certain investment earnings to the Treasury of the United States, if required, which must continue to be satisfied after the issuance of the Bonds in order that interest on the Bonds not be included in gross income for federal income tax purposes. The failure to meet these requirements may cause interest on the Bonds to be included in gross income for federal income tax purposes retroactive to their date of issuance. The Commonwealth has covenanted to comply, to the extent permitted by the Constitution and the laws of the

Commonwealth, with the requirements of the Code in order to maintain the exclusion from gross income for federal income tax purposes of interest on the Bonds. Bond Counsel is not aware of any provision of the Constitution or laws of the Commonwealth which would prevent the Commonwealth from complying with the requirements of the Code.

In the opinion of Bond Counsel, subject to continuing compliance by the Commonwealth with the tax covenant referred to above, under the provisions of the Acts of Congress now in force and under existing regulations, rulings and court decisions, interest on the Bonds will not be includable in gross income for federal income tax purposes. Interest on the Bonds will not be an item of tax preference for purposes of the federal alternative minimum tax imposed on individuals and corporations. Interest on the Bonds will, however, be includable in the computation of the alternative minimum tax on corporations imposed by the Code. Bond Counsel is rendering no opinion on the effect of any action taken or not taken after the date of its opinion without its approval (except for such action or omission to act as is provided for in the documents pertaining to the Bonds) or in reliance upon the advice of counsel other than such firm on the exclusion from gross income of the interest on the Bonds for federal income tax purposes. Bond Counsel is further of the opinion that under the provisions of the Acts of Congress now in force, the Bonds and the interest thereon will be exempt from state, Commonwealth and local income taxation.

Ownership of tax-exempt obligations such as the Bonds may result in collateral federal income tax consequences to certain taxpayers, including, without limitation, financial institutions, property and casualty insurance companies, certain foreign corporations, certain S Corporations with excess passive income, individual recipients of Social Security or Railroad Retirement benefits, taxpayers who may be deemed to have incurred or continued indebtedness to purchase or carry tax-exempt obligations and taxpayers who may be eligible for the earned income tax credit.

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

Prospective purchasers of the Bonds should consult their tax advisors as to the applicability and impact of any collateral consequences.

Legislation affecting municipal securities is constantly being considered by the United States Congress. There can be no assurance that legislation enacted after the date of issuance of the Bonds will not have an adverse effect on the tax-exempt status of the Bonds. Legislative or regulatory actions and proposals may also affect the economic value of tax exemption or the market prices of the Bonds.

Premium Bonds

The excess, if any, of the tax basis of a Bond to a purchaser in the initial public offering of the Bonds (other than a purchaser who holds such Bonds as inventory, stock in trade or for sale to customers in the ordinary course of business) over the amount payable at maturity of that Bond is "Bond Premium." Bond Premium is amortized over the term of such Bond for federal income tax purposes (in the case of a Bond with Bond Premium 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 such Bond). No deduction is allowed for such amortization of Bond Premium. Bond Premium is, however, treated as an offset to qualified stated interest received on the Bonds. An owner of such Bond is required to decrease his adjusted basis in such Bond by the amount of amortizable bond premium attributable to each taxable year such Bond is held. An owner of such Bond should consult his tax advisor with respect to the precise determination for federal income tax purposes of the treatment of Bond Premium upon sale, redemption or other disposition of such Bond and with respect to Commonwealth, state, and local income tax consequences of owning and disposing of such Bond.

LEGAL MATTERS

The proposed form of opinion of Sidley Austin Brown & Wood LLP, New York, New York, Bond Counsel, is 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.

UNDERWRITING

The Underwriters have jointly and severally agreed, subject to certain conditions, to purchase the Bonds from the Commonwealth at an aggregate discount of $2,807,148.20 from the initial offering prices of the Bonds. The obligation of the Underwriters to purchase the Bonds is subject to certain conditions precedent, and they will be obligated to purchase all the Bonds if any Bonds are purchased. The Underwriters may offer to sell the Bonds to certain dealers (including dealers depositing the Bonds into unit investment trusts, certain of which may be sponsored or managed by the Underwriters) and others at prices lower than the initial public offering prices. The offering prices may be changed from time to time by the Underwriters.

Morgan Stanley and Co. Incorporated ("Morgan Stanley"), a managing underwriter, has entered into a written agreement with Popular Securities, Inc. ("Popular Securities") pursuant to which Popular Securities has agreed to cooperate in connection with Morgan Stanley's 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, Popular Securities will be entitled to receive a portion of Morgan Stanley's actual net profits, if any, in connection with the underwriting of the Bonds. Other Underwriters have entered into similar agreements with respect to the sharing of underwriting net profits and have disclosed such arrangements to the Commonwealth and Government Development Bank.

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 S&P are expected to give the Insured Bonds ratings of "Aaa" and "AAA," respectively, based on the expected issuance by FSA of the Policy. Ratings reflect only the respective views of the rating agencies and an explanation of the significance of each rating may be obtained only from the respective rating agency.

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

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

CONTINUING DISCLOSURE

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

1. to file, within 305 days after the end of each fiscal year commencing with the fiscal year ending June 30, 2004, with each NRMSIR and with any Commonwealth state information depository ("SID"), core financial information and operating data for the prior fiscal year, including (i) the Commonwealth's audited financial statements, prepared in accordance with generally accepted accounting principles in effect from time to time, and (ii) material historical quantitative data (including financial information and operating data) on the Commonwealth and its revenues, expenditures, financial operations and indebtedness, in each case generally found in this Official Statement; and

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

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

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

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

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

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 a separate document containing such information.

The Commonwealth has made similar continuing disclosure covenants in connection with prior bond issuances, and has complied with all such covenants, except as hereinafter noted. The Commonwealth's audited financial statements for the fiscal year ended June 30, 2002 were filed after the Commonwealth's filing deadline of May 1, 2003, because of delays in finalizing such financial statements resulting from the implementation of Governmental Accounting Standards Board Statement No. 34 ("GASB 34"). The Commonwealth's audited financial statements for the fiscal year ended June 30, 2003 were also filed after the Commonwealth's filing deadline of April 30, 2004, because of delays in finalizing the financial statements of certain of the Commonwealth's reporting units due to the implementation of GASB 34.

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

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

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

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

The Covenants may only be amended if:

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

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

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

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

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

MISCELLANEOUS

The foregoing summaries of or references to Act 216, the Bonds, the Bond Resolution and the summaries of or references to the various acts contained in the Commonwealth Report, are made subject to all the detailed provisions thereof to which reference is hereby made for further information and do not purport to be complete statements of any or all of such provisions.

Appended to and constituting a part of this Official Statement are the Commonwealth Report (*Appendix I*), the proposed form of opinion of Bond Counsel (*Appendix II*), and a specimen of the Policy (*Appendix III*).

The information set forth in this Official Statement and incorporated herein by reference, except for information pertaining to DTC, 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 under *Bond Insurance* and in *Appendix III* was supplied by FSA.

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

COMMONWEALTH OF PUERTO RICO

By: /s/ Juan José Rodríguez
Acting Secretary of the Treasury

APPENDIX I

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

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COMMONWEALTH OF PUERTO RICO

Financial Information and Operating Data Report
August 1, 2004

INTRODUCTION

Geographic Location and Demography

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

According to the United States Census Bureau, the population of Puerto Rico was 3,808,610 in 2000, compared to 3,522,000 in 1990. As of 2000, the population of San Juan, the island's capital and largest city, was 434,375.

Relationship with the United States

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

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

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

The official languages of Puerto Rico are Spanish and English.

Governmental Structure

The Constitution of the Commonwealth provides for the separation of powers of the executive, legislative, and judicial branches of government. The Governor is elected every four years. The Legislature consists of a Senate and a House of Representatives, the members of which are elected for four-year terms. The highest court within the local jurisdiction is the Supreme Court of Puerto Rico. Puerto Rico constitutes a District in the Federal Judiciary and has its own United States District Court.

Decisions of this court may be appealed to the United States Court of Appeals for the First Circuit and from there to the Supreme Court of the United States.

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

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

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

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

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

Political Trends

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

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

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

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

The next general election (gubernatorial, municipal, and legislative) in Puerto Rico will be held in November 2004. Voter participation in Puerto Rico is substantially higher than in the United States, averaging 83% since 1972.

THE ECONOMY

General

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

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

Personal income, both aggregate and per capita, has increased consistently each fiscal year from 1985 to 2003. In fiscal year 2003, aggregate personal income was $43.6 billion ($41.7 billion in 2000 prices) and personal income per capita was $11,279 ($10,784 in 2000 prices).* Personal income includes transfer payments to individuals in Puerto Rico under various social programs. Total federal payments to Puerto Rico, which include transfers to local government entities and expenditures of federal agencies in Puerto Rico, in addition to federal transfer payments to individuals, are lower on a per capita basis in Puerto Rico than in any state of the United States. Transfer payments to individuals in fiscal year 2003 were $9.6 billion, of which $7.4 billion, or 77%, represented entitlements to individuals who had previously performed services or made contributions under programs such as Social Security, Veterans' Benefits, Medicare and U.S. Civil Service retirement pensions.

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

Total average employment (as measured by the Department of Labor and Human Resources Household Employment Survey) has also increased. For example, from fiscal year 1999 to fiscal year 2004, average employment increased from 1,146,700 to 1,234,200.

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

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

Commonwealth of Puerto Rico
Gross Product

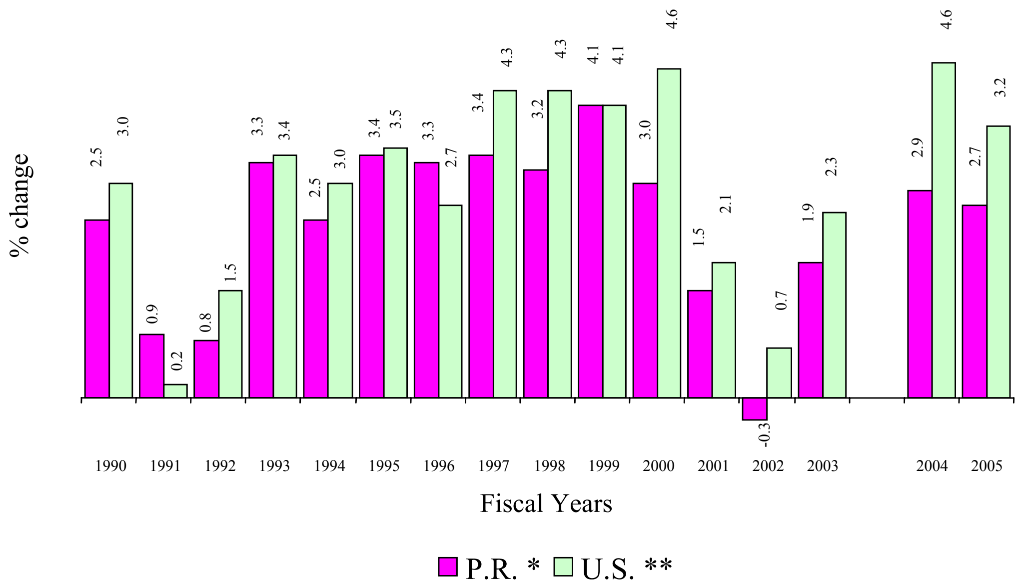
	Fiscal Years Ended June 30				
	1999	**2000**	**2001**	**2002**	**2003**(1)
Gross product - \$ millions(2)	\$ 38,281	\$ 41,419	\$ 44,047	\$ 45,008	\$ 47,354
Real gross product - \$ millions (2000 prices)	40,225	41,419	42,044	41,910	42,689
Annual percentage increase in real gross product (2000 prices)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

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

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

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

Real GNP Growth Rate



* P.R. Planning Board

** Global Insight 9/04.

Since the 1950s, the Puerto Rico Planning Board (the "Planning Board") has prepared a complete set of macroeconomic measures like those prepared for the United States by the Bureau of Economic Analysis ("BEA") of the Department of Commerce. In contrast with the BEA, which computes the economic accounts on a quarterly basis, the Planning Board computes the economic accounts on an annual basis. Like the BEA, the Planning Board revises the macroeconomic numbers on a regular basis. The Planning Board has always classified the latest annual numbers as preliminary until they are revised and made final in conjunction with the release of new data each year. At present, all macroeconomic accounts for fiscal year 2003 are preliminary until the revised figures are released.

Fiscal Year 2003

The Planning Board's preliminary reports of the performance of the Puerto Rico economy during fiscal year 2003 indicate that the economy registered an increase of 1.9% in real gross product. Gross product was $47.4 billion in fiscal year 2003 ($42.7 billion in 2000 prices) compared to $45.0 billion in fiscal year 2002 ($41.9 billion in 2000 prices). This represents an increase in nominal gross product of 5.2%. Aggregate personal income increased from $42.2 billion in fiscal year 2002 ($40.8 billion in 2000 prices) to $43.6 billion in fiscal year 2003 ($41.7 billion in 2000 prices), and personal income per capita increased from $10,969 in fiscal year 2002 ($10,603 in 2000 prices) to $11,279 in fiscal year 2003 ($10,784 in 2000 prices). According to the Department of Labor and Human Resources Household Employment Survey (the "Household Survey"), total monthly employment averaged 1,210,800 in fiscal year 2003 compared to 1,169,600 in fiscal year 2002, an increase of 3.5%. Notwithstanding this increase in average monthly employment, the unemployment rate increased from 12.0% during fiscal year 2002 to 12.1% during fiscal year 2003 due to a higher labor participation rate and a significant increase in the civilian population aged 16 years and over.

Fiscal Year 2004

The Planning Board's current real gross product forecast for fiscal year 2004, released in February 2004, projected an increase of 2.9%, slightly higher than the original forecast of 2.5%.

According to the Household Survey, total monthly seasonally adjusted employment for fiscal year 2004 averaged 1,251,900, an increase of 2.1% compared to 1,226,000 for fiscal year 2003. The seasonally adjusted unemployment rate for fiscal year 2004 was 11.1%, a decrease from 11.9% for fiscal year 2003. As in the past, the economy of Puerto Rico followed the performance of the United States economy.

Fiscal Year 2005

The Planning Board's current real gross product forecast for fiscal year 2005, released in February 2004, projected an increase of 2.7%. The major short term risks that could have an adverse effect on the economy of Puerto Rico include the continuation of the high price of oil resulting from the conflict in Iraq, the possibility of further terrorist attacks to the United States, the upward turn of interest rates, and the devaluation of the American dollar, which affects the value of imports to Puerto Rico. Although the level of interest rates began to increase slightly at the end of fiscal year 2004, interest rates still remain at historically low levels, a factor which could stimulate economic activity in Puerto Rico for the short and medium-term.

Economic Development Program for the Private Sector

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

Puerto Rico Tax Incentives

One of the benefits enjoyed by the Commonwealth is that corporations operating in Puerto Rico (other than corporations organized in the United States) and individuals residing in Puerto Rico generally are not subject to federal income taxes. This enables the Commonwealth to utilize local tax legislation as a tool for stimulating economic development in Puerto Rico. See "Tax Incentives" below.

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

The 1998 Tax Incentives Act was also amended to allow a credit against the Puerto Rico 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 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, not to exceed $5,000,000 per exempted business. The maximum amounts of such credits that may be authorized by the Secretary of the Treasury for any fiscal year is $15,000,000.

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

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

Acceleration and Simplification of Local Permitting Process

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

Reduction of the Costs of Doing Business

The Commonwealth believes that, to make Puerto Rico more competitive and foster investment, it needs to reduce the cost of doing business in Puerto Rico. One of the costs of doing business in Puerto Rico that is high, particularly for the manufacturing industry, relative to competing jurisdictions, is the cost of electricity. Puerto Rico is heavily dependent on oil imports for the production of electricity. As a result of the construction of two cogeneration plants, however, one of which is fueled by liquefied natural gas and the other by coal, Puerto Rico's dependence on oil imports for the production of electricity has been reduced from 99% to 74%. The Electric Power Authority now estimates that these plants could provide up to 33% of its electric energy requirements.

Federal Tax Incentives

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

Employment and Unemployment

The number of persons employed in Puerto Rico during fiscal year 2004 averaged 1,234,200, a 1.9% increase from 1,210,800 in fiscal year 2003. Unemployment, although at relatively low historical levels, remains above the United States average. The average unemployment rate decreased from 12.5% in fiscal year 1999 to 11.4% in fiscal year 2004. For the months of May, June and July 2004, the unemployment rate (seasonally adjusted) was 9.8%, 9.3% and 9.7%, respectively.

The following table presents annual statistics of employment and unemployment for fiscal year 1999 through fiscal year 2003 and monthly statistics for fiscal year 2004 and July 2004. These employment figures are based on the Household Survey, which includes self-employed individuals, instead of the non-farm payroll employment survey (the "Payroll Survey"), which does not. The number of self-employed individuals represents around 17% of civilian employment in Puerto Rico, more than double the level in the United States.

Commonwealth of Puerto Rico
Employment and Unemployment [1]

Fiscal Years Ended June 30	Labor Force	Employed	Unemployed	Unemployment Rate[2]
		(Annual Average)		
1999	1,310	1,147	163	12.5%
2000	1,303	1,159	143	11.0
2001	1,293	1,158	135	10.5
2002	1,330	1,170	160	12.0
2003	1,378	1,211	167	12.1
Fiscal Year 2004		(Seasonally Adjusted)		
July	1,408	1,231	176	12.5%
August	1,390	1,233	158	11.4
September	1,376	1,213	162	11.8
October	1,391	1,234	157	11.3
November	1,390	1,213	177	12.7
December	1,400	1,238	162	11.6
January	1,382	1,222	160	11.6
February	1,373	1,234	138	10.1
March	1,431	1,271	160	11.2
April	1,452	1,305	147	10.1
May	1,450	1,308	142	9.8
June	1,449	1,314	135	9.3
Fiscal Year 2005		(Seasonally Adjusted)		
July	1,410	1,273	137	9.7%

(1) Thousands of persons 16 years of age and over. Totals may not add due to rounding.
(2) Unemployed as percentage of labor force.

Source: Department of Labor and Human Resources - Household Survey

Economic Performance by Sector

During the period between fiscal year 1999 and 2003, the manufacturing and services sectors generated the largest portion of gross domestic product. The three sectors of the economy that provide the most employment are manufacturing, services and government.

The following table presents annual statistics of gross domestic product by sector and gross product for the five fiscal years ended June 30, 2003.

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

	Fiscal Years Ended June 30				
	1999	**2000**	**2001**	**2002**	**2003[1]**
Manufacturing	$23,312	$24,079	$29,037	$30,527	$31,297
Services[2]	22,435	24,920	26,615	27,168	28,745
Government[3]	5,530	5,478	5,992	6,303	7,147
Transportation, communication and public utilities	4,032	4,237	4,698	4,934	5,145
Agriculture, forestry and fisheries	336	529	348	228	203
Construction[4]	1,668	1,875	1,802	1,814	1,760
Statistical discrepancy	529	585	717	333	66
Total gross domestic product[5]	$57,841	$61,702	$69,208	$71,306	$74,363
Less: net payment abroad	(19,560)	(20,283)	(25,162)	(26,298)	(27,009)
Total gross product[5]	$38,281	$41,419	$44,046	$45,008	$47,354

(1) Preliminary.
(2) Includes wholesale and retail trade, finance, insurance and real estate, tourism, and other services.
(3) Includes the Commonwealth, its municipalities and certain public corporations, and the federal government. Excludes certain other public corporations, like the Electric Power Authority and the Aqueduct and Sewer Authority.
(4) Includes mining.
(5) Totals may not add due to rounding.

Source: Planning Board

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

The following table presents annual statistics of average employment based on the North American Industry Classification System (NAICS) for fiscal years 2000 to 2004.

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

	Fiscal Years Ended June 30				
	2000	**2001**	**2002**	**2003**	**2004(2)**
Natural Resources and Mining	1,425	1,455	1,292	1,173	1,182
Construction	73,492	73,729	69,208	68,701	68,355
Manufacturing					
Durable Goods	57,383	56,249	49,348	47,534	45,886
Non-Durable Goods	85,550	82,236	72,595	69,319	70,000
Sub Total	142,933	138,485	121,943	116,853	115,886
Trade, Transportation, Warehouse & Utilities					
Wholesale Trade	32,000	32,327	31,489	31,218	32,344
Retail Trade	131,817	133,821	127,716	128,189	131,873
Transportation, Warehouse & Utilities	19,458	19,285	17,603	17,124	16,926
Sub Total	183,275	185,433	176,808	176,530	181,144
Information	21,108	20,597	21,943	21,216	21,347
Finance	45,583	44,974	43,963	42,128	41,584
Professional & Business	96,750	97,164	95,223	96,938	95,006
Educational & Health	80,692	84,202	84,452	87,590	90,561
Leisure & Hospitality	65,942	66,435	64,273	66,200	68,263
Other Services	17,408	17,330	16,602	16,338	15,967
Government	286,133	282,723	288,679	298,751	303,914
Total Non-Farm	1,014,742	1,012,528	984,385	992,418	1,003,208

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

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

Manufacturing

Manufacturing is the largest sector of the Puerto Rico economy in terms of gross domestic product. The Planning Board estimates that in fiscal year 2003 manufacturing generated $31.3 billion, or 42.1%, of gross domestic product. During fiscal year 2003, payroll employment for the manufacturing sector was 116,853, a decrease of 4.2% compared with fiscal year 2002, with most of the job losses occurring in labor-intensive industries. Most of the island's manufacturing output is shipped to the United States mainland, which is also the principal source of semi-finished manufactured articles on which further manufacturing operations are performed in Puerto Rico. The United States minimum wage laws are applicable in Puerto

Rico. As of July 2004, the average hourly manufacturing wage rate in Puerto Rico was 66.9% of the average mainland United States rate.

Manufacturing in Puerto Rico is now more diversified than during the earlier phases of its industrial development and includes several industries less prone to business cycles. In the last three decades, industrial development has tended to be more capital intensive and more dependent on skilled labor. This gradual shift in emphasis is best exemplified by the large investment over the last decade in the pharmaceutical, scientific instruments, computers and electrical products industries in Puerto Rico. One of the factors assisting the development of the manufacturing sector has been the tax incentives offered by the federal and Puerto Rico governments. Federal legislation enacted in 1996, however, which amended Section 936 of the Internal Revenue Code of 1986, as amended, phases out the federal tax incentives during a ten-year period. See "Tax Incentives - Incentives Under the Code" under *The Economy.*

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

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

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

(1) Preliminary.
(2) Includes petroleum products; petrochemicals; tobacco products; stone, clay and glass products; textiles and others.
(3) Totals may not add due to rounding.

Source: Planning Board

The following table presents annual statistics of average manufacturing employment by industry based on the North American Industry Classification System (NAICS) for fiscal years 2000 to 2004.

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

Industry Group	Fiscal Years Ended June 30 2000	2001	2002	2003	2004[(2)]
Durable Goods					
Nonmetallic Mineral Products Manufacturing	4,833	4,726	4,447	4,255	4,312
Cement and Concrete Products Manufacturing	3,700	3,723	3,494	3,373	3,409
Fabricated Metal Product	7,267	7,218	6,403	6,054	5,780
Computer and Electronic	14,958	14,316	11,471	11,549	11,271
Navigational, Measuring	4,617	4,330	4,661	4,186	4,409
Electrical Equipment	8,917	8,225	7,064	6,927	6,606
Electrical Equipment Manufacturing	4,992	4,564	4,030	3,630	3,854
Miscellaneous Manufacturing	11,725	12,046	11,299	12,147	11,683
Medical Equipment and Supplies Manufacturing	10,300	10,784	10,110	11,187	10,781
Other Durable Goods Manufacturing	9,683	9,718	8,255	6,602	6,234
Total – Durable Goods	57,383	56,249	49,348	47,534	45,886
Non-Durable Goods					
Food Manufacturing	17,417	17,109	14,469	13,213	12,567
Beverage and Tobacco Products Manufacturing	3,425	3,571	3,423	3,352	3,757
Apparel Manufacturing	17,517	16,265	11,872	8,935	8,646
Cut and Sew Apparel Manufacturing	16,358	15,162	11,174	8,914	8,642
Chemical Manufacturing	29,450	29,124	30,265	31,621	31,868
Pharmaceutical and Medicine Manufacturing	24,300	24,275	25,707	27,337	28,157
Plastics and Rubber Products	4,108	3,820	3,399	3,154	3,007
Plastics Product Manufacturing	3,675	3,412	3,105	2,875	2,686
Other Non-Durable Goods Manufacturing	13,633	12,347	9,206	9,044	10,155
Total – Non-Durable Goods	85,550	82,236	72,595	69,319	70,000
Total Manufacturing Employment	142,933	138,485	121,943	116,853	115,886

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

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

Total employment in the manufacturing sector decreased by 27,047 from fiscal year 2000 to fiscal year 2004. This reduction in manufacturing employment occurred during a period of significant expansion in real manufacturing output, as reflected in the growth of exports. This trend suggests a significant increase in manufacturing investment and productivity. Most of the decrease in employment has been concentrated in labor intensive industries, particularly apparel, textiles, tuna canning, and leather products.

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

Employment 2,500 and over	**Product**
Abbott Laboratories, Inc.	Pharmaceuticals
Baxter International, Inc.	Pharmaceuticals
Eaton Corporation	Electronic Instruments
Johnson and Johnson	Pharmaceuticals
Pfizer Inc.	Pharmaceuticals
Sara Lee Corp.	Apparel
Wyeth	Pharmaceuticals

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

Employment 500 to 999	**Product**
Advanced Medical Optics	Ophthalmic Products
Amgen Manufacturing	Pharmaceuticals
Astra Zeneca PLC	Pharmaceuticals
B. Braun Medical	Medical Equipment
Becton-Dickinson & Co.	Scientific Instruments
Bumble Bee Seafoods	Food
Cardinal Health, Inc.	Pharmaceuticals
Consolidated Container Co.	Packaging Products
GlaxoSmithKline	Pharmaceuticals
Guidant Corp.	Medical Instruments
Hamilton Sundstrand Corp.	Electrical Instruments
Ingersoll-Rand Co.	Electrical Instruments
Ivax Pharmaceutical	Pharmaceuticals Ophthalmic
Novartis-Holding AG	Products
Ocular Science	Ophthalmic Products
Pall Corporation	Filters
St. Jude Medical Inc.	Surgical Instruments
Striker Corp.	Surgical Instruments
Tyco Int.	Communications
Unilever PLC	Consumer Products
United States Surgical Corp.	Scientific Instruments
Wellco Enterprise, Inc.	Leather

Employment 200 to 499	**Product**
Alcan Packaging	Rubber and Plastics
Altama Delta Group	Footwear
Bacardí	Food
Bard Shannon LTD.	Scientific Instruments
Biovail Laboratories	Pharmaceuticals
Carolina Underwear Co.	Apparel
Celestica, Inc.	Electronic Instruments
Checkpoint Systems Inc.	Electronic Instruments
Coca Cola Company	Food
Colgate-Palmolive Company	Consumer Products
Curtis Instruments Inc.	Electrical Instruments
Davis Creek Managing	Metal Products
E.I. DuPont de Nemours & Co.	Chemicals
Eastern Canvas Products	Textile Products
Emerson Electric Co.	Electronic Instruments
Espace Europee de Lenterprise	Pharmaceuticals
Essilor International	Ophthalmic Products
Hershey Foods	Food
ICN Pharmaceuticals Inc.	Pharmaceuticals
Loctite Corporation	Chemicals
Lutron Electronics Co.	Electronic Instruments
Linde Gas LCC	Chemicals
Micro Technology	Electronic Instruments
Millipore Corporation	Surgical Instruments
Molex Inc.	Electrical Instruments
Mylan Laboratories	Chemicals
Northrop Grumman	Electrical Instruments
Owens Illinois Inc.	Glass and Plastics
Packaging Coordinators Inc.	Packaging Products
PepsiCo	Food
Pilgrim's Pride Co.	Food
Positronic Industries	Electronic Instruments
Procter & Gamble Co.	Pharmaceuticals
Rocky Shoes & Boots	Footwear
Shell Transport and Trading Co.	Petroleum Refining
Siemens AG	Electrical Instruments
Sitnasuak Native Corp.	Apparel
Standard Motor Products Inc.	Motor Vehicle Parts
Storage Technology Corp.	Electronics
Surgical Specialties Corp.	Surgical Instruments
Symmetricom Inc.	Electronic Equipment
Temple-Inland	Packaging Products
Thomas & Betts	Electrical Instruments
Timberland Company	Leather
Watson Phamaceutical, Inc.	Pharmaceuticals

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

Source: PRIDCO, Office of Economic Research

Services

Puerto Rico has experienced significant growth in the services sector, which includes finance, insurance, real estate, wholesale and retail trade, tourism and other services, in terms of both income and employment over the past decade, showing a favorable trend as compared with certain other industrialized economies. During the period between fiscal years 1999 and 2003, the gross domestic product in this sector, in nominal terms, increased at an average annual rate of 6.4%, while payroll employment in this sector increased at an average annual rate of 1.1%. It should also be noted that in the Puerto Rico labor market self-employment, which is not accounted for in the Payroll Survey, represents approximately 17% of total employment according to the Household Survey. Most of the self-employment is concentrated in the service and construction sectors. For example, in fiscal year 2003, the number of self-employed individuals was 180,464, out of which 46.0% were in the service sector and 10.5% were in the construction sector. The development of the services sector has been positively affected by demand generated by other sectors of the economy, such as manufacturing, construction and agriculture. The services sector in Puerto Rico has a diversified base.

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

The services sector ranks second to manufacturing in its contribution to gross domestic product, and it is the sector with the greatest employment. In fiscal year 2003, services generated $28.7 billion of gross domestic product, or 38.7%, of the total. Services employment grew from 485,241 in fiscal year 1999 to 506,941 in fiscal year 2003 (representing 51.1% of total employment). This represents a cumulative increase of 4.5%. Wholesale and retail trade, finance, insurance and real estate experienced significant growth in fiscal years 1999 to 2003, as measured by gross domestic product. From fiscal year 1999 to 2003, gross domestic product increased in wholesale and retail trade from $8.1 billion to $8.6 billion and in finance, insurance, and real estate from $8.2 billion to $12.7 billion. There are sixteen commercial banks and trust companies currently operating in Puerto Rico. Total assets of these institutions as of June 30, 2004 were $85.4 billion. As of December 31, 2003, there were thirty-five international banking entities operating in Puerto Rico licensed to conduct offshore banking transactions with total assets of $56.5 billion.

The following tables set forth gross domestic product for fiscal years 1999 to 2003 and employment for the services sector for fiscal years 2000 to 2004.

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

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

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

Source: Planning Board

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

	Fiscal Years Ended June 30				
	2000	2001	2002	2003	2004[(1)]
Trade, Transportation, Warehouse & Utilities	183,275	185,433	176,808	176,531	181,144
Wholesale Trade	32,000	32,327	31,489	31,218	32,344
Retail Trade	131,817	133,821	127,716	128,189	131,873
Transportation, Warehouse & Utilities	19,458	19,285	17,603	17,124	16,926
Information	21,108	20,597	21,943	21,216	21,347
Finance	45,583	44,974	43,963	42,128	41,584
Professional and Business	96,750	97,164	95,223	96,938	95,006
Educational & Health	80,692	84,202	84,452	87,590	90,561
Leisure & Hospitality	65,942	66,435	64,273	66,200	68,263
Other Services	17,408	17,330	16,602	16,338	15,967
Total	510,758	516,135	503,264	506,941	513,872

(1) Preliminary

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

Hotels and Related Services - Tourism

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

In fiscal year 2004, the number of persons registered in tourist hotels was 1,791,432, an increase of 3.4% over the number of persons registered during fiscal year 2003. The number of non-resident tourists registered in tourist hotels during fiscal year 2004 increased 6.0% in comparison with the same period of fiscal year 2003. The average occupancy rate in tourist hotels during fiscal year 2004 was 72.4% compared to 68.0% in fiscal year 2003. The average number of rooms rented in tourist hotels increased 4.9% during fiscal year 2004 compared with fiscal year 2003.

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

The following table presents data relating to visitors to Puerto Rico and tourist expenditures for the five fiscal years ended June 30, 2003.

Commonwealth of Puerto Rico
Tourism Data

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

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

Sources: Puerto Rico Tourism Company and the Planning Board

Government

The government sector of Puerto Rico plays an important role in the economy. In fiscal year 2003, government accounted for $7.1 billion of Puerto Rico's gross domestic product, or 9.6%, of the total. The government is also a significant employer, providing jobs for 303,914 workers, or 30.3%, of total non-farm payroll employment in fiscal year 2004. The government's share of non-farm payroll employment (including the central government, the public corporations and the municipalities, but excluding the federal government), measured according to the payroll survey, had decreased from 34.9% in fiscal year 1980 to 26.4% in fiscal year 2000.

On February 25, 1998, legislation was enacted permitting the unionization of employees of the central government (excluding municipal employees). Under this law, government employees are given collective bargaining rights subject to a number of limitations. Among those limitations are: employees are prohibited from striking; salary increases are contingent on the availability of budgeted revenues; employees cannot be required to become union members and pay union dues; and collective bargaining negotiations cannot occur in an election year.

Transportation

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

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

The island's major cities are connected by a modern highway system, which, as of December 31, 2003, totaled approximately 4,591 miles. The highway system comprises 379 miles of primary system highways, 230 miles of primary urban system highways, 955 miles of secondary system highways and 3,027 miles of tertiary highways and roads.

The Commonwealth has conducted a request for proposal process to select a private company to develop, construct, operate and maintain a world-class container facility on the south coast of Puerto Rico, to be called the Port of the Americas. The Port of the Americas Authority, created by legislation, will select and negotiate with the developer and operator of the project. To date, approximately $17.7 million have been invested in the development of the project. Construction is expected to begin in 2005, and partial operation of the Port of the Americas could begin as early as 2006.

Construction

Although the construction industry represents a relatively small segment of the economy compared to other sectors, it has made significant contributions to the growth of economic activity. However, during the period from fiscal year 1999 through fiscal year 2003, real construction investment decreased 3.1%. This decline is relatively small when compared to the relatively high levels of construction activity.

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

During fiscal year 2004, total sales of cement, including imports, decreased 1.9% compared with fiscal year 2003. This decrease in total sales of cement was attributable in part to heavy rains that affected the island in November 2003, causing a 31% decrease in sales as compared to November 2002. Excluding November 2003, total sales of cement for fiscal year 2004 increased 0.9%. Total imports of iron and steel products increased 36.2% during fiscal year 2003. During fiscal year 2004, the total value of construction permits increased 8.2% compared with fiscal year 2003.

The Planning Board's forecast for construction investment, both public and private, for fiscal year 2004 was $6.7 billion, in nominal terms, an increase (in real terms) of 4.6% when compared to fiscal year 2003. For fiscal year 2004, approximately $3.1 billion was expected to be invested in public improvements. Public investment will be primarily in housing, new schools (and school reconstruction programs), water projects, and other public infrastructure projects.

Agriculture

The Department of Agriculture and related agencies have directed their efforts at increasing and improving local agricultural production, increasing efficiency and the quality of produce, and stimulating the consumption of locally produced agricultural products. During fiscal year 2003, gross income from agriculture was $756.2 million, an increase of 1.7% compared with fiscal year 2002. Agriculture gross income consists of the total value of production in the principal agricultural sectors, which include traditional crops, livestock and poultry, grains, vegetables, fruits, and other products. During fiscal year 2003, non-traditional crops, fruits, starchy and other vegetables, and ornamental plants contributed a higher percentage of the sector's income.

The Commonwealth supports agricultural activities through incentives, subsidies, and technical and support services, in addition to income tax exemptions for qualified income derived by bona fide farmers. Act No. 225, approved on December 1, 1995, increased the tax benefits available to bona fide farmers. The Act provides a 90% income tax exemption for income derived from agricultural operations, an investment tax credit equal to 50% of the investment in qualified agricultural projects, and a 100% exemption from excise taxes, real and personal property taxes, municipal license taxes and tariff payments. It also provides full income tax exemption for interest income from bonds, notes and other debt instruments issued by financial institutions to provide financing to agricultural businesses. Subsequent legislation imposed an aggregate annual limit of $15 million on the investment tax credits available under Act No. 225.

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

Higher Education

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

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

Commonwealth of Puerto Rico
Trend in College Enrollment

	Commonwealth of Puerto Rico			Mainland United States		
Academic Year	Population 18-24 Years of Age	Higher Education Enrollment	Percent[(1)]	Population 18-24 Years of Age	Higher Education Enrollment	Percent[(1)]
1970	341,448[(2)]	57,340	16.8%	23,714,000[(2)]	8,580,887	36.2%
1980	397,839[(2)]	130,105	32.7	30,022,000[(2)]	12,096,895	40.3
1990	417,636[(2)]	156,147	37.4	26,961,000[(2)]	13,621,000	50.5
2000	428,892[(2)]	176,015	41.0	27,143,455[(2)]	15,312,000	56.4
2001	425,519[(3)]	185,015	43.5	27,831,000[(3)]	15,873,000	57.0
2002	422,549[(3)]	190,776	45.1	28,342,000[(3)]	15,608,000	55.1
2003	418,390[(3)]	199,842	47.8	28,899,571[(4)]	15,756,000[(4)]	54.5

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

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

The University of Puerto Rico, the only public university in Puerto Rico, has eleven campuses located throughout the island. The University's total enrollment for academic year 2003-2004 was 68,627 students. The Commonwealth is legally bound to appropriate annually for the University of Puerto Rico an amount equal to 9.60% of the average annual revenue from internal sources for each of the two fiscal years immediately preceding the current fiscal year.

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

Tax Incentives

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

Industrial Incentives Program

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

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

Under the 1998 Tax Incentives Act, companies can repatriate or distribute their profits free of Puerto Rico dividend taxes. In addition, passive income derived from the investment of eligible funds in Puerto Rico financial institutions, obligations of the Commonwealth and other designated investments are fully exempt from income and municipal license taxes. Individual shareholders of an exempted business are allowed a credit against their Puerto Rico income taxes equal to 30% of their proportionate share of the exempted business's income tax liability. Gain from the sale or exchange of shares of an exempted business by its shareholders during the exemption period is subject to a 4% income tax rate.

Tourism Incentives Program

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

As part of the incentives to promote the tourism industry, the Commonwealth established the Tourism Development Fund as a subsidiary of Government Development Bank for Puerto Rico ("GDB") with the authority to (i) make investments in or provide financing to entities that contribute to the development of the tourism industry and (ii) provide financial guarantees for financing hotel development projects. To date, the Fund has provided financial guarantees for loans made or bonds issued to finance the development of fifteen hotel projects representing over 3,600 new hotel rooms.

Incentives under the Code

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

The Tax Reform Act of 1976 created Section 936 of the Code, which revised the tax treatment of United States corporations operating in Puerto Rico by taxing such corporations on their worldwide income in a manner similar to that applicable to any other United States corporation but providing such corporations a full credit for the federal tax on their business and qualified investment income in Puerto Rico. The credit provided an effective 100% federal tax exemption for operating and qualifying investment income from Puerto Rico sources.

As a result of amendments to Section 936 made in 1996 (the "1996 Amendments"), the tax credit is being phased out over a ten-year period for companies that were operating in Puerto Rico in 1995 and is no longer available for corporations that establish operations in Puerto Rico after October 13, 1995. The 1996 Amendments also eliminated the credit previously available for income derived from certain qualified investments in Puerto Rico.

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

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

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

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

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

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

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

Controlled Foreign Corporations

Because of the credit limitations and impending phase out of Sections 30A and 936, many corporations previously operating thereunder have reorganized their operations in Puerto Rico to become controlled foreign corporations ("CFCs"). A CFC is a corporation that is organized outside the United States and is controlled by United States shareholders. In general, a CFC may defer the payment of federal income taxes on its trade or business income until such income is repatriated to the United States in the form of dividends or through investments in certain United States properties. The Puerto Rico Office of Industrial Tax Exemption has received notification from over eighty corporations that have converted part or all of their operations to CFCs. These include most of the major pharmaceutical, instrument and electronics companies manufacturing in Puerto Rico.

CFCs operate under transfer pricing rules for intangible income that are different from those applicable to corporations operating under Sections 936 and 30A. In many cases, they are allowed to attribute a larger share of this income to their Puerto Rico operation but must make a royalty payment "commensurate with income" to their U.S. affiliates. Section 936 companies were exempted from Puerto Rico withholding taxes on any cost sharing payments they might have opted to make, but CFCs are subject to a ten percent Puerto Rico withholding tax on royalty payments.

DEBT

Public Sector Debt

Public sector debt comprises bonds and notes of the Commonwealth, its municipalities, and public corporations ("notes" as used in this section refers to certain types of non-bonded debt regardless of maturity), subject to the exclusions described below. The Constitution of Puerto Rico limits the amount of general obligation (full faith and credit) debt that can be issued or guaranteed by the Commonwealth. The Commonwealth's policy has been and continues to be to maintain the amount of such debt prudently below the constitutional limitation. Direct debt of the Commonwealth is supported by Commonwealth taxes. Debt of municipalities, other than bond anticipation notes, is supported by real and personal property taxes and municipal license taxes. Debt of public corporations, other than bond anticipation notes, is generally supported by the revenues of such corporations from rates charged for services or products. See *Public Corporations.* However, certain debt of public corporations is supported, in whole or in part, directly or indirectly, by Commonwealth appropriations or taxes.

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

The following table presents a summary of public sector debt as of June 30, 2004. Excluded from the table is debt not primarily payable from either Commonwealth or municipal taxes, Commonwealth appropriations or rates charged by public corporations for services or products. Also excluded from the table is debt the inclusion of which would reflect double counting, including but not limited to $1.323 billion of outstanding bonds issued by the Municipal Finance Agency to finance its purchase of bonds of Puerto Rico municipalities, and $1.185 billion of obligations of GDB issued to purchase certain

Commonwealth public sector debt and for other purposes, of which $267 million is guaranteed by the Commonwealth.

Commonwealth of Puerto Rico
Public Sector Debt
(in thousands)

	June 30, 2004
Puerto Rico direct debt(1)	$ 8,519,327
Municipal debt	2,046,043
Public corporations debt	
Puerto Rico guaranteed debt(2)	652,490
Debt supported by Puerto Rico appropriations or taxes(3)	14,970,726
Other non-guaranteed debt(4)	7,754,058
Total public corporations debt	23,377,274
Total public sector debt	$33,942,644

(1) Includes general obligation bonds, tax and revenues anticipation notes, and lines of credit provided by GDB. Includes $10 million of certain indebtedness originally issued by the Urban Renewal and Housing Corporation that was transferred to the Commonwealth by virtue of Act No. 134 of the Legislature of Puerto Rico, approved on December 13, 1994 ("Act No. 134") (such indebtedness is referred to as "Transferred CRUV Debt"). Excludes certain Commonwealth general obligation bonds that have been refunded with proceeds that were invested in guaranteed investment contracts or other securities not eligible to effect a legal defeasance, even though such bonds will be considered outstanding under their respective authorizing resolutions and for purposes of calculating the Commonwealth's constitutional debt limitation.

(2) Consists of $499.9 million of bonds issued by the Aqueduct and Sewer Authority and $152.5 million of State Revolving Fund Loans, incurred under various federal water laws. Excludes Public Buildings Authority bonds in the principal amount of $2.898 billion as of June 30, 2004 and $267 million of GDB bonds payable from available moneys of GDB.

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

(4) Excludes $1.066 billion of Infrastructure Financing Authority bonds, which are payable solely from the investment income of funds on deposit in the Infrastructure Development Fund consisting of proceeds from the sale of a controlling interest in Puerto Rico Telephone Company. Excludes $1.155 billion of Children's Trust bonds which are payable solely from the payments to be received pursuant to the tobacco litigation settlement. Excludes the $660 million of Housing Finance Authority bonds, which are payable from Puerto Rico Housing Administration's annual allocation of Public Housing Capital Funds from the United States Department of Housing and Urban Development.

Source: Government Development Bank

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

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

The following table presents the debt service requirements for Commonwealth general obligation bonds outstanding as of June 30, 2004 and bonds of the Aqueduct and Sewer Authority for which debt service payments are being made under the Commonwealth guaranty.

The table excludes debt service on certain general obligation bonds refunded with refunding bonds the proceeds of which, pending the redemption of the refunded bonds, were invested in guaranteed investment contracts or other securities not eligible to effect a legal defeasance. Such refunded bonds will be considered to be outstanding under their respective authorizing resolutions and for purposes of calculating the Commonwealth's constitutional debt limitation. With respect to other debt of the Aqueduct and Sewer Authority, see *Public Corporations*. Debt service requirements for each fiscal year, as shown in the following table, include principal and interest due on July 1 immediately following the close of such fiscal year.

Puerto Rico
Debt Service Requirements*
(In thousands)

	Outstanding Bonds				
Fiscal Year Ending June 30	**Principal**	**Interest**	**Total Debt Service**	**PRASA Bonds Debt Service**	**Grand Total**
2005	125,825	339,067	464,892	30,127	495,019
2006	165,159	362,155	527,314	30,121	557,434
2007	152,172	375,019	527,191	30,126	557,317
2008	190,202	346,727	536,929	30,131	567,060
2009	228,710	303,890	532,600	30,123	562,723
2010	242,310	290,473	532,783	29,984	562,767
2011	253,312	277,091	530,404	29,928	560,332
2012	272,475	257,780	530,255	30,127	560,382
2013	289,545	240,773	530,318	30,128	560,446
2014	286,728	245,686	532,414	30,125	562,539
2015	300,180	232,499	532,679	30,126	562,805
2016	314,635	218,306	532,941	30,121	563,061
2017	329,527	203,796	533,323	30,122	563,444
2018	346,135	188,573	534,708	30,126	564,834
2019	378,621	156,727	535,348	30,125	565,473
2020	435,605	130,197	565,802	0	565,802
2021	305,050	108,853	413,903	0	413,903
2022	229,055	94,996	324,051	0	324,051
2023	195,340	84,913	280,253	0	280,253
2024	180,520	76,450	256,970	0	256,970
2025	188,330	68,945	257,275	0	257,275
2026	187,475	61,439	248,914	0	248,914
2027	195,855	53,323	249,178	0	249,178
2028	204,565	44,891	249,456	0	249,456
2029	213,830	35,895	249,725	0	249,725
2030	224,120	25,777	249,897	0	249,897
2031	234,425	15,589	250,014	0	250,014
2032	66,620	4,785	71,405	0	71,405
2033	36,555	1,880	38,435	0	38,435
	$6,772,879	$4,846,498	$11,619,377	$451,540	$12,070,917

*Totals may not add due to rounding.

Sources: Government Development Bank and Department of the Treasury

Commonwealth Guaranteed Debt

As of June 30, 2004, $2.898 billion of Commonwealth guaranteed bonds of the Public Buildings Authority were outstanding. Maximum annual debt service on these bonds is $219.5 million in fiscal year ending June 30, 2011, with their final maturity being July 1, 2036. No payments under the Commonwealth guaranty have been required to date for bonds of the Public Buildings Authority.

As of June 30, 2004, $267 million of Commonwealth guaranteed obligations of GDB were outstanding. No payments under the Commonwealth guaranty have been required for any obligations of GDB to date.

As of June 30, 2004, the aggregate outstanding principal amount of the Series 1995 revenue bonds of the Aqueduct and Sewer Authority guaranteed by the Commonwealth was $318.1 million. On January 2, 1997, the Commonwealth began to make debt service payments under the Commonwealth guaranty and expects to make all debt service payments required on these revenue bonds.

In addition, in April 2000, the Commonwealth extended its guaranty to all of the outstanding bonds issued by the Aqueduct and Sewer Authority to the United States Department of Agriculture, Rural Development, and to all of the outstanding loans by the State Revolving Funds for the benefit of the Aqueduct and Sewer Authority. The guaranty will also cover any additional bonds and loans that may be issued until June 30, 2005. It is expected that this guaranty will be extended through new legislation to cover debt obligations issued until 2010. As of June 30, 2004, the principal amount outstanding on these bonds was $181.9 million and the principal amount outstanding of these loans was $152.5 million.

Trends of Public Sector Debt

The following table shows the growth rate of short-term and long-term public sector debt and the growth rate of gross product (in current dollars) for the five fiscal years ended June 30, 2004. As of June 30, 2004, outstanding short-term debt, relative to total debt, was 6.4%.

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

	Public Sector Debt					Gross Product[(1)]	
June 30	Long Term	Short Term[(2)]	Short Term as % of Total	Total	Rate of Increase	Amount	Rate of Increase
2000…...…………….	21,620	2,202[(3)]	9.2	23,822	5.0	41,419	8.2
2001[(4)]……….…..…..	22,345	2,870[(5)]	11.4	25,215	5.8	44,047	6.3
2002[(6)]……….…..…..	26,737	1,250[(3)]	4.5	27,987	11.0	45,008	2.2
2003[(7)]…………...…..	28,102	1,605[(3)]	5.4	29,707	6.1	47,354	5.2
2004[(8)]….……..……..	31,767	2,175	6.4	33,942	14.3	N/A	N/A

*Totals may not add due to rounding.
(1) In current dollars.
(2) Obligations (other than bonds) issued with an original maturity of three years or less and lines of credit with a remaining maturity of three years or less are considered short-term debt.
(3) Does not include the tax and revenue anticipation notes that were outstanding at the close of the indicated fiscal years because prior to the end of said fiscal years sufficient funds had been set aside for the payment of such notes in full.
(4) Excludes $397.0 million of bonds of Children's Trust outstanding on this date. If these bonds had been included, the rate of growth of public sector debt for fiscal year 2001 would have been 12.1%. Excludes $1.093 billion of bonds of Infrastructure Financing Authority outstanding on this date, which are payable solely from the investment income of funds on deposit in the Infrastructure Development Fund consisting of proceeds from the sale of a controlling interest in Puerto Rico Telephone Company.
(5) Includes a $164 million line of credit from GDB to the Secretary of the Treasury the proceeds of which were applied to pay debt service on general obligation bonds in lieu of funds available therefor in the General Fund.
(6) Excludes $390.1 million of bonds of Children's Trust outstanding on this date. Excludes $1.082 billion of bonds of Infrastructure Financing Authority outstanding on this date, which are payable solely from the investment income of funds on deposit in the Infrastructure Development Fund consisting of proceeds from the sale of a controlling interest in Puerto Rico Telephone Company.
(7) Excludes $1.171 billion of bonds of Children's Trust outstanding on this date. Excludes $1.074 billion of bonds of Infrastructure Financing Authority outstanding on this date, which are payable solely from the investment income of funds on deposit in the Infrastructure Development Fund consisting of proceeds from the sale of a controlling interest in Puerto Rico Telephone Company.
(8) Excludes $1.155 billion of bonds of Children's Trust outstanding on this date. Excludes $1.066 billion of bonds of Infrastructure Financing Authority outstanding on this date, which are payable solely from the investment income of funds on deposit in the Infrastructure Development Fund consisting of proceeds from the sale of a controlling interest in Puerto Rico Telephone Company.

Source: Government Development Bank

The following table shows the trend of public sector debt by major category for the five fiscal years ended June 30, 2004.

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

	Commonwealth			Municipalities			Public Corporations(1)			Total		Grand Total(4)
June 30	Long Term(4)	Short Term(2)	Total	Long Term	Short Term(2)	Total	Long Term	Short Term(2)	Total	Long Term	Short Term(2)	
2000	5,349	0(3)	5,349	1,396	68	1,464	14,875	2,134	17,008	21,620	2,202	23,822
2001	5,674	164(5)	5,838	1,469	163	1,632	15,201(6)	2,543	17,744	22,345	2,870	25,215
2002	6,025	91(3)	6,116	1,618	177	1,795	19,094(7)	982	20,076	26,737	1,250	27,987
2003	6,709	177(3)	6,886	1,754	201	1,955	19,639(8)	1,227	20,866	28,102	1,605	29,707
2004	7,758	761	8,519	1,820	226	2,046	22,190(9)	1,187	23,377	31,768	2,174	33,942

*Totals may not add due to rounding.
(1) Includes Commonwealth guaranteed debt.
(2) Obligations (other than bonds) issued with an original maturity of three years or less and lines of credit with a remaining maturity of three years or less are considered short-term debt.
(3) Does not include the tax and revenue anticipation notes which were outstanding at the close of the indicated fiscal years because prior to the end of said fiscal years sufficient funds had been set aside for the payment of such notes in full.
(4) Includes the Transferred CRUV Debt.
(5) Includes a $164 million line of credit from GDB to the Secretary of the Treasury the proceeds of which were applied to pay debt service on general obligation bonds in lieu of funds available therefor in the General Fund.
(6) Excludes $397.0 million original principal amount of bonds issued by Children’s Trust. Excludes $1.093 billion original principal amount of bonds issued by Infrastructure Financing Authority, which are payable solely from the investment income of funds on deposit in the Infrastructure Development Fund consisting of proceeds from the sale of a controlling interest in Puerto Rico Telephone Company.
(7) Excludes $390.1 million of bonds of Children’s Trust outstanding on this date. Excludes $1.082 billion of bonds of Infrastructure Financing Authority outstanding on this date, which are payable solely from the investment income of funds on deposit in the Infrastructure Development Fund consisting of proceeds from the sale of a controlling interest in Puerto Rico Telephone Company.
(8) Excludes $1.171 billion original principal amount of bonds of Children’s Trust. Excludes $1.074 billion of bonds of Infrastructure Financing Authority outstanding on this date, which are payable solely from the investment income of funds on deposit in the Infrastructure Development Fund consisting of proceeds from the sale of a controlling interest in Puerto Rico Telephone Company.
(9) Excludes $1.155 billion original principal amount of bonds of Children’s Trust. Excludes $1.066 billion of bonds of Infrastructure Financing Authority outstanding on this date, which are payable solely from the investment income of funds on deposit in the Infrastructure Development Fund consisting of proceeds from the sale of a controlling interest in Puerto Rico Telephone Company.

Source: Government Development Bank

PUBLIC CORPORATIONS

In Puerto Rico, many governmental or quasi-governmental functions are performed by public corporations. These are governmental entities created by the Legislature with varying degrees of independence from the central government. Public corporations are generally created to perform a single function or a limited number of related functions. Most public corporations obtain revenues from rates charged for services or products, but many are subsidized to some extent by the central government. Most public corporations are governed by boards appointed by the Governor with the advice and consent of the Senate, but some public corporations are subsidiaries of departments of the central government. Capital improvements of most of the larger public corporations are financed by revenue bonds under trust agreements or bond resolutions or notes under loan agreements. The following table presents the outstanding bonds and notes of certain of the public corporations as of June 30, 2004 (“notes” as used in this section refers primarily to certain types of non-bonded debt regardless of maturity). Debt of certain other public corporations is excluded from this table because such debt is payable primarily from funds or grants provided by the federal government or is payable from sources other than Commonwealth appropriations or taxes or revenues of public corporations, or is payable from revenues derived from private sector services or products, such as industrial development bonds. Also excluded from this table is debt of certain public corporations the inclusion of which would reflect double counting. No deductions have been made in the table for debt service funds and debt service reserve funds. More detailed information about the major public corporations is presented in the following sections.

Commonwealth of Puerto Rico
Outstanding Debt of Public Corporations
June 30, 2004
(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	$ 499,940	$ 0	$ 499,940	$152,550	$ 64,546[1]	$ 217,096	$ 652,490	$ 64,546[1]	$ 717,036
Electric Power Authority	0	5,032,471	5,032,471	0	186,471	186,471	0	5,218,942	5,218,942
Highway and Transportation Authority	0	5,799,144	5,799,144	0	0	0	0	5,799,144	5,799,144
Housing Finance Authority[2]	0	682,502	682,502	0	143,819	143,819	0	826,321	826,321
Industrial Development Company	0	300,884	300,884	0	37,407	37,407	0	338,291	338,291
Infrastructure Financing Authority	0	927,990[3]	927,990	0	8,664	8,664	0	936,654	936,654
Public Buildings Authority	2,898,283	0	2,898,283	0	0	0	2,898,283	0	2,898,283
Public Finance Corporation	0	4,333,856[4]	4,333,856		0	0	0	4,333,856[4]	4,333,856
Ports Authority	0	78,955	78,955	0	313,793	313,793	0	392,748	392,748
University of Puerto Rico	0	409,109	409,109	0	16,120	16,120	0	425,229	425,229
Others	0	0	0	0	1,490,770	1,490,770	0	1,490,770	1,490,770
Total[5]	$3,398,223	$17,564,911	$20,963,134	$152,550	$2,261,590	$2,414,140	$3,550,773	$19,826,501	$23,377,274

(1) Principal of and interest on this debt is reimbursed from Commonwealth appropriations.
(2) Excludes the $660 million of Housing Finance Authority bonds, which are payable solely from Puerto Rico Public Housing Administration's annual allocation of Public Housing Capital Funds from the United States Department of Housing and Urban Development.
(3) Excludes $1.066 billion of outstanding bonds of Infrastructure Financing Authority, which are payable solely from the investment income of funds on deposit in the Infrastructure Development Fund consisting of proceeds from the sale of a controlling interest in Puerto Rico Telephone Company.
(4) Payable primarily from Commonwealth appropriations.
(5) Excludes accretion of interest from the respective issuance dates on capital appreciation bonds. Also excludes $1.155 billion original principal amount of Children's Trust Tobacco Settlement Asset-Backed Bonds, Series 2002, issued on October 10, 2002, which will be repaid from payments made by certain tobacco companies under a master settlement agreement. See "Other Public Corporations" below.

Source: Government Development Bank

Government Development Bank for Puerto Rico

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

As of June 30, 2004, $1.5 billion of bonds and notes of GDB were outstanding. As of said date, GDB also had $3.6 billion in loans to the central government of the Commonwealth and its public corporations and municipalities. Act No. 12 of May 9, 1975, as amended, provides that the payment of principal of and interest on specified notes and other obligations of GDB, not exceeding $550 million, may be guaranteed by the Commonwealth, of which $267 million were outstanding as of June 30, 2004.

Act No. 271 of November 21, 2002, requires GDB to provide the Special Communities Perpetual Trust with a $500 million line of credit and to make a capital contribution to the Trust of $500 million. This contribution will be withdrawn from GDB's equity capital and disbursed gradually to the Trust after full disbursement of the line of credit. See "Other Public Corporations – Special Communities Perpetual Trust" below. GDB expects to replenish its equity capital with future operating net income. As of June 30, 2004, the Trust had drawn approximately $90.9 million on the line of credit.

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

GDB has the following principal subsidiaries:

Housing Finance Authority (formerly known as Housing Finance Corporation) was originally created in November 1977 to provide needed rental-housing units and stimulate the construction industry under federally subsidized programs. Effective February 8, 2002, the Housing Finance Corporation became the Housing Finance Authority and the Housing Bank and Finance Agency was dissolved and its powers transferred to the Authority. The Authority is engaged in insuring and servicing mortgages originated by the Urban Renewal and Housing Corporation. It also provides financing for rental housing units, stimulates the construction industry under federally subsidized programs and provides interim financing for low-income housing projects and single-family homeownership programs. Housing Finance Corporation had issued tax-exempt revenue bonds and notes to finance the construction of housing units approved for federal rental subsidies and to finance home ownership of single family housing units, which bonds and notes are now limited obligations of the Housing Finance Authority payable solely from revenues collected in respect of such housing units. The Federal Housing Administration has insured mortgages on certain of the housing units. As of June 30, 2004, $826.3 million of Housing Finance Authority bonds and notes were outstanding (excluding bonds payable solely from securities pledged to the payment of such bonds and bonds payable solely from federal funds).

As of June 30, 2004, the Authority also had outstanding $676.4 million of bonds issued to (i) pay obligations of the Commonwealth under law, (ii) fund certain payments of the Commonwealth under its mortgage subsidy program for low and moderate income families, (iii) guarantee certain insurance obligations of the Housing Bank and Finance Agency under certain programs.

Tourism Development Fund was created in November 1993 to promote Puerto Rico's hotel and tourism industry, primarily by making available guarantees to secure the payment of private financing used for new hotel development projects. The Tourism Development Fund is also authorized to make capital investments and provide direct financing to tourism related projects. As of June 30, 2004, the Tourism Development Fund had outstanding loans and guarantees with respect to the financing of fourteen hotel and tourism-related projects in an aggregate amount in excess of $562.5 million.

The Tourism Development Fund has made payments under its guarantees and letters of credit in the aggregate amount of approximately $216.7 million with respect to several projects, including repayment in full of the bonds of three projects, which bonds had been declared due and payable at the direction of the Tourism Development Fund due to the failure of the borrowers of such projects to comply with their obligations under the related reimbursement agreements. After taking these payments and all related recoveries into consideration, the unrestricted net assets of the Tourism Development Fund as of

June 30, 2004 were approximately $92.4 million (unaudited), and its allowance for loan losses on guarantees, loans, and letters of credit was approximately $36.4 million (unaudited).

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 June 30, 2004, the Corporation had $4.333 billion aggregate principal amount of bonds outstanding, substantially all of which have been issued to purchase debt of agencies and instrumentalities of the Commonwealth, and are payable from Commonwealth appropriations.

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

Other Public Corporations

Aqueduct and Sewer Authority. Puerto Rico Aqueduct and Sewer Authority ("PRASA") owns and operates a system of public water supply and sanitary sewer facilities.

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

PRASA has reported net losses of $100.7 million, $0.5 million, $191.8 million and $185.8 million during fiscal years 2000, 2001, 2002 and 2003, respectively. The net losses reported for fiscal years after 2000 are not comparable to the losses reported in prior fiscal years due to the implementation of a change in government accounting rules which allows governmental grants to be treated as revenues instead of as capital contributions. Without such favorable treatment of government grants, PRASA's net loss would have been $169.6 million in fiscal year 2001, $349 million in fiscal year 2002 and $189.3 million in fiscal year 2003. These losses reflect the continuing financial and operating difficulties that PRASA has experienced in recent years. The total debt of PRASA was $717 million as of June 30, 2004.

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

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

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

Children's Trust issued $1.171 billion aggregate principal amount of Tobacco Settlement Asset-Backed Bonds in October 2002. As of June 30, 2004, the outstanding principal amount of the bonds was $1.155 billion. These bonds and any other additional senior bonds issued by Children's Trust are secured by a statutory pledge of the payments made and to be made by participating manufacturers under the Master Settlement Agreement. To date, all payments required to be made under the Master Settlement Agreement have been made on a timely basis and Puerto Rico's share thereof has been received by Children's Trust.

Convention Center District Authority was created to own, develop, finance, plan, design, build, operate, maintain, administrate and promote the Convention Center and designated private parcels located within the Convention Center District in San Juan. The Authority currently has lines of credit with GDB totaling $415.7 million, of which $205.5 million was outstanding as of June 30, 2004. As further discussed below, a recently inaugurated multi-purpose coliseum in San Juan has been transferred to the Convention Center District Authority.

Electric Power Authority owns and operates the island's electric system. The capital improvement program for the five-year period ending June 30, 2008, is estimated to cost approximately $2.1 billion and will be financed primarily by borrowed funds, supplemented by internally generated funds. The Authority's bonded debt consists of Power Revenue Bonds, secured by a lien on net revenues of the electric system. As of June 30, 2004, the Authority's total debt was $5.219 billion, including $5.033 billion of bonds outstanding (not including accretion of interest from the respective issuance dates on capital appreciation bonds). As a means of reducing its dependency on oil, the Authority has entered into long-term power purchase contracts with the operators of two cogeneration plants that use fuels other than oil. These two cogeneration projects consist of EcoElectrica LP's 507 megawatts liquefied natural gas plant at Guayanilla and a 454 megawatts clean coal facility at Guayama operated by an affiliate of Applied Energy Systems ("AES"). EcoElectrica's and AES's plants started commercial operations in March 2000 and November 2002, respectively. Currently, these two cogeneration plants provide approximately 26% of the Authority's energy needs.

Health Insurance Administration was created in 1993 to implement the health reform by negotiating and contracting for the provision of comprehensive health insurance coverage for qualifying (generally low income) Puerto Rico residents. Under this system, the government selects, through a bidding system, one private health insurance company in each of several designated regions of the island

and pays such insurance company the insurance premium for each eligible beneficiary within such region. The health insurance system covers all of the municipalities, and approximately 1.5 million persons were covered by the system during fiscal year 2004.

The total cost of the health insurance program for fiscal year 2004 is estimated at $1.354 billion, compared to $1.248 billion for fiscal year 2003 and $1.271 billion for fiscal year 2002. For fiscal year 2004, the General Fund covered $964.5 million of the total cost of the health insurance program, while the remaining $390 million was expected to be paid from federal and municipal sources. The fiscal year 2005 budget estimates the cost of the health insurance program to be $1.444 billion, of which the General Fund is estimated to cover $984.5 million, while the remaining $460 million is expected to be paid from federal and municipal sources.

Highway and Transportation Authority is responsible for highway construction in Puerto Rico. Such construction is financed by debt (interim notes and revenue bonds), revenues of the Authority, and federal and Commonwealth grants. Debt service on the Authority's revenue bonds constitutes a first lien on its gross revenues, which consist currently of all the proceeds of the gasoline tax; one-half of the proceeds of the tax on gas oil or diesel oil; all the proceeds of the excise taxes on crude oil, unfinished oil and derivative products, up to $120 million per fiscal year; highway toll revenues; and the gross receipts of $15.00 per vehicle per year from certain motor vehicle license fees. Such revenues (except for toll revenues) may be applied first to the payment of debt service on general obligation bonds and notes of the Commonwealth and payments required to be made by the Commonwealth under its guarantees of bonds and notes to the extent that no other revenues are available for such purpose. The Commonwealth has never applied such revenues for such payment. In April 2004, the Authority issued approximately $140 million of bonds secured solely by Federal Highway Aid grant revenues. As of June 30, 2004, the Authority's total debt was $5.799 billion.

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

The Authority is a party to a concession agreement under which a private company designed, constructed and currently is operating a toll bridge spanning the San José Lagoon. The toll bridge was financed with special facility revenue bonds of the Authority, the outstanding principal balance of which was $153.2 million as of December 31, 2003, payable by the private operator of the bridge principally from toll revenues. The concession is for a term of 35 years, subject to earlier termination or extension. The bridge opened for traffic in February 1994. In certain circumstances as described in the concession agreement, including where toll revenues are insufficient to generate certain rates of return to the private operator, the private operator may require the Authority, among other things, to assume the operator's obligations with respect to the special facility revenue bonds. Some of those circumstances, including low toll revenues, exist at this time, but the Authority does not currently anticipate that the operator will exercise its remedy against the Authority.

Puerto Rico Industrial Development Company participates in the Commonwealth-sponsored economic development program by providing physical facilities, general assistance, and special incentive grants to manufacturers. The Company was merged with the Economic Development Administration in January 1998. Rentals derived from the leasing of specified facilities of the Company are pledged to the payment of the Company's revenue bonds. As of June 30, 2004, the Company's total debt was $338.2 million.

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 June 30, 2004, approximately $2.2 billion of the Authority's bonds were outstanding. The Authority has financed the construction of a multi-purpose coliseum in San Juan with a line of credit provided by GDB, which line had an outstanding balance of $140.9 million as of June 30, 2004. The coliseum was recently completed and transferred to the Convention Center District Authority.

Infrastructure Financing Authority was created in June 1988 to provide financial, administrative, consulting, technical, advisory, and other types of assistance to other public corporations and governmental instrumentalities of Puerto Rico authorized to develop infrastructure facilities and to establish alternate means for financing infrastructure facilities. The Authority is authorized to issue bonds and provide loans, grants and other financial assistance for the construction, acquisition, repair, maintenance and reconstruction of infrastructure projects by public corporations and instrumentalities of the Commonwealth. The Authority's enabling act also established the Puerto Rico Infrastructure Fund, funded with annual fixed amounts from the first proceeds of federal excise taxes imposed on rum and other articles produced in Puerto Rico and sold in the United States which are transferred to Puerto Rico pursuant to the United States Internal Revenue Code of 1986, as amended. Currently, this amount is $70 million, and it will increase to $90 million for fiscal years 2007 to 2052. The Authority is using these amounts to provide financial support to water and sewer projects. As of June 30, 2004, the Authority's total debt was $936.7 million.

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

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

Maritime Shipping Authority commenced operations in 1974 upon the acquisition of three shipping lines serving Puerto Rico and the United States mainland. In 1995, the assets and operations of the Maritime Shipping Authority were sold to a private investor group. The remaining debt of the Authority was refinanced through the issuance of bonds by Public Finance Corporation, a subsidiary of GDB. The aggregate principal amount of such bonds outstanding as of June 30, 2004, was $312.2 million (not including accreted values of capital appreciation bonds outstanding). The bonds are payable from funds to be appropriated annually by the Legislature of Puerto Rico.

Municipal Finance Agency was created in 1972 as a municipal "bond bank" for Puerto Rico. The Agency is authorized to issue bonds to purchase general obligation bonds and notes of Puerto Rico municipalities and to fund a debt service reserve. Debt service on the Agency's bonds is payable from debt service payments on municipal bonds held by the Agency and from the debt service reserve, including investment income thereon. The Commonwealth has agreed to pay such amounts to the debt service reserve as may be necessary to maintain it at its required level, subject to appropriation by the Legislature, which appropriation is authorized but not legally required to be made. To date no such payments have been required. As of June 30, 2004, the Agency had $1.323 billion of bonds outstanding.

Ports Authority owns and operates the major airport and seaport facilities in Puerto Rico. The Authority derives revenues from a variety of sources, including charges on airplane fuel sales, air terminal space rentals, landing fees, wharfage, dockage and harbor fees, and rentals for the lease of seaport equipment and property. Act No. 1 of January 1, 2000, authorized the transfer of the Authority's maritime ferry operations to Puerto Rico Maritime Transportation Authority, a newly created government agency. As of June 30, 2004, the Authority had $392.7 million in debt, including $313.8 million under a line of credit with GDB.

Public Buildings Authority is authorized to construct, purchase or lease office, school, health, correctional and other facilities for lease to departments, public corporations, and instrumentalities of the Commonwealth. Bonds that have been issued by the Authority to finance such facilities (through retirement of interim notes or otherwise) are payable from lease payments, which are largely derived from legislative appropriations and are further secured by the Commonwealth's guaranty. The Authority is authorized by law to have outstanding at any one time up to $3.325 billion of bonds guaranteed by the Commonwealth. As of June 30, 2004, $2.898 billion of such bonds of the Authority was outstanding (not including accretion of interest from the respective issuance dates on capital appreciation bonds).

Special Communities Perpetual Trust is an irrevocable and permanent trust created in November 2002 as a public corporation. The Trust's principal purpose is to fund development projects which address the infrastructure and housing needs of underprivileged communities. The Trust's capital will consist of moneys drawn under a $500 million GDB line of credit, which is currently in use by the Trust, and a $500 million grant from GDB to be disbursed over time after the line of credit has been fully disbursed. As of June 30, 2004, the Trust's GDB line of credit had an outstanding balance of $90.9 million.

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

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

University of Puerto Rico (the "University"), with 68,627 students in academic year 2003-2004, is by far the largest institution of higher education on the island. Government appropriations are the principal source of University revenues, but additional revenues are derived from tuition, student fees, auxiliary enterprises, interest income, federal grants, and other sources. University capital improvements have been financed mainly by revenue bonds. As of June 30, 2004, the University's total debt was $425.2 million.

On December 21, 2000, AFICA issued its $86,735,000 Educational Facilities Revenue Bonds, 2000 Series A (University Plaza Project) for the purpose of financing the construction of additional student housing and parking and office space for the University. The project is being built and will be operated by Desarrollos Universitarios, Inc., a Puerto Rico not-for-profit corporation, and will be leased to the University for a term equal to the term of the bonds with lease payments being in sufficient amounts to pay debt service on said bonds as they become due.

Other public corporations (not described above) have outstanding debt in the aggregate amount of $793.6 million as of June 30, 2004. Debt service on $265.3 million of such outstanding debt is being paid from legislative appropriations. However, the Commonwealth is not obligated to make any such appropriations. Additional legislative appropriations are made to enable certain of such corporations to pay their operating expenses.

INSURANCE MATTERS

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

RETIREMENT SYSTEMS

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

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

The Teachers Retirement System covers primarily public school teachers, the Judiciary Retirement System covers judges, and the Employees Retirement System covers all other employees of the Commonwealth, its municipalities and instrumentalities. As of June 30, 2003, the total number of active members of the three systems was as follows: Employees Retirement System, 166,914; Teachers Retirement System, 49,046; and Judiciary Retirement System, 338. The three systems are financed by contributions made by employers (the Commonwealth, public corporations, and municipalities) and employees, and investment income. The central government is responsible for approximately 67% of total employer contributions to the Employees Retirement System, and the other 33% is the responsibility of public corporations and municipalities. The central government is also responsible for 100% and 99% of total employer contributions to the Judiciary and Teachers Retirement Systems, respectively. Retirement and related benefits provided by the systems and required contributions to the systems by employees are determined by law. Required employers' contributions to the systems are determined by law and are not actuarially determined. For the Employees Retirement System, required employer contributions consist of 9.275% of applicable payroll in the case of municipalities, central government and public corporations. Required employee contributions for the Employees Retirement System vary according to salary and how the individual employee's retirement benefits are coordinated with social security benefits. For the Judiciary Retirement System, required contributions consist of 20% of applicable payroll for the employer and 8% for the employees.

According to the most recent actuarial valuation of the Employees Retirement System and Judiciary Retirement System submitted by a firm of independent consulting actuaries, as of June 30, 2001, the total pension benefit obligation for the Employees Retirement System and Judiciary Retirement System was $9.881 billion and $162.2 million, respectively. The unfunded pension benefit obligation of the Employees Retirement System and Judiciary Retirement System for the same period was $7.453 billion and $92.1 million, respectively, representing a funding ratio of 25% and 43%, respectively. This funding ratio does not take into account the reduction in the value of their respective equity portfolios resulting from the decline in the equities market since fiscal year 2001. It is estimated that as of June 30, 2003, the total pension benefit obligation for the Employees Retirement System is $11.292 billion and the unfunded pension benefit obligation is $9.349 billion, representing a funding ratio of 17%.

The most recent actuarial valuation was completed in accordance with the "Projected Unit Credit" method. An investment return of 8.5% per year, a salary increase of 5% per year, and a post-retirement benefit increase of 3% every third year were assumed. In the case of the Employees Retirement System, Act No. 10 of May 21, 1992 provided three benefit increases of 3% each. The first 3% increase was granted to retirees who had been receiving their annuities for three or more years as of that date. The second 3% increase was granted to retirees who had been receiving their annuities for three or more years as of January 1, 1995. This increase is being financed by additional contributions from the employers. The third 3% increase was granted to retirees who had been receiving their annuities for three or more years as of January 1, 1998. This third increase is being partially funded with additional contributions from some of the employers. In June 2001, the Legislature approved a law providing a fourth 3% increase, effective as of January 1, 2001, in post-retirement annuity payments granted on or prior to January 1, 1998. This increase will be funded by the General Fund for retirees who were employees of the central government and by municipalities and public corporations for retirees who were their employees. In June 2003, the Legislature approved a law providing a fifth increase of 3% in post retirement benefits effective January 1, 2004. This increase will also be funded by the General Fund for retirees who were employees of the central government and by municipalities and public corporations for retirees who were their employees. Subsequent increases will depend upon the explicit approval of the System's Board of Trustees and the Legislature, and must provide a funding source. In the case of the Judiciary Retirement System, Act No. 41 of June 13, 2001 provides a 3% increase in annuity payments, commencing on January 1, 2002 and every three years thereafter, to retirees who have been receiving their annuities for three or more years as of that date. This increase will be funded by the General Fund.

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

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

The law approving the sale of a controlling interest in PRTC to a consortium led by GTE International Telecommunications Incorporated (subsequently acquired by Verizon Communications Inc.) provides that any future proceeds received by the government from the sale of its then remaining 43% stock ownership in PRTC will be transferred to the Employees Retirement System to reduce its accumulated unfunded pension benefit obligation. In January 2002, Verizon exercised its option to purchase an additional 15% of the stock of PRTC for $172 million. The proceeds of the sale were transferred to the Employees Retirement System.

The Employees Retirement System's disbursements of benefits during fiscal years 2002, 2003, and 2004 exceeded contributions and investment income for those years. The cash shortfall for fiscal years 2002 and 2003 was covered with a portion of the proceeds from the sale to Verizon of the 15% stock ownership in PRTC.

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

According to the most recent actuarial valuation of the Teachers Retirement System submitted by a firm of independent consulting actuaries, as of June 30, 2001, the accrued actuarial liability of the system was $3.684 billion and the value of assets amounted to $2.284 billion, representing a funding ratio of 62%, and the resulting unfunded accrued liability was $1.400 billion. This funding ratio does not take into account the recent significant decline in the equities market and the resulting reduction in the value of the equity portfolio. As of June 30, 2003, the estimated annual actuarial liability was $3.921 billion, and the value of assets amounted to $2.142 billion, representing an estimated funding ratio of 55% and an estimated unfunded accrued liability of $1.779 billion. As of June 30, 2000, the remaining amortization period for the unfunded liability was 19 years. The actuarial valuation assumed an investment return of 8% per year and salary increases of 5% per year. Act No. 45 of January 27, 2000 increased the amount of the employee contribution from 7% to 9%, effective immediately. This will result in an increase of employee contributions of $1.5 million per month.

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

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

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

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

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

COMMONWEALTH FINANCIAL STATEMENTS

For fiscal year 2003, the financial statements of the Commonwealth were audited by KPMG LLP. KPMG LLP did not audit the financial statements of the Public Buildings Authority capital project fund (a major fund), and certain activities, funds and component units identified separately in their report. Those financial statements were audited by other auditors whose reports were furnished to KPMG LLP, and its opinion on the basic financial statements, insofar as it relates to the amounts included in the basic financial statements pertaining to such activities, funds and component units, was based solely on the reports of the other auditors.

It is expected that the financial statements of the Commonwealth for fiscal year 2004 will be available during the second quarter of fiscal year 2005. Preparation of the financial statements of the Commonwealth involved the collection and combination of audited financial statements from approximately fifty separate reporting entities.

PUERTO RICO TAXES, OTHER REVENUES AND EXPENDITURES

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

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

Summary and Management's Discussion of General Fund Results

The following table presents the revenues and expenditures of the General Fund on a cash basis for fiscal year 2000 through fiscal year 2004 and the budgeted revenues and expenditures for fiscal year 2005. The information through fiscal year 2003 is based on actual fiscal year-end results. The information relating to fiscal year 2004 is preliminary and subject to audit adjustments. The information relating to fiscal year 2005 is based on the current budget of revenues and expenditures for fiscal year 2005.

The amounts shown on the table as expenditures may be different than those reflected in the budget or in the Commonwealth's financial statements because the table shows only cash disbursements, while the budget includes all authorized expenditures, regardless of when the related cash is actually disbursed. In addition, transfers to the Redemption Fund (used to pay debt service on the Commonwealth's bonds), which are included in the budget under "debt service," are shown as a deduction from total revenues in calculating "adjusted revenues" in the table and are not included under "expenditures." Finally, certain expenditures incurred in excess of budgeted amounts may not be reflected in the table as expenditures to the extent they are paid from reserve funds, such as moneys in the Budgetary Fund. For example, in fiscal years 2003 and 2004, there were approximately $150 million and

$85 million, respectively, of such expenditures that are not reflected in the table. A discussion of the budget for fiscal year 2005 appears below under "Budget of the Commonwealth of Puerto Rico."

Amounts listed under "Other Income" represent recurring General Fund revenues not appropriately attributable to other revenue line items, such as repayment of General Fund advances to municipalities and government agencies and funds. "Other Expenditures" represent recurring General Fund expenditures not appropriately attributable to other expenditures line items, such as advances to government agencies and municipalities, which advances are to be reimbursed to the General Fund by law. Amounts listed under "Capital Outlays and Other Debt Service" represent debt service on obligations and capital expenditures for which the Legislature has by resolution agreed to appropriate funds. "Transfers to Agencies" represents moneys appropriated for the operation of the Health Facilities and Services Administration or, after the dissolution of that Administration, the Department of Health. General Fund revenues, expenditures and transfers as presented in the table differ from the General Fund revenues, expenditures and transfers as presented in the financial statements of the Commonwealth, as the latter statements reflect an expanded General Fund entity in accordance with generally accepted accounting principles.

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

	2001	2002	2003	2004(p)	2005(c)
Beginning cash balance	$ 287,055	$ 125,154	$ 350,284	$ 179,058	$ 108,512
Revenues from internal sources:					
Income Taxes:					
Individuals	2,259,090	2,449,982	2,517,678	2,720,920	2,912,000
Corporations	1,696,766	1,706,137	1,776,985	1,831,027	1,950,000
Partnerships	3,026	2,670	2,101	3,005	2,000
Withheld from non-residents	696,835	583,256	517,141	631,100	575,000
Tollgate taxes	49,511	59,515	45,321	31,579	30,000
Interest	14,782	14,310	11,278	10,108	15,000
Dividends	58,580	62,548	49,790	70,192	53,000
Total income taxes	4,778,590	4,878,418	4,920,294	5,297,931	5,537,000
Commonwealth excise taxes:					
Alcoholic beverages	237,512	249,705	299,582	296,302	304,000
Cigarettes	119,135	116,055	149,487	144,733	150,000
Motor vehicles	406,252	418,024	499,252	551,181	560,000
Other excise taxes	579,050	681,344	703,029	701,129	765,000
Total Commonwealth excise taxes	1,341,949	1,465,128	1,651,350	1,693,345	1,779,000
Property taxes	287	-	-	-	-
Inheritance and gift taxes	7,475	1,962	2,825	15,691	3,000
Licenses	76,338	82,575	85,876	84,231	90,000
Other:					
Lottery	57,482	61,358	67,621	65,387	70,000
Electronic Lottery	70,211	57,897	89,443	86,115	90,000
Miscellaneous non-tax revenues	299,758	562,213(1)	438,457	379,501	360,000
Total Other	427,451	681,468	595,521	531,003	520,000
Total revenues from internal sources	6,632,090	7,109,551	7,255,866	7,622,201	7,929,000
Revenues from non-Commonwealth sources:					
Federal excise taxes	286,890	314,253	309,958	328,921	350,000
Customs	43,154	30,595	25,918	34,266	30,000
Total revenues from non-Commonwealth sources	330,044	344,848	335,876	363,187	380,000
Total net revenues	6,962,134	7,454,399	7,591,742	7,985,388	8,309,000
Other Income (refunds)(2)	84,878	111,411	(78,927)	62,789	(17,875)
Transfers to Redemption Fund(3)	(245,814)	(274,773)	(331,925)	(341,538)	(369,985)
Proceeds of notes and other borrowings(4)	825,703	1,161,856	2,259,775	3,940,397	2,075,000
Repayment of notes and other borrowings(5)	(686,024)	(1,201,084)	(2,021,832)	(3,713,634)	(1,541,387)
Adjusted revenues	6,940,877	7,251,622	7,418,833	7,933,402	8,454,753
Expenditures:					
Grants and subsidies	3,078,505	2,862,288	3,773,579	3,468,531	2,514,899
Personal services	2,779,989	2,884,636	3,119,476	3,951,387	5,315,147
Other services	778,236	764,655	583,343	400,594	508,041
Materials and supplies	106,072	106,294	80,491	73,757	134,661
Equipment purchases	46,326	20,397	33,170	20,572	16,267
Capital outlays and other debt service	33,235	73,806	-	675	-
Transfers to agencies	280,415	314,416	-	-	-
Prior year disbursements	-	-	-	88,432	44,254
Total expenditures	7,102,778	7,026,492	7,590,059	8,003,948	8,533,269
Adjusted revenues less expenditures	(161,901)	225,130	(171,226)	(70,546)	(78,516)
Ending cash balance	$ 125,154	$ 350,284	$ 179,058	$ 108,512	$ 29,996

(p) Preliminary
(c) Current budget.
(1) Includes certain non-recurring revenues totaling $244.1 million.
(2) Consists of net revenue from General Fund's non budgetary funds plus a reserve for future tax refunds reduced by estimated tax refunds.
(3) Consists of amounts to pay principal of and interest on general obligation bonds and notes of the Commonwealth. Does not include amounts deposited directly to the Redemption Fund from non-General Fund revenues.
(4) Consists of proceeds of Commonwealth tax and revenue anticipation notes and borrowings from Government Development Bank.
(5) Consists of repayment of Commonwealth tax and revenue anticipation notes and borrowings from Government Development Bank.

Source: Department of the Treasury

Budgeted Fiscal Year 2005 Compared to Preliminary Fiscal Year 2004

The General Fund budget for fiscal year 2005, which commenced on July 1, 2004, provides for total net revenues of $8.309 billion, which represents an increase of $324 million, or 4.1%, over the budget for fiscal year 2004. Total budgeted net revenues and actual net revenues of the General Fund for fiscal year 2004, which ended on June 30, 2004, were $7.925 billion and $7.985 billion, respectively.

The major changes in budgeted revenues for fiscal year 2005 compared to actual revenues for fiscal year 2004 are expected to be: (i) projected increases in total income taxes of $239 million; (ii) projected increases in total excise taxes of $85 million; and (iii) projected decreases in non-tax revenues of $5 million. The budgeted General Fund revenues for fiscal year 2005 assumes a 5.7% nominal and 2.9% real growth in gross product, and additional revenues of $131 million from the new legislative measures described below. Budgeted revenues also include the proceeds of a $550 million loan from GDB, such loan being secured by tax receivables. Such loan may have a maximum term of ten years.

As a means of increasing revenues for fiscal year 2005, the following laws have been or are expected to be enacted: (1) a "sunset provision" which enables early retirement or "rollover" of certain individual retirement account funds without penalties under the Commonwealth's income tax law; (2) a one-year "sunset provision" for variable annuities by insurance companies in the United States held by Puerto Rico citizens for "rollovers" to variable annuities by Puerto Rico insurance companies; and (3) a "sunset provision" to lower all long-term capital gains tax rates by 50%. In particular, gains realized from the sale or exchange of a capital asset by resident individuals, if held for more than six months, will be taxed at a rate of 5% (6.25% in the case of corporate taxpayers) if located in Puerto Rico and at a rate of 10% (12.5% in the case of corporate taxpayers) if located outside Puerto Rico. Similarly, lump sum distributions by resident individuals on income from pensions will be taxed at a rate of 10%.

Preliminary Fiscal Year 2004 Compared to Fiscal Year 2003

Preliminary General Fund total net revenues for fiscal year 2004 were $7.985 billion, representing an increase of $393 million, or 5.2%, from fiscal year 2003 net revenues. This amount excludes proceeds of a loan of $233 million obtained from GDB, which is included as part of "Proceeds of notes and other borrowings." The loan has a term of ten years, and may be repaid sooner to the extent that sufficient revenues are available for such purpose. This amount also excludes $82 million of additional non-recurring revenues. The major changes in revenues from fiscal year 2003 were: (i) increases in total income taxes of $378 million, mainly resulting from increases in income taxes from individuals of $203 million and in income taxes withheld from non-residents of $114 million; (ii) increases in total excise taxes of $42 million; and (iii) decreases in other revenues of $65 million, mainly as a result of a decrease in miscellaneous non-tax revenues of $59 million. Approximately $170 million of the increase in total income taxes for fiscal year 2004 relates to the collection of past taxes as a result of an incentives plan implemented by the Secretary of the Treasury.

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

Fiscal Year 2003 Compared to Fiscal Year 2002

General Fund total net revenues for fiscal year 2003 were $7.592 billion, representing an increase of $138 million, or 1.8%, from fiscal year 2002 revenues. This amount excludes proceeds of a loan of $250 million obtained from GDB, which is included as part of "Proceeds of notes and other borrowings." The loan has a term of five years, and may be repaid sooner to the extent that sufficient revenues are available for such purpose. The major changes from fiscal year 2002 were: (i) increases in income taxes from individuals of $67 million and in corporate income taxes of $71 million; (ii) increases in excise taxes on alcoholic beverages and cigarettes of $83 million, and increases in motor vehicle excise taxes of $81 million; (iii) an increase in electronic lottery revenues of $32 million; and (iv) a decrease in miscellaneous non-tax revenues of $124 million and in income taxes withheld from non-residents of $66 million. The decrease in miscellaneous non-tax revenues relates to certain special administrative measures that had been implemented by the Secretary of the Treasury in fiscal year 2002 and that do not apply to fiscal year 2003.

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

Fiscal Year 2002 Compared to Fiscal Year 2001

General Fund total revenues for fiscal year 2002 were $7.454 billion, representing an increase of $492 million, or 7.1%, from fiscal year 2001 revenues. The major changes from fiscal year 2001 were: (i) an increase in income taxes from individuals of $190 million; (ii) increases in Commonwealth excise taxes of $124 million; (iii) an increase in miscellaneous non-tax revenues of $262 million; and (iv) a decrease in income taxes withheld from non-residents of $113 million.

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

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

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 at graduated rates. A flat tax is imposed on certain payments made to non-residents of Puerto Rico, which is collected through an income tax withholding.

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

Gain realized from the sale or exchange of a capital asset by resident individuals, if held for more than six months, is taxed at a rate of 20%. It is taxed at a rate of 10% if the capital asset consists of certain property located or deemed located in Puerto Rico. Gains realized by Puerto Rico resident individuals, trusts and estates from the sale of stock of certain Puerto Rico corporations in an initial public offering made prior to January 1, 2008 are subject to a special capital gains rate of 7%.

On August 22, 2004, the Governor signed into law Act 226 to provide a temporary reduction in the long-term capital gains tax rate. Act 226 reduces the long-term capital gains tax rates by 50% for transactions that take place from July 1, 2004 through June 30, 2005, provided that the net long-term capital gain is reinvested in Puerto Rico.

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 10% tax rate.

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

The PR Code provides for six income tax brackets for corporations and partnerships, with the highest rate (39%) applicable to net taxable income in excess of $300,000. Gains realized from the sale or exchange of a capital asset, if held for more than six months, are taxed at a maximum rate of 25% or 12.5% if the capital asset consists of certain property located or deemed located in Puerto Rico sold or exchanged after December 31, 2000. Act 226 reduces the long-term capital gains tax rates by 50% for transactions that take place from July 1, 2004 through June 30, 2005. Dividends received by Puerto Rico corporations and partnerships of foreign corporations and partnerships engaged in trade or business in Puerto Rico are subject to general income tax rates. A dividends received credit may be available. A special tax rate of 17% is applicable to dividend distributions of REITs received by corporations. Interest income on certain qualifying debt obligations issued by Puerto Rico corporations and certain qualifying foreign corporations and paid to resident corporations and partnerships qualifies for a special tax rate.

Certain corporations and partnerships covered by the tax incentives acts continue to be subject to a maximum tax rate of 45% on their taxable income. Corporations and partnerships covered by the

Puerto Rico Tourism Incentives Act of 1993, as amended, are subject to a maximum tax rate of 42% on their taxable income. The PR Code also provides for an alternative minimum tax of 22%. Corporations and partnerships operating under a new grant of tax exemption issued under the 1998 Tax Incentives Act are subject to a maximum income tax rate of 7% during their basic exemption period.

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

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

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

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

Excise Taxes

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

Other Taxes and Revenues

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

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

Revenues from non-Commonwealth sources include customs duties collected in Puerto Rico and excise taxes on shipments of rum from the island to the United States mainland. The customs duties and excise taxes on shipments are imposed and collected by the United States and returned to the Commonwealth. The excise tax on shipments of rum from Puerto Rico and other rum producing countries is $13.50 per gallon. Of this amount, $13.25 per gallon was returned to the Treasury of Puerto Rico during the period from July 1, 1999 to December 31, 2003. Effective January 1, 2004, the amount returned was reduced to $10.50 per gallon. However, legislation is currently pending in both houses of the United States Congress that would extend the period during which the tax returned to Puerto Rico would remain at $13.25 per gallon until December 2005, or, alternatively, at $13.25 per gallon until September 2004 and then increase to $13.50 per gallon from October 2004 to December 2005, depending upon which version is enacted.

Property Taxes

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

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

The following table presents the assessed valuations and real and personal property taxes collected for the fiscal years ending June 30, 1999 through 2003.

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

Fiscal Years Ended June 30	Assessed Valuations[1]	Taxes Levied	Collections of Current Year	Collections of Previous Years	Total
1999	$20,042,738	$642,555	$523,886	$47,309	$571,195
2000	20,514,014	704,568	594,151	64,812	658,963
2001	21,575,063	736,667	614,411	70,496	684,907
2002	22,743,568	792,799	645,117	60,677	705,794
2003	23,138,903	824,933	671,163	79,421	750,584

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

Source: Municipal Revenues Collection Center

Collections of Income and Excise Taxes

The Department of the Treasury has continued its program for improving tax collections, which began in fiscal year 1986. The program has consisted, in part, of taking the initiative in sponsoring and implementing tax reform, particularly in the areas of excise taxes and income taxes, in order to decrease the incidences of nonpayment of taxes and to expand the taxpayer base. The program has also included (i) improving the methods by which delinquent taxpayers are identified, primarily through the use of computer analyses, (ii) computerizing the processing of tax returns, and (iii) identifying and eliminating taxpayer evasion.

Transfers to General Obligation Redemption Fund

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

Components of General Fund Expenditures

Grants and Subsidies

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

Personal Services

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

Other Services

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

Materials and Supplies

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

Equipment Purchases

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

Capital Outlays and Other Debt Service

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

Transfers to Agencies

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

Other Expenditures

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

Federal Grants

Puerto Rico receives grants under numerous federal programs. Federal grants to the agencies and instrumentalities of the Commonwealth government, including public corporations, are estimated to be \$4.768 billion for fiscal year 2005, an increase of \$49 million, or 1.2%, from fiscal year 2004. The following table presents revenues from federal grants by broad program areas, which are accounted in the central accounting system of the Department of the Treasury. The figures for fiscal years 2001 and 2002 are actual figures. The preliminary figures for fiscal year 2003 and the estimated figures for fiscal years 2004 and 2005 are based on the information submitted by each agency to the Office of Management and Budget.

Commonwealth of Puerto Rico
Federal Grants(1)
(in thousands)

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

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

Source: Office of Management and Budget

BUDGET OF THE COMMONWEALTH OF PUERTO RICO

Office of Management and Budget

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

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

Budgetary Process

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

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

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

Financial Control and Adjustment Procedures

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

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

A Budgetary Fund was created by Act No. 147 of June 18, 1980, as amended (the "Budgetary Fund"), to cover the appropriations approved in any fiscal year in which the revenues available for such fiscal year are insufficient, to secure the payment of public debt, and to provide for unforeseen circumstances in the provision of public service. Currently, an amount equal to one percent of the General Fund net revenues of the preceding fiscal year is deposited annually into the Fund. In addition, other income (not classified as revenues) that is not assigned by law to a specific purpose is also required to be deposited in the Budgetary Fund. The maximum balance of the Budgetary Fund may not exceed 6% of the total appropriations included in the budget for the preceding fiscal year. As of July 1, 2004, the balance in the Budgetary Fund was $126 million (this amount includes the fiscal year 2005 appropriation and excludes amounts which will be transferred out of the Budgetary Fund to cover excess expenditures during fiscal year 2004).

An Emergency Fund was created by Act No. 91 of June 21, 1966, as amended (the "Emergency Fund"), to cover unexpected public needs caused by calamities, such as wars, hurricanes, earthquakes, droughts, floods and plagues, and to protect people's lives and property and the public sector credit. The Emergency Fund is capitalized annually with an amount totaling no less than one percent of the General Fund net revenues of the preceding fiscal year. During the fiscal year 2004 budget process, Act No. 91 was amended to set an upper limit to the Emergency Fund of $150 million at the beginning of the fiscal year. As of July 1, 2004, the balance in the Emergency Fund was $154.8 million, including fiscal year 2005 appropriations.

Appropriations

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

(i) General Fund appropriations for recurring ordinary operating expenses of the central government and for contributions to public corporations, municipalities, and private organizations. Such appropriations are made by a single annual law known as the Joint Resolution of the General Budget.

(ii) General Fund appropriations for special operating expenses and for capital expenditures. Such appropriations are authorized by separate law for one or more years for special programs or activities, which may be permanent or transitory.

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

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

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

Approximately 27.9% of the General Fund is committed for payment of fixed charges such as municipal subsidies, grants to the University of Puerto Rico, contributions to the Aqueduct and Sewer Authority, funding for the judiciary branch, rental payments to the Public Buildings Authority, among others, and debt service on direct debt of the Commonwealth. In the case of the judiciary branch, legislation approved in December of 2002 provides that, commencing with fiscal year 2004, the Commonwealth will appropriate annually to the judiciary branch an amount initially equal to 3.3% of the average annual revenue from internal sources for each of the two preceding fiscal years. This percentage will increase until it reaches 4% in fiscal year 2008, and may be further increased upon review, with scheduled reviews every five years.

Fiscal Year 2004 Budget

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

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

	General Fund[1]	Bond Fund	Special Funds	Total
Revenues from internal sources:				
Property taxes	$ 0	-	$ 103,524	$ 103,524
Personal income taxes	2,816,000	-	-	2,816,000
Retained non-resident income tax	560,000	-	-	560,000
Corporate income taxes	1,826,000	-	-	1,826,000
Partnership income taxes	2,000	-	-	2,000
Tollgate taxes	22,000	-	-	22,000
17% withholding tax on interest	13,000	-	-	13,000
10% withholding tax on dividends	47,000	-	-	47,000
Inheritance and gift taxes	3,000	-	-	3,000
Excise taxes:				
Alcoholic beverages	313,000	-	-	313,000
Motor vehicles and accessories	543,000	-	-	543,000
Cigarettes	159,000	-	-	159,000
Special excise tax on certain petroleum products	22,000	-		22,000
General 5% excise tax	543,000	-		543,000
Other	173,000	-	57,900	230,900
Licenses	87,000	-	-	87,000
Miscellaneous non-tax revenues:				
Contributions from lottery fund	66,000	-	-	66,000
Electronic lottery	88,000	-	-	88,000
Registration and document certification fees	171,000	-	-	171,000
Other	121,000	-	259,032	380,032
Total revenues from internal sources	7,575,000	-	420,456	7,995,456
Revenues from non-Commonwealth sources:				
Federal excise taxes on off-shore shipments	330,000	-	-	330,000
Federal grants	0	-	3,973,549[2]	3,973,549
Customs	20,000	-	-	20,000
Total revenues from non-Commonwealth sources	350,000	-	3,973,549	4,323,549
Total revenues	$7,925,000	-	$4,394,005	$12,319,005
Other:				
Other Income	369,995	-	-	369,995
Balance from previous year	-	-	347,902	347,902
Bonds authorized	-	540,000	-	540,000
Total other sources	369,995	540,000	347,902	1,257,897
Total resources	$ 8,294,995	$ 540,000	$4,741,907	$13,576,902
Appropriations:				
Current expenses:				
General government	868,446	-	54,069	922,515
Education	2,552,438	-	977,036	3,529,474
Health	1,403,772	-	419,118	1,822,890
Welfare	404,015	-	2,099,589	2,503,604
Economic development	182,973	-	63,204	246,177
Public safety and protection	1,394,746	-	87,608	1,482,354
Transportation and communications	83,549	-	44,857	128,406
Housing	24,802	-	205,965	230,767
Contributions to municipalities	362,857	-	2,091	364,948
Special pension contributions	187,173	-	0	187,173
Debt service	342,538	-	103,524	446,062
Other debt service	487,686	-	25,300	512,986
Total appropriations-current expenses	8,294,995	-	4,082,361	12,377,356
Capital improvements	0	540,000	258,538	798,538
Total appropriations	8,294,995	540,000	4,340,899	13,175,894

	General Fund[(1)]	Bond Fund	Special Funds	Total
Year-end balance	0	-	401,008	401,008
Total appropriations and year-end balance	$8,294,995	$540,000	$4,741,907	$13,576,902

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

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

In the fiscal year 2004 budget, revenues and other resources of all budgetary funds totaled $12.689 billion, excluding balances from the previous fiscal year and general obligation bonds authorized. The net increase in General Fund revenues in the fiscal year 2004 budget, as compared to fiscal year 2003, is accounted mainly by increases in corporate income taxes (up $49 million), personal income taxes (up $48 million), excise taxes on motor vehicles and accessories (up $44 million), retained non-resident income tax (up $43 million), federal excise taxes on offshore shipments (up $20 million), excise taxes on alcoholic beverages (up $14 million), excise taxes on cigarettes (up $10 million) and decreases in customs (down $6 million) and tollgate taxes (down $23 million).

Current expenses and capital improvements of all budgetary funds totaled $13.176 billion, an increase of $754.4 million from fiscal year 2003. The major changes in General Fund budgeted expenditures by program in fiscal year 2004 were: increases in health (up $127.4 million), education (up $107.2 million), debt service on Commonwealth's general obligation and guaranteed debt (up $10.6 million), general government (up $63.3 million), other debt service consisting primarily of Commonwealth appropriation debt (up $63.2 million), special pension contributions (up $56.6 million), contributions to municipalities (up $7.8 million), transportation and communications (up $7.6 million), public safety and protection (up $7.5 million), welfare (up $2.9 million), and housing (up $2.2 million) and a decrease in economic development (down $3.9 million).

Preliminary General Fund net revenues for fiscal year 2004 were $7.985 billion, exceeding the original General Fund budget by $60.4 million. General Fund expenditures for fiscal year 2004 are estimated at $8.593 billion, exceeding the original General Fund budget by $298 million. The higher expenditures occurred in the areas of education, public safety and protection and health. The government expects to cover such shortfalls with expected reimbursements of certain federal funds relating to education, funds previously encumbered but not expended and by transferring funds from the Budgetary Fund.

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

Fiscal Year 2005 Budget

The consolidated budget for fiscal year 2005 totals $24.652 billion. Of this amount, $13.908 billion is assigned to the central government. This amount includes General Fund total resources and appropriations of $8.859 billion, which represents an increase of $564 million, or 6.8%, over budgeted amounts for fiscal year 2004. These total resources include $8.309 billion of total revenues and $550 million of additional resources relating to a loan to be obtained from GDB secured by tax receivables. The budget for fiscal year 2005 was approved on July 1, 2004. The following table presents a summary of the Commonwealth's central government budget for the fiscal year ending June 30, 2005.

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

	General Fund	Bond Fund	Special Funds	Total
Revenues from internal sources:				
Property taxes	$ 0	-	$ 109,849	$ 109,849
Personal income taxes	2,865,000	-	-	2,865,000
Retained non-resident income tax	560,000	-	-	560,000
Corporate income taxes	1,935,000	-	-	1,935,000
Partnership income taxes	2,000	-	-	2,000
Tollgate taxes	30,000	-	-	30,000
17% withholding tax on interest	15,000	-	-	15,000
10% withholding tax on dividends	53,000	-	-	53,000
Inheritance and gift taxes	3,000	-	-	3,000
Excise taxes:				
Alcoholic beverages	304,000	-	-	304,000
Motor vehicles and accessories	560,000	-	0	560,000
Cigarettes	150,000	-	-	150,000
Special excise tax on certain products	10,000	-		10,000
General 5% excise tax	598,000	-		598,000
Other	256,000	-	61,400	317,400
Licenses	90,000	-	-	90,000
Miscellaneous non-tax revenues:				
Contributions from lottery fund	70,000	-	-	70,000
Electronic lottery	90,000	-	-	90,000
Registration and document certification fees	208,000	-	-	208,000
Other	130,000	-	279,058	409,058
Total revenues from internal sources	7,929,000	-	450,307	8,379,307
Revenues from non-Commonwealth sources:				
Federal excise taxes on off-shore shipments	350,000	-	-	350,000
Federal grants	0	-	4,022,519	4,022,519
Customs	30,000	-	-	30,000
Total revenues from non-Commonwealth sources	380,000	-	4,022,519	4,402,519
Total revenues	$8,309,000	-	$4,472,826	$12,781,826
Other:				
Other Income	550,000	-	-	550,000
Balance from previous year	-	-	401,008	401,008
Bonds authorized	-	550,000	-	550,000
Total other sources	550,000	550,000	401,008	1,501,008
Total resources	$8,859,000	550,000	$4,873,834	$14,282,834
Appropriations:				
Current expenses:				
General government	818,488	-	51,992	870,480
Education	2,836,342	-	1,097,358	3,933,700
Health	1,433,393	-	456,266	1,889,659
Welfare	440,179	-	2,103,780	2,543,959
Economic development	198,316	-	66,603	264,919
Public safety and protection	1,556,979	-	86,102	1,643,081
Transportation and communications	92,136	-	51,303	143,439
Housing	26,539	-	206,259	232,798
Contributions to municipalities	368,571	-	2,031	370,602
Special pension contributions	239,158	-	0	239,158
Debt service	369,985	-	109,849	479,834
Other debt service	478,914	-	25,000	503,914
Total appropriations-current expenses	8,859,000	-	4,256,543	13,115,543
Capital improvements	0	550,000	243,199	793,199
Total appropriations	8,859,000	550,000	4,499,742	13,908,742

	General Fund	Bond Fund	Special Funds	Total
Year-end balance	0	-	374,092	374,092
Total appropriations and year-end balance	$8,859,000	$550,000	$4,873,834	$14,282,834

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

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

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

Current expenses and capital improvements of all funds total $13.909 billion, an increase of $732.8 million from fiscal year 2004. The major changes in General Fund expenditures by program in fiscal year 2005 are: increases in education (up $283.9 million), public safety and protection (up $162.2 million), special pension contributions (up $52 million), welfare (up $36.2 million), health (up $29.6 million), economic development (up $15.3 million), transportation and communications (up $8.6 million), contributions to municipalities (up $5.7 million), and housing (up $1.7 million) and decreases in other debt service consisting primarily of Commonwealth appropriation debt (down $8.8 million) and general government (down $50.0 million).

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

Differences between Budget and Basic Financial Statements

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

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

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

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

LITIGATION

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

With respect to pending and threatened litigation, as of June 30, 2003, the Commonwealth has included in its financial statements reported liabilities of approximately $70 million for awarded and anticipated unfavorable judgments. This amount represented the amount estimated at the time as a probable liability or a liability with a fixed or expected due date, which would require future available financial resources for its payment. The Commonwealth believes that the ultimate liability in excess of amounts provided in the financial statements, if any, would not be significant.

The Commonwealth is a defendant in two lawsuits filed in local and federal district court by an association of insurance companies seeking to recover from the Commonwealth approximately $74 million of compulsory insurance premiums allegedly belonging to the insurance companies or their policyholders which were transferred by the Secretary of the Treasury to the General Fund. The Commonwealth believes that its ultimate liability, if any, would not be significant.

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

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

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October __, 2004

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

Dear Sir:

We have examined Act No. 216 of the Legislature of Puerto Rico, approved August 19, 2004 (the "Act"), and certified copies of the legal proceedings, including a resolution adopted by the Acting Secretary of the Treasury of the Commonwealth of Puerto Rico and approved by the Governor of the Commonwealth of Puerto Rico (the "Resolution"), and other proofs submitted relative to the issuance and sale of the following described bonds (the "Bonds"):

$440,460,000
COMMONWEALTH OF PUERTO RICO

PUBLIC IMPROVEMENT BONDS OF 2005, SERIES A

Dated: Date of Delivery.

Maturing on July 1 of the years and in such principal amounts, subject to redemption and bearing interest at the rates, all as set forth in the Resolution. The Bonds are issuable as registered Bonds without coupons in the manner and in accordance with the terms and conditions of the Resolution.

We have also examined one of the Bonds as 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 and proofs 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 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. Under the provisions of the Acts of Congress now in force and under existing regulations, rulings and court decisions, (i) subject to continuing compliance with the covenant referred to below and requirements of the Internal Revenue Code of 1986, as amended (the "Code"), and the Resolution regarding the use, expenditure and investment of Bond proceeds and the timely payment of certain investment earnings to the Treasury of the United States, if required, interest on the Bonds is not includable in gross income for federal income tax purposes; and (ii) the Bonds and the interest thereon are exempt from state, Commonwealth of Puerto Rico and local income taxation. No opinion is expressed as to the effect of any action taken or not taken after the date of this opinion without our approval (except for such action or omission to act as is provided in the documents pertaining to the Bonds) or in reliance upon advice of counsel other than ourselves on the exclusion from gross income of the interest on said Bonds for federal income tax purposes.

Interest on the Bonds is not an item of tax preference for the purposes of the federal alternative minimum tax imposed on individuals and corporations. Interest on the Bonds is, however, includable in the computation of the alternative minimum tax on corporations imposed by the Code. The Code contains other provisions that could result in tax consequences, upon which we express no opinion, as a result of (a) ownership of Bonds or (b) the inclusion in certain computations (including, without limitation, those related to the corporate alternative minimum tax) of interest that is excluded from gross income.

The Commonwealth of Puerto Rico has covenanted to comply, to the extent permitted by the Constitution and laws of the Commonwealth of Puerto Rico, with the requirements of the Code so that interest on the Bonds will remain exempt from federal income taxes to which it is not subject on the date of issuance of the Bonds. We are not aware of any provisions of the Constitution or laws of the Commonwealth of Puerto Rico which would prevent the Commonwealth of Puerto Rico from complying with the requirements of the Code.

Respectfully submitted,

[To be signed, "Sidley Austin Brown & Wood LLP"]

FINANCIAL SECURITY ASSURANCE®

MUNICIPAL BOND INSURANCE POLICY

ISSUER:

BONDS:

Policy No.: -N

Effective Date:

Premium:

FINANCIAL SECURITY ASSURANCE INC. ("Financial Security"), for consideration received, hereby UNCONDITIONALLY AND IRREVOCABLY agrees to pay to the trustee (the "Trustee") or paying agent (the "Paying Agent") (as set forth in the documentation providing for the issuance of and securing the Bonds) for the Bonds, for the benefit of the Owners or, at the election of Financial Security, directly to each Owner, subject only to the terms of this Policy (which includes each endorsement hereto), that portion of the principal of and interest on the Bonds that shall become Due for Payment but shall be unpaid by reason of Nonpayment by the Issuer.

On the later of the day on which such principal and interest becomes Due for Payment or the Business Day next following the Business Day on which Financial Security shall have received Notice of Nonpayment, Financial Security will disburse to or for the benefit of each Owner of a Bond the face amount of principal of and interest on the Bond that is then Due for Payment but is then unpaid by reason of Nonpayment by the Issuer, but only upon receipt by Financial Security, in a form reasonably satisfactory to it, of (a) evidence of the Owner's right to receive payment of the principal or interest then Due for Payment and (b) evidence, including any appropriate instruments of assignment, that all of the Owner's rights with respect to payment of such principal or interest that is Due for Payment shall thereupon vest in Financial Security. A Notice of Nonpayment will be deemed received on a given Business Day if it is received prior to 1:00 p.m. (New York time) on such Business Day; otherwise, it will be deemed received on the next Business Day. If any Notice of Nonpayment received by Financial Security is incomplete, it shall be deemed not to have been received by Financial Security for purposes of the preceding sentence and Financial Security shall promptly so advise the Trustee, Paying Agent or Owner, as appropriate, who may submit an amended Notice of Nonpayment. Upon disbursement in respect of a Bond, Financial Security shall become the owner of the Bond, any appurtenant coupon to the Bond or right to receipt of payment of principal of or interest on the Bond and shall be fully subrogated to the rights of the Owner, including the Owner's right to receive payments under the Bond, to the extent of any payment by Financial Security hereunder. Payment by Financial Security to the Trustee or Paying Agent for the benefit of the Owners shall, to the extent thereof, discharge the obligation of Financial Security under this Policy.

Except to the extent expressly modified by an endorsement hereto, the following terms shall have the meanings specified for all purposes of this Policy. "Business Day" means any day other than (a) a Saturday or Sunday or (b) a day on which banking institutions in the State of New York or the Insurer's Fiscal Agent are authorized or required by law or executive order to remain closed. "Due for Payment" means (a) when referring to the principal of a Bond, payable on 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 unless Financial Security shall elect, in its sole discretion, to pay such principal due upon such acceleration together with any accrued interest to the date of acceleration and (b) when referring to interest on a Bond, payable on the stated date for payment of interest. "Nonpayment" means, in respect of a Bond, the failure of the Issuer to have provided sufficient funds to the Trustee or, if there is no Trustee, to the Paying Agent for payment in full of all principal and interest that is Due for Payment on such Bond. "Nonpayment" shall also include, in respect of a Bond, any payment of principal or interest that is Due for Payment made to an Owner by or on behalf of the Issuer 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. "Notice" means telephonic or telecopied notice, subsequently confirmed in a signed writing, or written notice by registered or certified mail, from an Owner, the Trustee or the Paying Agent to Financial Security which notice shall specify (a) the person or entity making the claim, (b) the Policy Number, (c) the claimed amount and (d) the date such claimed amount became Due for Payment. "Owner" means, in respect of a Bond, the person or entity who, at the time of Nonpayment, is entitled under the terms of such Bond to payment thereof, except that "Owner" shall not include the Issuer or any person or entity whose direct or indirect obligation constitutes the underlying security for the Bonds.

Financial Security may appoint a fiscal agent (the "Insurer's Fiscal Agent") for purposes of this Policy by giving written notice to the Trustee and the Paying Agent specifying the name and notice address of the Insurer's Fiscal Agent. From and after the date of receipt of such notice by the Trustee and the Paying Agent, (a) copies of all notices required to be delivered to Financial Security pursuant to this Policy shall be simultaneously delivered to the Insurer's Fiscal Agent and to Financial Security and shall not be deemed received until received by both and (b) all payments required to be made by Financial Security under this Policy may be made directly by Financial Security or by the Insurer's Fiscal Agent on behalf of Financial Security. The Insurer's Fiscal Agent is the agent of Financial Security only and the Insurer's Fiscal Agent shall in no event be liable to any Owner for any act of the Insurer's Fiscal Agent or any failure of Financial Security to deposit or cause to be deposited sufficient funds to make payments due under this Policy.

To the fullest extent permitted by applicable law, Financial Security agrees not to assert, and hereby waives, only for the benefit of each Owner, all rights (whether by counterclaim, setoff or otherwise) and defenses (including, without limitation, the defense of fraud), whether acquired by subrogation, assignment or otherwise, to the extent that such rights and defenses may be available to Financial Security to avoid payment of its obligations under this Policy in accordance with the express provisions of this Policy.

This Policy sets forth in full the undertaking of Financial Security, and shall not be modified, altered or affected by any other agreement or instrument, including any modification or amendment thereto. Except to the extent expressly modified by an endorsement hereto, (a) any premium paid in respect of this Policy is nonrefundable for any reason whatsoever, including payment, or provision being made for payment, of the Bonds prior to maturity and (b) this Policy may not be canceled or revoked. THIS POLICY IS NOT COVERED BY THE PROPERTY/CASUALTY INSURANCE SECURITY FUND SPECIFIED IN ARTICLE 76 OF THE NEW YORK INSURANCE LAW.

In witness whereof, FINANCIAL SECURITY ASSURANCE INC. has caused this Policy to be executed on its behalf by its Authorized Officer.

[Countersignature] FINANCIAL SECURITY ASSURANCE INC.

By ______________________ By ______________________
Authorized Officer

A subsidiary of Financial Security Assurance Holdings Ltd. (212) 826-0100
350 Park Avenue, New York, N.Y. 10022-6022

Form 500NY (5/90)