

**\$730,835,000**  
**PUERTO RICO MUNICIPAL FINANCE AGENCY**  
**\$413,115,000 2005 Series A Bonds**  
**\$59,075,000 2005 Series B Refunding Bonds**  
**\$258,645,000 2005 Series C Refunding Bonds**

The 2005 Series A Bonds are being issued to provide funds for the purchase by the Agency from Government Development Bank for Puerto Rico of general obligation bonds and notes of various municipalities of the Commonwealth of Puerto Rico. The 2005 Series B Refunding Bonds are being issued to provide funds that will be used, together with other available moneys, to refund some of the outstanding 1997 Series A Bonds of the Agency. The 2005 Series C Refunding Bonds are being issued to provide funds that will be used, together with other available moneys, to refund some of the outstanding 1999 Series A Bonds and 1999 Series B Refunding Bonds of the Agency. The 2005 Series A Bonds, 2005 Series B Refunding Bonds and 2005 Series C Refunding Bonds will hereinafter collectively be referred to as the "Bonds."

The Bonds will be secured by and payable from the following:

- The payment of principal and interest on general obligation municipal bonds and notes that are being pledged by the Agency under their respective indentures. The general obligation municipal bonds and notes are secured by *ad valorem* taxation, without limitation as to rate or amount, on all taxable property within the issuing municipalities. The good faith, credit and unlimited taxing power of each issuing municipality are pledged for the payment of its general obligation municipal bonds and notes.
- The moneys in a Reserve Account created under their respective indentures. The Agency's Enabling Act provides that the Commonwealth shall annually apportion and pay to the Agency such sum as shall be necessary to maintain the Reserve Account in the required amount (as described herein). The payment of such sum by the Commonwealth is subject to appropriation by the Legislature of Puerto Rico, which appropriation is authorized but not legally required to be made.

The Bonds will have the following characteristics:

- The Bonds will be dated their delivery date.
- The Bonds will be registered under The Depository Trust Company's book-entry only system. Purchasers of the Bonds will not receive definitive Bonds.
- The Bonds are subject to redemption prior to maturity as set forth herein, the earliest possible date of redemption being August 1, 2015.
- Interest on the 2005 Series A Bonds and 2005 Series C Refunding Bonds will be payable semi-annually to maturity (or earlier redemption) on the 1<sup>st</sup> days of February and August, beginning August 1, 2006. Interest on the 2005 Series B Refunding Bonds will be payable semi-annually to maturity (or earlier redemption) on the 1<sup>st</sup> days of January and July, beginning July 1, 2006.
- The inside cover page contains information concerning the maturity schedules, interest rates, prices and yields on the Bonds.
- The scheduled payment of principal and interest on some of the 2005 Series A Bonds, 2005 Series B Refunding Bonds and 2005 Series C Refunding Bonds when due will be guaranteed under bond insurance policies to be issued concurrently with the delivery of the Bonds by Financial Security Assurance Inc. and CDC IXIS Financial Guaranty North America, Inc., as indicated on the inside cover page of this Official Statement
- In the opinion of Bond Counsel, under existing federal laws and regulations, interest on the Bonds will be exempt from federal income taxation and the Bonds and the interest thereon will be exempt from state, Commonwealth and local income taxation. However, see "TAX EXEMPTION" beginning on page 36 of this Official Statement for alternative minimum tax consequences with respect to interest on the Bonds, a description of certain rules that the Agency and each issuer of municipal bonds must comply with to preserve the federal tax exemption of such interest and other tax considerations.
- It is expected that settlement for the Bonds will occur on or about December 22, 2005.

NEITHER THE CREDIT OF THE COMMONWEALTH NOR THAT OF ANY OF ITS GOVERNMENT INSTRUMENTALITIES WILL BE PLEDGED FOR THE PAYMENT OF THE BONDS. THE BONDS ARE LIMITED OBLIGATIONS OF THE AGENCY PAYABLE SOLELY FROM PRINCIPAL AND INTEREST PAYMENTS RECEIVED BY THE RESPECTIVE TRUSTEES FROM THE MUNICIPAL BONDS PLEDGED UNDER THEIR RESPECTIVE INDENTURES AND FROM MONEYS HELD IN THE RESERVE ACCOUNTS AND OTHER FUNDS AND ACCOUNTS UNDER THEIR RESPECTIVE INDENTURES.

BANC OF AMERICA SECURITIES LLC  
CITIGROUP  
LEHMAN BROTHERS

MORGAN STANLEY  
GOLDMAN, SACHS & Co.  
MERRILL LYNCH & Co.  
WACHOVIA BANK, NATIONAL ASSOCIATION

RAMIREZ & Co.  
JP MORGAN  
RAYMOND JAMES & ASSOCIATES, INC.

December 9, 2005

**\$730,835,000**  
**PUERTO RICO MUNICIPAL FINANCE AGENCY**  
**\$413,115,000 2005 Series A Bonds**  
**\$59,075,000 2005 Series B Refunding Bonds**  
**\$258,645,000 2005 Series C Refunding Bonds**

**\$354,475,000 Serial 2005 Series A Bonds**

<u>Maturity Date</u> <u>August 1,</u>	<u>Principal</u> <u>Amount</u>	<u>Interest</u> <u>Rate</u>	<u>Yield</u>	<u>Price</u>	<u>Maturity Date</u> <u>August 1,</u>	<u>Principal</u> <u>Amount</u>	<u>Interest</u> <u>Rate</u>	<u>Yield</u>	<u>Price</u>
2006	\$16,165,000	5 %	3.68%	100.783%	2014	\$ 2,765,000*	3.90%	3.90%	100.000 %
2007	18,860,000	3.60	3.62	99.966	2015	15,495,000*	4	3.98	100.155
2008	2,995,000	3.65	3.69	99.898	2016	16,240,000*	5	4.07	107.330*
2008	16,725,000	5	3.69	103.225	2017	17,140,000*	5	4.11	107.002*
2009	2,890,000	3.80	3.83	99.896	2018	8,000,000†	5	4¼	105.861*
2009	16,835,000	5	3.83	103.904	2018	9,995,000*	5	4.15	106.674*
2010	2,100,000	3.95	3.95	100.000	2019	22,760,000*	5	4.18	106.429*
2010	18,020,000	5	3.95	104.380	2020	990,000*	4.20	4.22	99.779
2011	3,440,000	4.05	4.07	99.897	2020	15,205,000*	5	4.22	106.104*
2011	15,150,000	5	4.07	104.617	2021	16,185,000*	5	4¼	105.861*
2012	4,275,000	4.15	4.18	99.824	2022	16,965,000*	5	4.28	105.619*
2012	12,785,000	5	4.18	104.687	2023	17,900,000	5¼	4.70	104.208*
2013	10,245,000*	5	3.81	107.791	2024	19,800,000	5¼	4.73	103.972*
2013	4,210,000*	3.80	3.81	99.931	2025	15,325,000	5¼	4.76	103.738*
2014	12,460,000*	5	3.90	107.974	2025	2,555,000	4¾	4.76	99.868

**\$58,025,000\* 5.00% Term Bond due August 1, 2030, Price 104.098\*%**  
**\$615,000\* 4.45% Term Bond due August 1, 2030, Price 99.699%**

**\$59,075,000 Serial 2005 Series B Refunding Bonds**

<u>Maturity Date</u> <u>July 1,</u>	<u>Principal</u> <u>Amount</u>	<u>Interest</u> <u>Rate</u>	<u>Yield</u>	<u>Price</u>	<u>Maturity Date</u> <u>July 1,</u>	<u>Principal</u> <u>Amount</u>	<u>Interest</u> <u>Rate</u>	<u>Yield</u>	<u>Price</u>
2006	\$1,560,000	5 %	3.80%	100.616%	2014	\$ 4,745,000†	5 %	4 %	107.162%
2007	285,000	3.60	3.62	99.969	2015	10,110,000†	4.10	4.10	100.000
2008	205,000	3.65	3.69	99.903	2016	6,690,000†	5¼	4.15	109.302
2009	215,000	3.80	3.83	99.901	2017	6,255,000†	5¼	4.19	109.610
2010	225,000	3.95	3.95	100.000	2018	6,375,000†	5¼	4.22	109.939
2011	240,000†	3.70	3.75	99.751	2019	6,835,000†	5¼	4.26	110.097
2012	255,000†	3.80	3.84	99.770	2020	715,000†	4¼	4.30	99.462
2013	270,000†	3.90	3.94	99.740	2020	4,615,000†	5¼	4.30	110.182
2014	7,035,000†	4.00	4	100.000	2021	2,445,000†	5¼	4.32	110.439

**\$258,645,000 Serial 2005 Series C Refunding Bonds**

<u>Maturity Date</u> <u>August 1,</u>	<u>Principal</u> <u>Amount</u>	<u>Interest</u> <u>Rate</u>	<u>Yield</u>	<u>Price</u>	<u>Maturity Date</u> <u>August 1,</u>	<u>Principal</u> <u>Amount</u>	<u>Interest</u> <u>Rate</u>	<u>Yield</u>	<u>Price</u>
2006	\$ 5,945,000	5 %	3.80%	100.710%	2015	\$ 3,520,000*	4 %	3.98%	100.155%
2007	1,100,000	3.60	3.62	99.966	2015	27,250,000*	5	3.98	108.074
2008	1,140,000	5	3.69	103.225	2016	36,825,000*	5	4.07	107.330*
2009	1,200,000	5	3.83	103.904	2017	26,310,000*	5¼	4.09	110.630
2010	1,125,000	5	3.95	104.380	2018	23,570,000*	5¼	4.12	111.021
2011	1,185,000	5	4.07	104.617	2019	18,800,000*	5¼	4.16	111.235
2012	250,000	4.15	4.18	99.824	2020	10,255,000†	5¼	4.30	110.221
2012	995,000	5	4.18	104.687	2021	9,135,000†	5¼	4.32	110.475
2013	1,245,000*	3.80	3.81	99.931	2022	11,145,000†	5¼	4.36	110.435
2013	41,580,000*	5	3.81	107.791	2023	4,500,000†	5¼	4.39	110.466
2014	31,570,000*	5	3.90	107.974					

\* Insured by Financial Security Assurance Inc.

† Insured by CDC IXIS Financial Guaranty North America, Inc.

\* Priced to call on 8/1/2015 at 100%.

No dealer, broker, sales representative or other person has been authorized by the Agency or the Underwriters to give any information or 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 Agency 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 offered hereby by any person in any jurisdiction in which it is unlawful for such person to make such offer, solicitation or sale. The information set forth herein has been furnished by the Agency, the Commonwealth, the Municipalities of San Juan, Bayamón, Carolina and Guaynabo, and various other agencies of the Commonwealth, and includes information obtained from other sources which are believed to be reliable. The information and expressions of opinion contained 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 Agency, the Commonwealth or the Municipalities of San Juan, Bayamón, Carolina and Guaynabo, since the date hereof. The Underwriters have provided the following sentence and the next paragraph for inclusion in this Official Statement. The Underwriters have reviewed the information in this Official Statement in accordance with, and as part of, their respective responsibilities to investors under the federal securities laws as applied to the facts and circumstances of this transaction, but the Underwriters do not guarantee the accuracy or completeness of such information.

IN CONNECTION WITH THE OFFERING OF THE BONDS, THE UNDERWRITERS MAY OVER-ALLOT OR EFFECT TRANSACTIONS WHICH STABILIZE OR MAINTAIN THE MARKET PRICES OF SUCH BONDS AT LEVELS ABOVE THOSE WHICH MIGHT OTHERWISE PREVAIL IN THE OPEN MARKET. SUCH STABILIZING, IF COMMENCED, MAY BE DISCONTINUED AT ANY TIME.

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**INTRODUCTORY STATEMENT**

This Official Statement of Puerto Rico Municipal Finance Agency (the “Agency”) is provided to furnish information with respect to its \$413,115,000 Puerto Rico Municipal Finance Agency 2005 Series A Bonds (the “2005 Series A Bonds”), \$59,075,000 Puerto Rico Municipal Finance Agency 2005 Series B Refunding Bonds (the “2005 Series B Refunding Bonds”), and \$258,645,000 Puerto Rico Municipal Finance Agency 2005 Series C Refunding Bonds (the “2005 Series C Refunding Bonds,” and together with the 2005 Series A Bonds and the 2005 Series B Refunding Bonds, the “Bonds”). The 2005 Series A Bonds will be issued pursuant to a Trust Indenture, dated as of December 1, 2005 (the “2005 Indenture”), between the Agency and JPMorgan Chase Bank, N.A., as trustee (the “2005 Trustee”) (for a summary of the 2005 Indenture, see *Appendix C* below). The 2005 Series B Refunding Bonds will be issued pursuant to a Trust Indenture, dated as of April 1, 1997, as amended (the “1997 Indenture”), between the Agency and Banco Santander Puerto Rico, as trustee (the “1997 Trustee”) (for a summary of the 1997 Indenture, see *Appendix D* below). The 2005 Series C Refunding Bonds will be issued pursuant to a Trust Indenture, dated as of December 1, 1999, as amended (the “1999 Indenture”), between the Agency and U.S. Bank Trust National Association, successor trustee (the “1999 Trustee,” and together with the 2005 Trustee and the 1997 Trustee, the “Trustees”) (for a summary of the 1999 Indenture, see *Appendix E* below).

The scheduled payment of principal of and interest on the 2005 Series A Bonds maturing on August 1 of the years 2013 through 2022 and 2030, except for the 2005 Series A Bonds maturing on August 1, 2018 in the principal amount of \$8,000,000, and the scheduled payment of principal of and interest on the 2005 Series C Refunding Bonds maturing on August 1 of the years 2013 through 2019 (collectively, “FSA Insured Bonds”) will be insured by municipal bond insurance policies (collectively, the “FSA Insurance Policy”) issued by Financial Security Assurance Inc. (“FSA”). The scheduled payment of principal of and interest on the 2005 Series A Bonds maturing on August 1, 2018 in the principal amount of \$8,000,000, the 2005 Series B Refunding Bonds maturing on or after July 1, 2011, and the 2005 Series C Refunding Bonds maturing on or after August 1, 2020 (collectively, the “CIFG Insured Bonds,” and together with the FSA Insured Bonds, the “Insured Bonds”) will be insured by municipal bond insurance policies (collectively, the “CIFG Insurance Policy,” and together with the FSA Insurance Policy, the “Insurance Policies”) issued by CDC IXIS Financial Guaranty North America, Inc. (“CIFG,” and together with FSA, the “Bond Insurers”).

This Official Statement includes the cover page, its appendices and the following documents, which have been filed with each nationally recognized municipal securities information repository (“NRMSIR”) and are incorporated herein by reference:

- (1) the Comprehensive Annual Financial Report of the Commonwealth of Puerto Rico (the “Commonwealth”) for the fiscal year ended June 30, 2004 (the “Commonwealth Annual Financial Report”), which includes the basic financial statements of the Commonwealth for the fiscal year ended June 30, 2004, together with the independent auditor’s report thereon, dated April 8, 2005, of KPMG LLP, San Juan, Puerto Rico, certified public accountants. KPMG LLP did not audit the financial statements of the Puerto Rico Public Buildings Authority capital project fund (a major fund) and certain activities, funds and component units separately identified in their report. Those financial statements were audited by other auditors whose reports have been furnished to KPMG LLP, and their opinion in 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;
- (2) the Continuing Disclosure Report of the Agency for the fiscal year ended June 30, 2004;

- (3) the Continuing Disclosure Report of the Municipality of San Juan (“San Juan”) for the fiscal year ended June 30, 2004, which report includes the general purpose financial statements of San Juan for the fiscal year ended June 30, 2004, together with the independent auditor’s report thereon, dated December 17, 2004, of Deloitte & Touche LLP, San Juan, Puerto Rico, certified public accountants;
- (4) the Continuing Disclosure Report of the Municipality of Bayamón (“Bayamón”) for the fiscal year ended June 30, 2004, which report includes the general purpose financial statements of Bayamón for the fiscal year ended June 30, 2004, together with the independent auditor’s report thereon, dated October 29, 2004, of Ortiz, Rodríguez, Rivera & Co., San Juan, Puerto Rico, certified public accountants;
- (5) the Agency’s general purpose financial statements for the fiscal year ended June 30, 2005, together with the independent auditor’s report thereon, dated September 12, 2005, of RSM ROC & Company, San Juan, Puerto Rico, certified public accountants (the “Agency’s 2005 Financial Statements”);
- (6) the Municipality of Carolina’s general purpose financial statements for the fiscal year ended June 30, 2004, together with the independent auditor’s report thereon, dated January 27, 2005, of PKF, LLP, San Juan, Puerto Rico, certified public accountants (“Carolina’s 2004 Financial Statements”); and
- (7) the Municipality of Guaynabo’s general purpose financial statements for the fiscal year ended June 30, 2004, together with the independent auditor’s report thereon, dated January 21, 2005, of Ortiz, Rodríguez, Rivera & Co., San Juan, Puerto Rico, certified public accountants (“Guaynabo’s 2004 Financial Statements”).

Any Appendix of an Official Statement of the Commonwealth or any appendix of an Official Statement of any instrumentality of the Commonwealth containing the same information as the Commonwealth Annual Financial Report, filed with each NRMSIR and the Municipal Securities Rulemaking Board (“MSRB”) after the date hereof and prior to the termination of any 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 filing with each NRMSIR by San Juan, Bayamón, Carolina, Guaynabo or the Agency of a document generally containing the same information set forth in their respective Continuing Disclosure Reports or financial statements, after the date hereof and prior to the termination of any offering of the Bonds, shall also be deemed to be incorporated by reference into this Official Statement and to be part of this Official Statement from the date of filing of such document. Any statement contained herein or in any of the above described documents incorporated herein by reference shall be deemed to be modified or superseded for purposes of this Official Statement to the extent that a statement contained herein or in any other 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 any of the documents incorporated herein by reference. Requests for such documents should be directed to Director-New York Office, Government Development Bank for Puerto Rico, 666 Fifth Avenue, 15<sup>th</sup> Floor, New York, New York 10103-1599, telephone number (212) 422-6420.

A copy of the Commonwealth Annual Financial Report, the Agency’s Continuing Disclosure Report, the San Juan Continuing Disclosure Report, the Bayamón Continuing Disclosure Report, the Agency’s 2005 Financial Statements, Carolina’s 2004 Financial Statements and Guaynabo’s 2004 Financial Statements may be obtained by contacting a NRMSIR. The address of each NRMSIR is set forth in “CONTINUING DISCLOSURE” below. The address of the MSRB is 1900 Duke Street, Suite 600, Alexandria, Virginia 22314, telephone number (703) 797-6600.

This Official Statement, including information incorporated in this Official Statement by reference, contains certain “forward-looking statements” concerning the Agency, San Juan, Bayamón, Carolina, Guaynabo and 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 Agency, San Juan, Bayamón, Carolina, Guaynabo and 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.

## THE AGENCY

The Agency, a public corporation and governmental instrumentality of the Commonwealth, was created by Act No. 29 of the Legislature of Puerto Rico, approved June 30, 1972, as amended (the “Enabling Act”), to allow the municipalities of Puerto Rico to access the capital markets so that such municipalities might finance more effectively their public improvement programs.

The Agency is authorized to issue bonds for the following purposes: (i) purchasing bonds and notes of municipalities within the Commonwealth secured by *ad valorem* taxation, without limitation of rate or amount, on all taxable property within each such municipality and issued in accordance with applicable law, (ii) making payments into the respective Bond Service Accounts, Operating Funds or Reserve Accounts (each as described herein) of any trust indenture under which bonds of the Agency are issued, (iii) funding bond anticipation notes theretofore issued by the Agency to provide funds to purchase general obligation municipal bonds and notes, and (iv) refunding any outstanding bonds of the Agency.

The Agency is located in the Minillas Government Center in San Juan, Puerto Rico. Its mailing address is P.O. Box 42001, San Juan, Puerto Rico 00940-2001, telephone (787) 722-2525.

### Organization and Membership of the Agency

The Agency is governed by a Board of Directors which is composed of the President of Government Development Bank for Puerto Rico (“GDB”), an instrumentality and public corporation of the Commonwealth, the Commissioner of Municipal Affairs and three additional members appointed by the Governor of Puerto Rico, one of whom must be either the mayor or chief financial officer of a municipality. The Commissioner of Municipal Affairs, the President of GDB, and the municipal officer appointed by the Governor of Puerto Rico shall be members of the Board during the period of their respective incumbencies. The other two members shall be appointed for a period of five years. The President of GDB serves as the Chairman of the Board and President of the Agency. There is currently one vacancy on the Board.

The following individuals are the current members of the Board:

<u>Member</u>	<u>Occupation</u>
Alfredo Salazar, President and Chairman of the Board	Acting President of GDB
Angel Castillo Rodríguez, Esq.	Commissioner of Municipal Affairs
Sol Luis Fontáñez Olivo	Mayor of the Municipality of Barceloneta
Pedro Pérez Rodríguez	Vice President of GDB

### Prior Bond Issues

As of August 31, 2005, the Agency had \$1,143,375,000 of bonds outstanding (collectively, the “Outstanding Bonds”). The Outstanding Bonds were authorized and issued pursuant to separate and unrelated trust indentures. Simultaneously with the issuance of the Bonds, some of the outstanding 1997 Series A Bonds, 1999 Series A Bonds, and 1999 Series B Refunding Bonds will be refunded with part of the proceeds of the 2005 Series B Refunding Bonds and the 2005 Series C Refunding Bonds. See “PLAN OF FINANCING.”

## PLAN OF FINANCING

### The 2005 Series A Bonds

A portion of the proceeds of the 2005 Series A Bonds will be deposited to the credit of the 2005 Acquisition Fund (as defined herein) under the 2005 Indenture and used by the 2005 Trustee to purchase at one time or from time to time (in accordance with the requisition procedures set forth in the 2005 Indenture) from GDB general obligation municipal bonds and notes (the “2005 Municipal Bonds”) of various municipalities within the Commonwealth. See “PRINCIPAL SOURCE OF PAYMENT FOR MUNICIPAL BONDS - The Municipal Bonds” and “Appendix C – Summary of the 2005 Indenture - Acquisition Fund.”

### The 2005 Series B Refunding Bonds

A portion of the proceeds of the 2005 Series B Refunding Bonds will be used, together with other available moneys, to refund some of the outstanding 1997 Series A Bonds (the “1997 Refunded Bonds”) in the amounts and maturities identified in the table below:

<u>Refunded Bonds</u>	<u>Principal Amount to be Refunded</u>	<u>Interest Rate</u>	<u>Maturity Date</u>	<u>Redemption Date</u>	<u>Redemption Price</u>
1997 Series A Bonds	\$34,480,000 <sup>(1)</sup>	5½%	07/01/2017	07/01/2007	101½%
	21,130,000	5½	07/01/2021	07/01/2007	101½

(1) Only a portion of this maturity is being refunded. \$10,895,000 principal amount of said maturity will remain outstanding after the issuance of the 2005 Series B Refunding Bonds.

The proceeds of the 2005 Series B Refunding Bonds to be used for such purpose shall be transferred to and held by the JPMorgan Chase Bank, N.A., as escrow agent for the 1997 Trustee in a special escrow fund, appropriately designated, for the sole and exclusive purpose of paying the principal of and redemption premium, if any, and interest to accrue to the redemption date on the 1997 Refunded Bonds (the “1997 Escrow Fund”).

Upon the deposit of a portion of the proceeds of the 2005 Series B Refunding Bonds and other available moneys in the 1997 Escrow Fund, all of the 1997 Refunded Bonds will, in the opinion of bond counsel, be no longer outstanding under the 1997 Indenture and the 1997 Refunded Bonds will be thereupon defeased. Such proceeds and other available moneys will be invested in direct, non-callable and non-prepayable obligations of the United States (or obligations unconditionally guaranteed by the United States), the principal of and interest on which, with any remaining moneys not so invested, will be sufficient to pay the principal of and premium on the 1997 Refunded Bonds at their redemption date, and to pay interest on the 1997 Refunded Bonds as such interest becomes due until the redemption date. The mathematical accuracy of the sufficiency of the amounts so deposited, and investment earnings thereon, to pay the principal of and redemption premium, if any, and interest on the 1997 Refunded Bonds as such amounts become due until the redemption date, will be verified by Causey Demgen & Moore Inc., as verification agent (the “Verification Agent”).

Upon the defeasance of the 1997 Refunded Bonds, the outstanding general obligation municipal bonds and notes (the “1997 Municipal Bonds”) held by the 1997 Trustee will be pledged by the Agency under the 1997 Indenture as security for the 2005 Series B Refunding Bonds, and any remaining 1997 Series A Bonds and 1997 Series B Refunding Bonds outstanding under the 1997 Indenture.

### The 2005 Series C Refunding Bonds

A portion of the proceeds of the 2005 Series C Refunding Bonds will be used, together with other available moneys, to refund some of the outstanding 1999 Series A Bonds and 1999 Series B Refunding Bonds (collectively, the “1999 Refunded Bonds”) in the amounts and maturities identified in the table below:

<b>Refunded Bonds</b>	<b>Principal Amount to be Refunded</b>	<b>Interest Rate</b>	<b>Maturity Date</b>	<b>Redemption Date</b>	<b>Redemption Price</b>
1999 Series A Bonds	\$40,480,000	5¾ %	08/01/2013	08/01/2009	101%
	26,385,000	5.875	08/01/2014	08/01/2009	101
	27,450,000	6	08/01/2015	08/01/2009	101
	33,655,000	6	08/01/2016	08/01/2009	101
	23,305,000	5½	08/01/2017	08/01/2009	101
	20,430,000	5½	08/01/2018	08/01/2009	101
	15,780,000	5½	08/01/2019	08/01/2009	101
	36,850,000	5½	08/01/2023	08/01/2009	101
1999 Series B Refunding Bonds	1,040,000 <sup>(1)</sup>	5¾	08/01/2013	08/01/2009	101
	4,150,000	5.875	08/01/2014	08/01/2009	101
	2,500,000	6	08/01/2015	08/01/2009	101
	2,645,000	6	08/01/2016	08/01/2009	101
	2,800,000	5½	08/01/2017	08/01/2009	101
	2,955,000	5½	08/01/2018	08/01/2009	101
	2,865,000	5½	08/01/2019	08/01/2009	101

(1) Only a portion of this maturity is being refunded. \$7,970,000 principal amount of said maturity will remain outstanding after the issuance of the 2005 Series C Refunding Bonds.

The proceeds of the 2005 Series C Refunding Bonds to be used for such purpose shall be transferred to and held by the 1999 Trustee in a special escrow fund, appropriately designated, for the sole and exclusive purpose of paying the principal of and redemption premium, if any, and interest to accrue to the redemption date on the 1999 Refunded Bonds (the “1999 Escrow Fund”).

Upon the deposit of a portion of the proceeds of the 2005 Series C Refunding Bonds and other available moneys in the 1999 Escrow Fund, all of the 1999 Refunded Bonds will, in the opinion of bond counsel, be no longer outstanding under the 1999 Indenture and the 1999 Refunded Bonds will be thereupon defeased. Such proceeds and other available moneys will be invested in direct, non-callable and non-prepayable obligations of the United States (or obligations unconditionally guaranteed by the United States), the principal of and interest on which, with any remaining moneys not so invested, will be sufficient to pay the principal of and premium on the 1999 Refunded Bonds at their redemption date, and to pay interest on the 1999 Refunded Bonds as such interest becomes due until the redemption date. The mathematical accuracy of the sufficiency of the amounts so deposited, and investment earnings thereon, to pay the principal of and redemption premium, if any, and interest on the 1999 Refunded Bonds as such amounts become due until the redemption date, will be verified by the Verification Agent.

Upon the defeasance of the 1999 Refunded Bonds, the outstanding general obligation municipal bonds and notes (the “1999 Municipal Bonds,” and together with the 2005 Municipal Bonds and the 1997 Municipal Bonds, the “Municipal Bonds”) held by the 1999 Trustee will be pledged by the Agency under the 1999 Indenture as security for the 2005 Series C Refunding Bonds, and any remaining 1999 Series A Bonds and 1999 Series B Refunding Bonds outstanding under the 1999 Indenture.



## Sources and Uses of Funds:

	<u>2005 Series A Bonds</u>	<u>2005 Series B Refunding Bonds</u>	<u>2005 Series C Refunding Bonds</u>
<b>Sources</b>			
Par Amount	\$413,115,000.00	\$ 59,075,000.00	\$258,645,000.00
Net Original Issue Premium	17,503,186.90	3,615,497.00	22,082,142.90
Anticipatory Hedge Premium	4,890,000.00	815,000.00	3,610,000.00
Available 1997 Indenture Moneys <sup>(1)</sup>	-	37,380,925.40	-
Available 1999 Indenture Moneys <sup>(2)</sup>	-	-	55,504,651.69
<b>Total Sources</b>	<u>\$435,508,186.90</u>	<u>\$100,886,422.40</u>	<u>\$339,841,794.59</u>
<b>Uses</b>			
Deposit to Acquisition Fund	\$405,636,000.00	\$ -	\$ -
Deposit to 2005 Indenture Reserve Account <sup>(3)</sup>	19,583,397.57	-	-
Deposit to 1997 Indenture Reserve Account <sup>(4)</sup>	-	16,908,591.86	-
Deposit to 1999 Indenture Reserve Account <sup>(5)</sup>	-	-	42,305,890.87
Deposit to 2005 Series B Refunding Bonds - Escrow Fund for 1997 Refunded Bonds	-	58,888,942.20	-
Deposit to 2005 Series C Refunding Bonds - Escrow Fund for 1999 Refunded Bonds	-	-	263,025,810.64
Cost of Issuance <sup>(6)</sup>	10,288,789.33	1,341,329.25	10,530,437.78
Funds Available for Municipal Capital Improvements <sup>(7)</sup>	-	23,747,559.09	23,979,655.30
<b>Total Uses</b>	<u>\$435,508,186.90</u>	<u>\$100,886,422.40</u>	<u>\$339,841,794.59</u>

(1) Consists of \$22,304,038.19 on deposit in the 1997 Reserve Account, \$2,908,300.00 on deposit in the 1997 Bond Service Account and \$12,168,587.21 of unspent proceeds from the 1997 Municipal Bonds.

(2) Consists of \$43,195,475.86 on deposit in the 1999 Reserve Account, \$1,930,000.00 termination payment received from the provider of the investment agreement in the 1999 Reserve Account being terminated concurrently with the issuance of the 2005 Series C Refunding Bonds, and \$10,379,175.83 of unspent proceeds from the 1999 Municipal Bonds.

(3) The amount deposited to the credit of the 2005 Reserve Account under the 2005 Indenture from the proceeds of the 2005 Series A Bonds will be equal to the 2005 Required Debt Service Reserve (as defined herein) and invested in a guaranteed investment agreement with a financial institution. See "SOURCES OF PAYMENT FOR THE BONDS."

(4) The amount on deposit in the 1997 Reserve Account under the 1997 Indenture will be equal to the 1997 Required Debt Service Reserve (as defined herein) and invested in a guaranteed investment agreement with a financial institution. See "SOURCES OF PAYMENT FOR THE BONDS."

(5) The amount on deposit to the 1999 Reserve Account under the 1999 Indenture will be equal to the 1999 Required Debt Service Reserve (as defined herein) and invested in a guaranteed investment agreement with a financial institution. See "SOURCES OF PAYMENT FOR THE BONDS."

(6) Includes underwriting discount, insurance premiums, legal, printing and other financing expenses, and \$1,665,000 to be used to pay a termination payment owed by the Agency in connection with an investment agreement in the 1999 Bond Service Account being terminated concurrently with the issuance of the 2005 Series C Refunding bonds (the moneys in the 1999 Bond Service Account subsequently being invested in a guaranteed investment agreement with another financial institution on the delivery date of said Bonds).

(7) From the proceeds of the respective Bonds indicated due in part to the debt service savings on account of the refundings.

On September 27, 2005 (the "Confirmation Date"), the Agency signed confirmations with Goldman Sachs Capital Markets, L.P. ("GSCM"), an affiliate of Goldman, Sachs & Co., one of the underwriters for the Bonds, under which the Agency and GSCM agreed to enter into on the date of delivery of the Bonds separate interest rate exchange transactions for each series of the Bonds whereby the Agency would pay GSCM a fixed rate of interest every six months (corresponding to the interest payment dates for the applicable series of Bonds) and GSCM would pay the Agency monthly a floating amount calculated based on a formula tied to the London Interbank Offered Rate. Rather than execute the transactions on the date of delivery of the Bonds, the parties to such confirmations agreed to terminate the exchange transactions on such date of delivery (in such context, the "Termination Date"). As a consequence of an increase in market interest rates from the Confirmation Date to the date on which the interest rates on the Bonds were determined, the Agency will receive on the Termination Date a payment from GSCM in the amount of \$9,315,000 (allocated among the Bonds as set forth in the preceding table on the line "Anticipatory Hedge Premium") an amount that approximates the present value of the increased interest cost to the Agency as a consequence of such increase and will use such payment to augment the sources listed in the table above.

## THE BONDS

### General

The Bonds will be dated their delivery date. Interest on the 2005 Series A Bonds and the 2005 Series C Refunding Bonds (at the respective rates set forth on the inside cover page of this Official Statement) will be payable semi-annually to maturity on the 1<sup>st</sup> days of February and August, beginning August 1, 2006 (said first interest payment representing seven months and nine days' interest). Interest on the 2005 Series B Refunding Bonds (at the respective rates set forth on the inside cover page of this Official Statement) will be payable semi-annually to maturity on the 1<sup>st</sup> days of January and July, beginning July 1, 2006 (said first interest payment representing six months and nine days' interest). The Bonds are subject to redemption at the times and at the prices set forth in "Redemption" below.

### Book-Entry Only System

The Depository Trust Company ("DTC"), New York, NY, will act as securities depository for the Bonds. The Bonds will be issued as fully-registered securities registered in the name of Cede & Co. (DTC's partnership nominee) or such other name as may be requested by an authorized representative of DTC. One fully-registered Bond will be issued for each maturity of each series of 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, 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 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 Securities Clearing Corporation, Government Securities Clearing Corporation, MBS Clearing Corporation, and Emerging Markets Clearing Corporation (NSCC, GSCC, MBSCC and EMCC are 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 Standard & Poor's Rating Services, a division of The McGraw-Hill Companies, Inc. ("S&P"), highest rating: AAA. The DTC Rules applicable to its Participants are on file with the Securities and Exchange Commission (the "SEC"). More information about DTC can be found at [www.dtcc.com](http://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 each Bond ("Beneficial Owner") is in turn to be recorded on the Direct and Indirect Participants' records. Beneficial Owners will not receive written confirmation from DTC of their purchase. Beneficial Owners are, however, expected to receive written confirmations providing details of their purchase, as well as periodic statements of their holdings, from the Direct or Indirect Participant through which the Beneficial Owner entered into the transaction. Transfers of ownership interests in the Bonds are to be accomplished by entries made on the books of Direct and Indirect Participants acting on behalf of Beneficial Owners. Beneficial Owners will not receive definitive Bonds, except in the event that use of the book-entry system for the Bonds is discontinued, as discussed below.

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

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

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

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

Redemption proceeds, distributions, and other 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 Agency or the applicable Trustee on the payable date in accordance with their respective holdings shown on DTC's records. Payments by Participants to Beneficial Owners will be governed by standing instructions and customary practices, as is the case with securities held for the accounts of customers in bearer form or registered in "street name," and will be the responsibility of such Participant and not of DTC, the Trustees or the Agency, subject to any statutory or regulatory requirements as may be in effect from time to time. Payment of redemption proceeds, distributions, and other payments to Cede & Co. (or such other nominee as may be requested by an authorized representative of DTC) is the responsibility of the Agency or the applicable Trustee, disbursement of such payments to Direct Participants will be the responsibility of DTC, and disbursement of such payments to the Beneficial Owners will be the responsibility of Direct and Indirect Participants.

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

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

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

## Transfers

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 such 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 respective corporate trust offices of the Trustees in San Juan, Puerto Rico or New York, New York, as applicable. Interest on the Bonds will be payable by check mailed to the respective addresses of the registered owners thereof as shown on the registration books of the Agency maintained by the respective Trustee as of the record date therefor. 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 respective corporate trust offices of the Trustees in San Juan, Puerto Rico or New York, New York, as applicable, upon the payment of any taxes or other governmental charges required to be paid with respect to such transfer or exchange.

## Redemption

*Optional Redemption.* The 2005 Series A Bonds maturing after August 1, 2015 may be redeemed prior to their maturity, at the option of the Agency, upon not less than 30 days' prior notice by mail to DTC or, if the book-entry system is discontinued, to the registered owners thereof from any available moneys (other than moneys deposited in the 2005 Sinking Fund under the 2005 Indenture in respect of an amortization requirement) either in whole or in part (and if in part, in such order of maturity), as directed by the Agency, on any date not earlier than August 1, 2015, at a redemption price equal to the principal amount to be redeemed, together with accrued interest thereon, and without premium.

The 2005 Series B Refunding Bonds are not subject to optional redemption.

The 2005 Series C Refunding Bonds maturing on August 1, 2016 may be redeemed prior to their maturity, at the option of the Agency, upon not less than 30 days' prior notice by mail to DTC or, if the book-entry system is discontinued, to the registered owners thereof from any available moneys (other than moneys deposited in the 1999 Sinking Fund under the 1999 Indenture in respect of an amortization requirement) either in whole or in part, as directed by the Agency, on any date not earlier than August 1, 2015, at a redemption price equal to the principal amount to be redeemed, together with accrued interest thereon, and without premium.

*Mandatory Redemption.* The 2005 Series A Bonds maturing on August 1, 2030 in the principal amounts of \$58,025,000 and \$615,000, respectively, 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 Bonds and otherwise subject to adjustment as described below), upon not less than 30 days' prior notice by mail to DTC or, if the book-entry system is discontinued, to the registered owners thereof on August 1, 2026 and on August 1 in each year thereafter from moneys in the 2005 Redemption Account under the 2005 Indenture at a redemption price of par plus accrued interest to the date fixed for redemption:

<b>Year</b>	<b>2030</b>	<b>2030</b>
2026	\$14,085,000	\$145,000
2027	16,335,000	165,000
2028	13,685,000	140,000
2029	7,885,000	95,000
2030	6,035,000*	70,000*
Average life in years	22.185	22.251

\* Final maturity.

If the amount of such term Bonds retired by purchase or redemption during any fiscal year exceeds the amount of the amortization requirement for such term Bonds for such fiscal year, the remaining amortization requirements for such maturity of such term Bonds shall be decreased for such subsequent fiscal years and in such amounts aggregating the amount of such excess as the Agency shall determine.

The 2005 Series B Refunding Bonds and the 2005 Series C Refunding Bonds are not subject to mandatory redemption.

*Effect of Calling for Redemption.* On the date so designated for redemption, notice having been given in the manner and under the conditions provided in the respective Indentures, the Bonds or portions of Bonds so called for redemption will become and be due and payable at the redemption price of such Bonds or portions thereof to be redeemed on such date, and if sufficient moneys, or Government Obligations (as defined herein) the principal of and interest on which when due will provide sufficient moneys, for payment of the redemption price are held in separate accounts by the respective Trustees in trust for the holders of the Bonds or portions thereof to be redeemed, as provided in the respective Indentures, interest on the corresponding Bonds or portions thereof so called for redemption will cease to accrue, such Bonds or portions thereof will cease to be entitled to any lien or security under the applicable Indenture, and the registered owners of such Bonds or portions thereof will have no rights in respect thereof except to receive payment of the redemption price thereof and the accrued interest and, to the extent provided in such Indenture, to receive Bonds of the same series and maturity for any unredeemed portions of the Bonds.

#### **Additional Bonds**

No additional bonds may be issued under each Indenture except to refund any bonds issued and then outstanding thereunder. All such refunding bonds will be issued on a parity with the bonds issued under such Indenture and will be entitled to the same benefit and security under such Indenture as the applicable series of Bonds. In addition, the Agency may from time to time issue additional bonds and notes as authorized under the Enabling Act, which bonds and notes would be authorized and issued pursuant to separate and unrelated trust indentures or authorizing resolutions and would be secured by general obligation municipal bonds and notes of various Puerto Rico municipalities other than the Municipal Bonds pledged or to be pledged, as applicable, under the Indentures to secure payment of the Bonds or any such refunding bonds.

### **SOURCES OF PAYMENT FOR THE BONDS**

#### **2005 Series A Bonds (2005 Indenture)**

The 2005 Series A Bonds, together with other bonds permitted to be issued and at the time outstanding under the 2005 Indenture (see *Appendix C – Summary of the 2005 Indenture – Refunding Bonds*) (collectively, the “2005 Indenture Bonds”), are equally and ratably secured by and payable from (i) payments of principal of and interest on the 2005 Municipal Bonds held by the 2005 Trustee under the 2005 Indenture (see “The Municipal Bonds” below); and (ii) moneys in and investment income from the 2005 Sinking Fund (as defined herein) (including any moneys paid to the Agency by the Commonwealth) (see “The 2005 Reserve Account” below) and the 2005 Acquisition Fund (see *Appendix C - Summary of the 2005 Indenture*). Some or all of the 2005 Municipal Bonds may be released from the lien of the 2005 Indenture if certain requirements are met (see *Appendix C - Summary of the 2005 Indenture - Release of 2005 Municipal Bonds*).

The principal amount of general obligation municipal bonds and notes issued by San Juan that is expected to be included in the 2005 Municipal Bonds totals \$90,325,000 or 22.3% of the total \$405,636,000 in principal amount of 2005 Municipal Bonds expected to be pledged as security for the 2005 Indenture Bonds. For additional information on San Juan, please refer to *Appendix B* hereto and to the San Juan Continuing Disclosure Report, which has been incorporated by reference into this Official Statement. The principal amount of the general obligation municipal bonds and notes issued by Bayamón that is expected to be included in the 2005 Municipal Bonds totals \$53,236,000 or 13.1% of the total \$405,636,000 in principal amount of 2005 Municipal Bonds expected to be pledged as security for the 2005

Indenture Bonds. For additional information on Bayamón, please refer to *Appendix B* hereto and to the Bayamón Continuing Disclosure Report, which has been incorporated by reference into this Official Statement.

The 2005 Trustee is required to collect the principal of and interest on all 2005 Municipal Bonds held by it on behalf of the Agency under the 2005 Indenture as such principal and interest become due and payable and deposit the moneys so received to the credit of the following Accounts within the 2005 Sinking Fund and to the 2005 Rebate Fund (as defined herein) created under the 2005 Indenture in the following order:

- (a) the 2005 Bond Service Account, such amount as may be required to make the total amount then in the 2005 Bond Service Account equal to the amount of interest then or to become within the next ensuing six months due and payable on all 2005 Indenture Bonds, including the 2005 Series A Bonds, then outstanding and the amount of principal then or to become within the next ensuing twelve months due and payable on all serial 2005 Indenture Bonds then outstanding plus such additional amount applicable at the time of such deposit as shall be necessary to make the balance in the 2005 Bond Service Account immediately after each interest payment date equal to the ending balance specified in a certificate of the Agency filed with the 2005 Trustee prior to the delivery of and payment for the 2005 Series A Bonds;
- (b) the 2005 Redemption Account, such amount as may be required to make the amount deposited in the 2005 Redemption Account in such fiscal year equal to the amortization requirements, if any, for such fiscal year for the term 2005 Indenture Bonds (including any term 2005 Series A Bonds) then outstanding;
- (c) the 2005 Reserve Account, such amount as may be required to make the amount then in the 2005 Reserve Account equal to the 2005 Required Debt Service Reserve (as defined herein); and
- (d) any balance to the 2005 Rebate Fund.

Moneys in the 2005 Rebate Fund will be applied by the Agency to satisfy any rebate liability it may have with the United States Treasury in respect of any of the Agency's outstanding tax-exempt bonds, whether or not issued under and secured by the 2005 Indenture. Any balance in the 2005 Rebate Fund after satisfying any such rebate liability will be transferred by the 2005 Trustee to the 2005 Operating Fund (as defined herein) as promptly as practicable. Moneys in the 2005 Rebate Fund and the 2005 Operating Fund are not part of the trust estate securing the 2005 Indenture Bonds.

Neither the credit of the Commonwealth nor that of any of its government instrumentalities will be pledged for the payment of the 2005 Indenture Bonds, including the 2005 Series A Bonds. The 2005 Series A Bonds are limited obligations of the Agency payable solely from principal and interest payments under the pledged 2005 Municipal Bonds and from moneys held in the 2005 Reserve Account and other funds and accounts under the 2005 Indenture. The good faith, credit and unlimited taxing power of each issuer of 2005 Municipal Bonds (a "2005 Municipal Issuer") will, however, be pledged to the payment of each of its 2005 Municipal Bonds that is being pledged by the Agency to secure payment of the 2005 Series A Bonds. See "Principal Source of Payment for Municipal Bonds" below.

### **The 2005 Reserve Account**

The Agency will cause to be deposited in the 2005 Reserve Account under the 2005 Indenture from the proceeds of the 2005 Series A Bonds an amount equal to \$19,583,397.57, being the sum of (i) 50% of the maximum principal and interest payments requirement for any fiscal year on the 2005 Series A Bonds and (ii) 50% of the maximum aggregate annual earnings for any fiscal year on the amount in clause (i) above based on the assumption that said amount in clause (i) is invested in Investment Obligations (as defined herein) in accordance with the provisions of the United States Internal Revenue Code of 1986, as amended (the "Code"), that bear interest at a rate per annum equal to the yield on the 2005 Series A Bonds determined in accordance with the provisions of the Code. The Agency is required to maintain in the 2005 Reserve Account an amount equal to the sum of: (i) the higher of (a) 50% of the maximum principal and interest requirement for any fiscal year on all 2005 Indenture Bonds then outstanding and (b) the largest amount of the maximum principal and interest requirement for any fiscal year on the 2005 Municipal Bonds of any 2005 Municipal Issuer; and (ii) 50% of the annual earnings for such fiscal year on the larger of the amounts in

clauses (a) and (b) above based on the assumption that said amount in clause (a) or (b) is invested in Investment Obligations and such Investment Obligations are allocated by the Agency among the various series of 2005 Indenture Bonds then outstanding in accordance with the provisions of the Code and as so allocated, bear interest at a rate per annum equal to the yield (determined in accordance with the provisions of the Code) on the corresponding series of 2005 Indenture Bonds (the “2005 Required Debt Service Reserve”).

All moneys paid to the Agency by the Commonwealth pursuant to the Enabling Act for the purpose of restoring the 2005 Reserve Account to the 2005 Required Debt Service Reserve are to be paid to the 2005 Trustee for deposit to the credit of the 2005 Reserve Account.

Moneys in the 2005 Reserve Account shall be applied first to the payment of interest on the 2005 Indenture Bonds then outstanding (including the 2005 Series A Bonds) and principal of the serial 2005 Indenture Bonds then outstanding (including any serial 2005 Series A Bonds) whenever moneys in the 2005 Bond Service Account are insufficient for such purpose, and then for the purpose of making the required deposits to the 2005 Redemption Account whenever moneys received by the 2005 Trustee from the payments of principal of and interest on the 2005 Municipal Bonds are insufficient for such purpose. Whenever moneys in the 2005 Reserve Account exceed the 2005 Required Debt Service Reserve, such excess shall be transferred to the 2005 Bond Service Account.

### **2005 Series B Refunding Bonds (1997 Indenture)**

The 2005 Series B Refunding Bonds, together with other bonds issued and outstanding under the 1997 Indenture (collectively, the “1997 Indenture Bonds”) are equally and ratably secured by and payable from (i) payments of principal of and interest on the 1997 Municipal Bonds held by the 1997 Trustee (see “The Municipal Bonds” below) and (ii) moneys in and investment income from the 1997 Reserve Account (including any moneys paid to the Agency by the Commonwealth) (see “The 1997 Reserve Account” below) (see *Appendix D - Summary of the 1997 Indenture*).

The principal amount of general obligation municipal bonds and notes issued by San Juan that is included in the 1997 Municipal Bonds totals \$16,080,000 or 11.9% of the total \$134,735,000 in principal amount of 1997 Municipal Bonds that are pledged as security for the 1997 Indenture Bonds (including the 2005 Series B Refunding Bonds). For additional information on San Juan, please refer to *Appendix B* hereto and to the San Juan Continuing Disclosure Report, which has been incorporated by reference into this Official Statement. The principal amount of the general obligation municipal bonds and notes issued by Carolina that is included in the 1997 Municipal Bonds totals \$20,330,000 or 15.1% of the total \$134,735,000 in principal amount of 1997 Municipal Bonds that are pledged as security for the 1997 Indenture Bonds (including the 2005 Series B Refunding Bonds). For additional information on Carolina, please refer to *Appendix B* hereto and to Carolina’s 2004 Financial Statements, which have been incorporated by reference into this Official Statement. The principal amount of the general obligation municipal bonds and notes issued by Guaynabo that is included in the 1997 Municipal Bonds totals \$21,755,000 or 16.2% of the total \$134,735,000 in principal amount of 1997 Municipal Bonds that are pledged as security for the 1997 Indenture Bonds (including the 2005 Series B Refunding Bonds). For additional information on Guaynabo, please refer to *Appendix B* hereto and to Guaynabo’s 2004 Financial Statements, which have been incorporated by reference into this Official Statement.

The 1997 Trustee is required to collect the principal of and interest on all 1997 Municipal Bonds held by it on behalf of the Agency as such principal and interest become due and payable and deposit the moneys so received to the credit of the following Accounts within the 1997 Sinking Fund (as defined herein) and to the 1997 Operating Fund (as defined herein) created under the 1997 Indenture in the following order:

- (a) the 1997 Bond Service Account, such amount as may be required to make the total amount then in the 1997 Bond Service Account equal to the amount of interest then or to become within the next ensuing six months due and payable on all 1997 Indenture Bonds (including the 2005 Series B Refunding Bonds) then outstanding and the amount of principal then or to become within the next ensuing twelve months due and payable on all serial 1997 Indenture Bonds (including any serial 2005 Series B Refunding Bonds) then outstanding plus such additional amount applicable at the time of such deposit as shall be necessary to make the balance in the 1997 Bond Service Account immediately after each interest payment date equal to the

ending balance specified in a certificate of the Agency filed with the 1997 Trustee prior to the delivery of and payment for the 2005 Series B Refunding Bonds;

(b) the 1997 Redemption Account, such amount as may be required to make the amount deposited in the 1997 Redemption Account in such fiscal year equal to the amortization requirements, if any, for such fiscal year for the term 1997 Indenture Bonds (including any term 2005 Series B Refunding Bonds) then outstanding, plus such additional amount, if any, of any surplus cash flow from the 1997 Municipal Bonds as may be specified in a certificate of the Agency filed with the 1997 Trustee upon the issuance of the 2005 Series B Refunding Bonds necessary, together with future amounts to be received on the 1997 Municipal Bonds, to equal any future amortization requirements for the term 1997 Indenture Bonds (including any term 2005 Series B Refunding Bonds) then outstanding as so specified by the Agency;

(c) the 1997 Reserve Account, such amount as may be required to make the amount then in the 1997 Reserve Account equal to the 1997 Required Debt Service Reserve (as defined herein); and

(d) the 1997 Operating Fund.

Neither the credit of the Commonwealth nor that of any of its government instrumentalities will be pledged for the payment of the 1997 Indenture Bonds, including the 2005 Series B Refunding Bonds. The 1997 Indenture Bonds are limited obligations of the Agency payable solely from principal and interest payments under the pledged 1997 Municipal Bonds and from moneys held in the 1997 Reserve Account and other funds and accounts under the 1997 Indenture. The good faith, credit and unlimited taxing power of each issuer of 1997 Municipal Bonds (a “1997 Municipal Issuer”) will, however, be pledged to the payment of each of its 1997 Municipal Bonds that is being pledged by the Agency to secure payment of the 1997 Indenture Bonds. See “Principal Source of Payment for Municipal Bonds” below.

### **The 1997 Reserve Account**

The Agency is required to maintain in the 1997 Reserve Account an amount equal to the lesser of: (i) ten percent (10%) of the original proceeds of each series of 1997 Indenture Bonds outstanding, (ii) the maximum annual principal and interest requirements for any fiscal year on all 1997 Indenture Bonds outstanding, and (iii) 125% of average annual debt service on all 1997 Indenture Bonds outstanding (the “1997 Required Debt Service Reserve”). After the issuance of the 2005 Series B Refunding Bonds and the refunding of the 1997 Refunded Bonds, this amount will be \$16,908,591.86.

All moneys paid to the Agency by the Commonwealth pursuant to the Enabling Act for the purpose of restoring the 1997 Reserve Account to the 1997 Required Debt Service Reserve are to be paid to the 1997 Trustee for deposit to the credit of the 1997 Reserve Account.

Moneys in the 1997 Reserve Account shall be applied first to the payment of interest on the 1997 Indenture Bonds then outstanding (including the 2005 Series B Refunding Bonds) and principal of the serial 1997 Indenture Bonds then outstanding (including any serial 2005 Series B Refunding Bonds) whenever moneys in the 1997 Bond Service Account are insufficient for such purpose, and then for the purpose of making the required deposits to the 1997 Redemption Account whenever moneys received by the 1997 Trustee from the payments of principal of and interest on the 1997 Municipal Bonds are insufficient for such purpose. Whenever moneys in the 1997 Reserve Account exceed the 1997 Required Debt Service Reserve, such excess shall be transferred to the 1997 Bond Service Account.



## **2005 Series C Refunding Bonds (1999 Indenture)**

The 2005 Series C Refunding Bonds, together with other bonds issued and outstanding under the 1999 Indenture (collectively, the “1999 Indenture Bonds”), are equally and ratably secured by and payable from (i) payments of principal of and interest on the 1999 Municipal Bonds held by the 1999 Trustee under the 1999 Indenture (see “The Municipal Bonds” below); and (ii) moneys in and investment income from the 1999 Reserve Account (including any moneys paid to the Agency by the Commonwealth) (see “The 1999 Reserve Account” below) (see *Appendix E - Summary of the 1999 Indenture*). Some or all of the 1999 Municipal Bonds may be released from the lien of the 1999 Indenture if certain requirements are met (see *Appendix E - Summary of the 1999 Indenture - Release of 1999 Municipal Bonds*).

The principal amount of general obligation municipal bonds and notes issued by San Juan that is included in the 1999 Municipal Bonds totals \$206,860,000 or 41.9% of the total \$494,310,000 in principal amount of 1999 Municipal Bonds that are pledged as security for the 1999 Indenture Bonds (including the 2005 Series C Refunding Bonds). For additional information on San Juan, please refer to *Appendix B* hereto and to the San Juan Continuing Disclosure Report, which has been incorporated by reference into this Official Statement. The principal amount of the general obligation municipal bonds and notes issued by Guaynabo that is included in the 1997 Municipal Bonds totals \$49,930,000 or 10.1% of the total \$494,310,000 in principal amount of 1999 Municipal Bonds that are pledged as security for the 1999 Indenture Bonds (including the 2005 Series C Refunding Bonds). For additional information on Guaynabo, please refer to *Appendix B* hereto and to Guaynabo’s 2004 Financial Statements, which have been incorporated by reference into this Official Statement.

The 1999 Trustee is required to collect the principal of and interest on all 1999 Municipal Bonds held by it on behalf of the Agency under the 1999 Indenture as such principal and interest become due and payable and deposit the moneys so received to the credit of the following Accounts within the 1999 Sinking Fund (as defined herein) and to the 1999 Operating Fund (as defined herein) created under the 1999 Indenture in the following order:

(a) the 1999 Bond Service Account, such amount as may be required to make the total amount then in the 1999 Bond Service Account equal to the amount of interest then or to become within the next ensuing six months due and payable on all 1999 Indenture Bonds (including the 2005 Series C Refunding Bonds) then outstanding and the amount of principal then or to become within the next ensuing twelve months due and payable on all serial 1999 Indenture Bonds (including any serial 2005 Series C Refunding Bonds) then outstanding, plus such additional amount applicable at the time of such deposit as shall be necessary to make the balance in the 1999 Bond Service Account immediately after each interest payment date equal to the ending balance specified in a certificate of the Agency filed with the 1999 Trustee prior to the delivery of and payment for the 2005 Series C Refunding Bonds;

(b) the 1999 Redemption Account, such amount as may be required to make the amount deposited in the 1999 Redemption Account in such fiscal year equal to the Amortization Requirements, if any, for such fiscal year for the term 1999 Indenture Bonds (including any term 2005 Series C Refunding Bonds) then outstanding, plus such additional amount, if any, of any surplus cash flow from the 1999 Municipal Bonds as may be specified in a certificate of the Agency filed with the 1999 Trustee upon the issuance of the term 2005 Series C Refunding Bonds necessary, together with future amounts to be received on the 1999 Municipal Bonds, to equal any future Amortization Requirements for the term 1999 Indenture Bonds (including any term 2005 Series C Refunding Bonds) then outstanding as so specified by the Agency;

(c) the 1999 Reserve Account, such amount as may be required to make the amount then in the 1999 Reserve Account equal to the 1999 Required Debt Service Reserve (as defined herein); and

(d) the 1999 Operating Fund.

Neither the credit of the Commonwealth nor that of any of its political subdivisions or instrumentalities will be pledged for the payment of the 1999 Indenture Bonds, including the 2005 Series C Refunding Bonds. The 1999 Indenture Bonds are limited obligations of the Agency payable solely from principal and interest payments under the pledged 1999 Municipal Bonds and from moneys held in the 1999 Reserve Account and other funds and accounts under the 1999 Indenture. The good faith, credit and unlimited taxing power of each issuer of 1999 Municipal Bonds (a “1999 Municipal Issuer,” and together with the 2005 Municipal Issuers and the 1997 Municipal Issuers, the “Municipal Issuers”) will, however, be pledged to the payment of each of its 1999 Municipal Bonds that is being pledged by the Agency to secure payment of the 1999 Indenture Bonds (including the 2005 Series C Refunding Bonds) outstanding under the 1999 Indenture. See “Sources of Payment for Municipal Bonds” below.

### **The 1999 Reserve Account**

The Agency is required to maintain in the 1999 Reserve Account an amount equal to the sum of (i) the higher of (a) 50% of the maximum principal and interest payments requirement for any fiscal year on all 1999 Indenture Bonds then outstanding and (b) the largest amount of the maximum principal and interest payments requirement for any fiscal year on the 1999 Municipal Bonds of any 1999 Municipal Issuer, and (ii) 50% of the annual earnings for such fiscal year on the larger of the amounts in clauses (a) and (b) above based on the assumption that said amount in clause (a) or (b) is invested in Investment Obligations with a yield (determined in accordance with the provisions of the Code) equal to the yield from time to time on all 1999 Indenture Bonds outstanding (the “1999 Required Debt Service Reserve”). After the issuance of the 2005 Series C Refunding Bonds and the refunding of the 1999 Refunded Bonds, this amount will be \$42,305,890.87.

All moneys paid to the Agency by the Commonwealth pursuant to the Enabling Act for the purpose of restoring the 1999 Reserve Account to the 1999 Required Debt Service Reserve are to be paid to the 1999 Trustee for deposit to the credit of the 1999 Reserve Account.

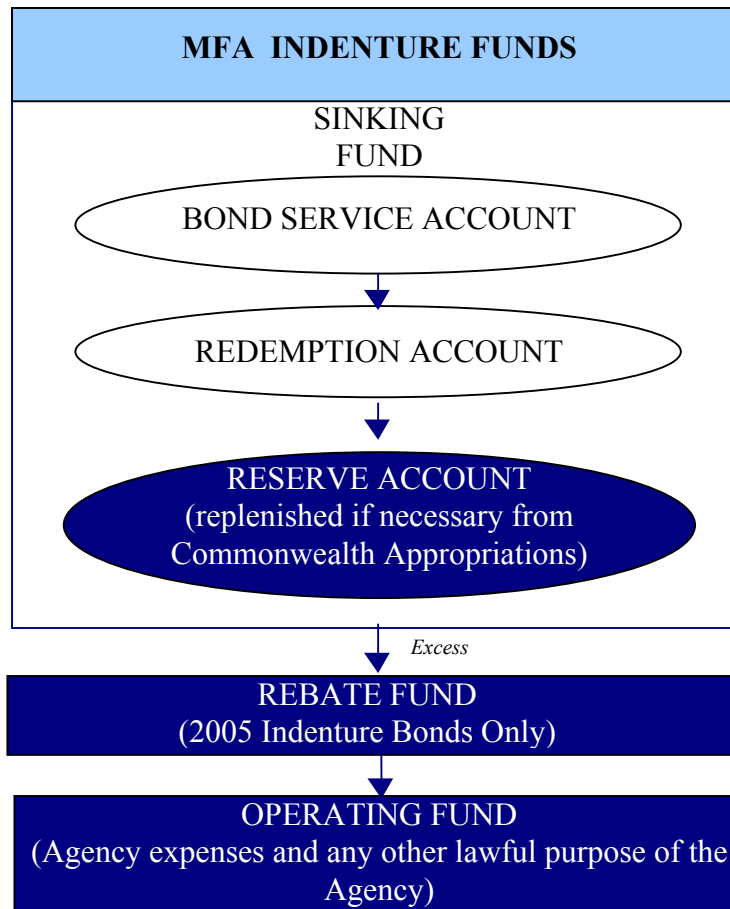
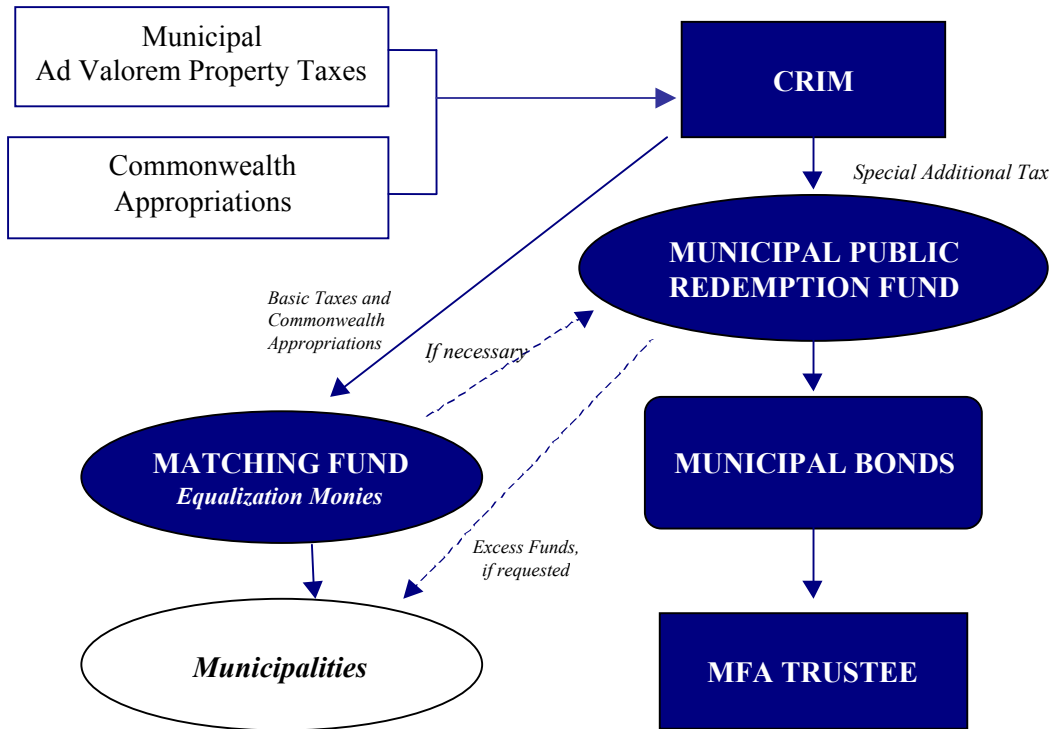
Moneys in the 1999 Reserve Account shall be applied first to the payment of interest on the 1999 Indenture Bonds then outstanding (including the 2005 Series C Refunding Bonds) and maturing principal of all serial 1999 Indenture Bonds then outstanding (including any serial 2005 Series C Refunding Bonds) whenever moneys in the 1999 Bond Service Account are insufficient for such purpose, and then for the purpose of making the required deposits to the 1999 Redemption Account whenever moneys received by the 1999 Trustee from the payments of principal of and interest on the 1999 Municipal Bonds are insufficient for such purpose. Whenever moneys in the 1999 Reserve Account exceed the 1999 Required Debt Service Reserve, such excess shall be transferred to the 1999 Bond Service Account.

### **Restoration of Applicable Reserve Account**

The Enabling Act provides that, in order to assure the maintenance of each Reserve Account in an amount equal to its Required Debt Service Reserve, there shall be annually apportioned and paid to the Agency by the Commonwealth for deposit in each Reserve Account such sum, if any, as shall be certified by the President of the Agency to the Secretary of the Treasury of the Commonwealth as necessary to restore the balance in the applicable Reserve Account to its Required Debt Service Reserve. The President of the Agency shall in each year, on or before December 1, deliver to the Secretary of the Treasury his certificate stating the sum, if any, required to restore the balance in each Reserve Account to its Required Debt Service Reserve, and the sum so certified shall be apportioned and paid to the Agency from any available or uncommitted funds in the General Fund of the Treasury during the then current fiscal year of the Commonwealth without further action by the Legislature. If there are no such available funds, the Secretary of the Treasury shall request the amount so certified from the Director of the Office of Management and Budget of the Commonwealth (“OMB”), who shall include it in the General Budget of the Commonwealth for the coming fiscal year. The payment of such amount is subject to appropriation by the Legislature, which appropriation is authorized but not legally required to be made.

## PRINCIPAL SOURCE OF PAYMENT FOR MUNICIPAL BONDS

The following diagrams demonstrate the principal source of payment for the Municipal Bonds of each Municipal Issuer and how payments on the Municipal Bonds are allocated to the above mentioned funds and accounts.



## The Municipal Bonds

*General.* As required by the Indentures and the Enabling Act, the Municipal Bonds are general obligation bonds or notes of each Municipal Issuer secured by *ad valorem* taxation, without limitation as to rate or amount, on all taxable property within the boundaries of the applicable Municipal Issuer. The good faith, credit and unlimited taxing power of each Municipal Issuer are pledged to the payment of its Municipal Bonds. The Municipal Bonds have been issued pursuant to Act No. 64 of the Legislature of Puerto Rico, approved July 3, 1996, as amended (“Act No. 64”), which revised and incorporated into a single statute the provisions of Act No. 7 of October 28, 1954, and of several other laws relating to municipal finance and municipal taxes and made certain changes to such provisions to, among other things, expedite and streamline the procedures for the issuance of municipal obligations, including general obligation municipal bonds and notes.

*Limitations on Ability of Municipalities to Issue General Obligation Debt.* GDB is required by Act No. 64 to give its prior approval to all proposed issues of general obligation bonds and notes by the municipalities of Puerto Rico. Prior to approving any proposed issue of general obligation debt, GDB is required to verify that the municipality has Available Legal Margin and Payment Capacity (as such terms are defined herein) to incur such additional general obligation debt.

As provided by the Commonwealth Constitution, the Legislature of Puerto Rico has fixed a limitation for the issuance of general obligation municipal bonds and notes for the payment of which the good faith, credit and taxing power of each municipality may be pledged. The principal amount outstanding of any such bonds and notes may not exceed 10% of the aggregate assessed valuation of the taxable property within such municipality (the “Legal Margin,” and the amount by which such municipality’s Legal Margin exceeds a municipality’s outstanding general obligation debt, the “Available Legal Margin”). Act No. 64 provides that in calculating the Available Legal Margin of a municipality, the amount of outstanding general obligation bonds and notes of such municipality is reduced by the amount of the excess, if any, of the funds deposited in such municipality’s Redemption Fund (as defined herein) with GDB over the amount of accrued but unpaid interest on such general obligation debt. For a discussion of the operation of the Redemption Fund see “Redemption Fund Deposits and Application” below.

Act No. 64 also requires that in order for a municipality to be able to issue additional general obligation bonds and notes such municipality must have sufficient “payment capacity.” Act No. 64 provides that a municipality has sufficient “payment capacity” to incur additional general obligation debt if the deposits in such municipality’s Redemption Fund and the annual amounts collected with respect to such municipality’s Special Additional Tax (as defined below), as projected by GDB, will be sufficient to service to maturity the municipality’s outstanding general obligation debt and the additional proposed general obligation debt (“Payment Capacity”).

*Special Additional Tax.* The principal source of payment for municipal general obligation bonds and notes is a special additional property tax (the “Special Additional Tax”), which, as provided by Act No. 83 of August 30, 1991, as amended (“Act No. 83”), may be imposed by a municipality without limitation as to rate or amount. Under Act No. 64, each municipality is required to levy the Special Additional Tax in such amounts as shall be required for the payment of its outstanding general obligation municipal bonds and notes. The current Special Additional Tax rates for municipalities vary from 0.50% to 2.25% of applicable assessed valuation in the case of both real and personal property. The Special Additional Tax is collected on behalf of the municipalities by the Municipal Revenues Collection Center, an independent municipal entity (“CRIM”). The Commonwealth has not conducted a real property reassessment since 1958. Therefore, all real property taxes collected by CRIM, including the Special Additional Tax, are based on the assessed valuation of real property in fiscal year 1957-58. The Special Additional Tax is available for the payment of debt service on general obligation debt of the municipalities, except for any Special Additional Tax collected on the real and personal property of the privatized Puerto Rico Telephone Company (“PRTC”) for those municipalities that elect not to deposit such PRTC property taxes in their Redemption Funds pursuant to Act No. 95 of the Legislature of Puerto Rico, approved June 24, 1998 (“Act No. 95”) (see *Redemption Fund Deposits and Application* below). Pursuant to Act No. 95, which amended Act No. 83, each municipality has the option of either: (i) depositing the amounts collected by CRIM relating to the Special Additional Tax on the real and personal property of PRTC in that municipality’s Redemption Fund, or (ii) using such amounts collected by CRIM for any other lawful purpose such as the payment of the municipality’s operating expenses.

*Redemption Fund Deposits and Application.* CRIM is required to deposit into each municipality's Redemption Fund with GDB the amounts collected with respect to such municipality's Special Additional Tax (including the annual appropriations from the Commonwealth's General Fund to compensate each municipality for the exemption from the Special Additional Tax portions of the \$15,000 Real Property Exemption (as defined below) and the \$50,000 Personal Property Exemption (as defined below)) and any additional amount derived from such municipality's Basic Tax (as defined below) and other available revenues to the extent necessary to pay principal of and interest on all general obligation indebtedness of such municipality. It has never been necessary to transfer into any municipality's Redemption Fund moneys derived from such municipality's Basic Tax.

Act No. 64, as amended by Act No. 44 of the Legislature of Puerto Rico, approved June 13, 2001 ("Act No. 44"), provides that the Special Additional Tax and other amounts deposited in a municipality's Redemption Fund are to be utilized first for the payment of the principal of and premium, if any, and interest on its general obligation bonds and notes. To the extent that such funds exceed the amount necessary to cover twelve months' debt service on such municipality's then outstanding general obligation indebtedness, as determined by GDB, Act No. 64 requires GDB to disburse the excess to the municipality, at its request, once during each fiscal year.

*Municipal Revenues.* Revenues of the municipalities of Puerto Rico are principally derived from *ad valorem* property taxes and Commonwealth contributions.

Act No. 83 authorizes municipalities to impose the following property taxes: (i) the Special Additional Tax, without limitation as to rate or amount, which as mentioned above is available primarily for the payment of a municipality's general obligation debt; and (ii) a basic property tax to fund operating expenses up to a maximum amount of 6% of the assessed valuation on all real property within such municipality and up to a maximum amount of 4% of the assessed valuation on all personal property within such municipality (collectively, the "Basic Tax"). Act No. 83 also continued in effect a special property tax imposed by the Commonwealth of 1.03% of the assessed valuation of all real and personal property within the Commonwealth (other than exempted property) (the "Special Tax") for the exclusive purpose of servicing the Commonwealth's general obligation debt. A portion of the Basic Tax levied by a municipality may be transferred to other municipalities by virtue of the operation of the Matching Fund (as defined herein) (see "Matching Fund and Equalization Moneys" below).

The current Basic Tax rates for municipalities vary from 5% to 6% of the assessed valuation in the case of real property, and from 3% to 4% of the assessed valuation in the case of personal property. In the aggregate, current property tax rates (including the Special Additional Tax and the Basic Tax) for the municipalities vary from 5.5% to 8.25% of the assessed valuation in the case of real property, and from 3.5% to 6.25% of the assessed valuation in the case of personal property. Interest is charged on delinquent taxes at the rate of 10%, with a penalty of up to 10% of the tax owed in the case of real property and up to 15% of the tax owed (or up to 40% if the delinquency also involves failure to file the required tax return) in the case of personal property.

As mentioned above, under Act No. 64, each municipality is required to levy the Special Additional Tax in such amounts as shall be required for the payment of its general obligation municipal bonds and notes. Principal of and interest on all general obligation municipal bonds and notes and on all municipal notes issued in anticipation of the issuance of general obligation bonds also constitute a first lien on the municipality's Basic Tax. Accordingly, the municipality's Basic Tax would be available to make debt service payments on general obligation municipal bonds and notes to the extent that the Special Additional Tax, together with moneys on deposit in the municipality's Redemption Fund, are not sufficient to cover such debt service. It has never been necessary to apply Basic Taxes to pay debt service on general obligation municipal bonds or notes of any Municipality.

Act No. 83 provides for an exemption from the Special Additional Tax and Basic Tax on the first \$15,000 of assessed valuation of primary personal residences of individuals (the “\$15,000 Real Property Exemption”) and an exemption from personal property taxes on the first \$50,000 of assessed valuation of property owned by businesses that have gross revenues of less than \$150,000 per annum (the “\$50,000 Personal Property Exemption”). Recognizing the importance of the real and personal property tax for the fiscal requirements of the municipalities, the Commonwealth makes annual appropriations to the municipalities from its General Fund as compensation for the amount of the revenues foregone owing to these exemptions. However, under Act No. 83 appropriations from the Commonwealth will not be provided to cover any amount of property taxes which any municipality elects to forgive for primary personal residences registered for the first time after January 1, 1992, and personal property of certain businesses registered for the first time after July 1, 1991.

Act No. 83 and Act No. 80 of the Legislature of Puerto Rico, approved August 30, 1991, as amended (“Act No. 80”), also provide for the following Commonwealth contributions to the municipalities: (i) 2.50% of the net internal revenues of the Commonwealth’s General Fund for fiscal year 2004-2005 and thereafter; (ii) 35% of the annual net revenues derived from the operation of the additional lottery system created by Act No. 10, of the Legislature of Puerto Rico, approved May 24, 1989, as amended (the amounts in clauses (i) and (ii), collectively, the “Designated Commonwealth Contributions”); (iii) an annual amount from the Commonwealth’s General Fund to compensate the municipalities for the \$15,000 Real Property Exemption and the \$50,000 Personal Property Exemption; and (iv) an annual amount from the Commonwealth’s General Fund to compensate the municipalities for the exemption of 0.20% of the assessed valuation of all taxable property within the municipalities (the amounts in clauses (i) through (iv), with the exception of the annual contributions from the Commonwealth as compensation to the municipalities for the Special Additional Tax portions of the \$15,000 Real Property Exemption and the \$50,000 Personal Property Exemption, are defined as the “Commonwealth Contributions”).

The municipal revenues described above are collected or received by CRIM on behalf of the levying municipality and are deposited by CRIM into the Redemption Fund and the Matching Fund, with the exception of the Special Tax which is deposited into the Commonwealth’s debt redemption fund.

*Matching Fund and Equalization Moneys.* Act No. 80 also established the Municipal Matching Fund (the “Matching Fund”) into which CRIM is required to deposit with GDB the total amount collected on account of Basic Taxes and the Commonwealth Contributions. Certain moneys in the Matching Fund (the “Equalization Moneys”) are available to CRIM in order to guaranty that each municipality will receive revenues in an amount at least equivalent to that received from Equalization Moneys in the previous fiscal year. The Equalization Moneys are made up of: (i) the Designated Commonwealth Contributions; and (ii) a portion of the Basic Tax equal to 1% of the assessed value of personal property and 3% of the assessed value of real property collected by each municipality (the “Designated Basic Tax”).

All Equalization Moneys are allocated to the municipalities as follows: first, as may be required so that each municipality receives at least the same amount of aggregate revenues received during the previous fiscal year on account of Equalization Moneys, using first the Designated Commonwealth Contributions, and then, to the extent necessary, the Designated Basic Tax (it has never been necessary to use the Designated Basic Tax to perform such equalization); second, Designated Basic Taxes remaining in the Equalization Moneys are allocated to the municipalities in proportion to the amount by which revenues from their Basic Taxes in such fiscal year exceed their revenues from Basic Taxes in the previous fiscal year; and third, to all municipalities based on certain economic and demographic criteria specified in Act No. 80. The remaining Matching Fund moneys are returned to the municipalities whose Basic Tax levies gave rise to such remaining moneys, and are used, with their other revenues, to meet operating expenses.

*CRIM.* Prior to July 1, 1993, the Secretary of the Treasury collected all municipal taxes upon real and personal property (which includes intangible property) in each municipality. Since July 1, 1993, and pursuant to Act No. 80, CRIM has undertaken all of the Secretary of the Treasury’s responsibilities relating to the collection and distribution of such taxes. CRIM is responsible for the appraisal, assessment, notice of imposition, and collection of all municipal property taxes. All property taxes collected by CRIM are deposited at GDB, which acts as fiscal agent to the Commonwealth and its municipalities.

CRIM is governed by a board (the “CRIM Board”) composed of the President of GDB, the Commissioner of Municipal Affairs and seven mayors of municipalities of the Commonwealth. The mayors elected as members of the CRIM Board hold office for a term of four years (and not more than two consecutive terms) and until their successors have been appointed. The Executive Director of CRIM is Norman E. Foy, Esq., and CRIM’s principal offices are located at State Road 1, Km. 17.2, San Juan, Puerto Rico 00926. In addition, CRIM operates nine regional centers located in the municipalities of Aguadilla, Arecibo, Bayamón, Caguas, Carolina, Humacao, Mayagüez, Ponce, and San Juan.

Real property is assessed by CRIM and personal property is self-assessed. The current gross assessed valuation figures for real property and personal property taxes for all municipalities are approximately \$13.6 billion and \$11.7 billion, respectively. These assessment values have not been adjusted to reflect the various applicable real property and personal property exemptions, such as those described under *Municipal Revenues* above and other exemptions granted under Commonwealth tax incentives laws. As mentioned above, no real property reassessment has been made in the Commonwealth since 1958. All real property taxes are assessed on the basis of the replacement cost of the related real property in fiscal year 1957-58 values, regardless of when such property was constructed.

Since 1999 CRIM has been undertaking a Property Tax Review, Appraisal and Collection Plan involving CRIM, participating municipalities and the private sector. The program is aimed at: (i) assessing all new construction projects and improvements to existing properties to include them in the tax rolls; (ii) investigating the incorrect use of the \$15,000 Real Property Exemption by targeting areas where properties are generally rented for business and residential use; and (iii) improving personal property tax collection efforts. CRIM expects that after full implementation of the program (currently expected in fiscal year 2006), which involves approximately fifty-four of the Commonwealth’s seventy-eight municipalities, it will collect approximately \$40 million annually in additional real and personal property taxes.

#### **Additional Tests and Covenants Relating to the Municipal Issuers**

In connection with the issuance of the Bonds, GDB and CRIM will enter into an agreement that will provide, among other things, as follows:

Additional general obligation bonds or notes of any municipality in Puerto Rico (a “Proposed Issue”) will be approved by GDB only if the following two tests are satisfied: (i) for each fiscal year that the current outstanding general obligation debt of said municipality and the Proposed Issue will be outstanding, the balance of the moneys in the municipality’s Redemption Fund as of the beginning of each such fiscal year plus the estimated Special Additional Tax collections for such fiscal year is not less than the sum of the principal and interest due on the municipality’s current outstanding general obligation debt and the Proposed Issue for the corresponding fiscal year; and (ii) as of June 30 of the fiscal year preceding the fiscal year in which the Proposed Issue will be issued, the ratio of the sum of the beginning balance of the municipality’s Redemption Fund for such preceding fiscal year and the municipality’s actual Special Additional Tax collections, actual Basic Tax collections, and Commonwealth Contributions for such preceding fiscal year to maximum annual debt service on all outstanding general obligation debt of the municipality (including the Proposed Issue) is not less than two to one. For purposes of the test in clause (i) above, “estimated Special Additional Tax collections” for any fiscal year shall equal the average of the collections of the Special Additional Tax for the two fiscal years preceding the fiscal year in which the Proposed Issue is to be issued.

GDB will undertake the following monitoring tests: (i) as of the end of each fiscal year (currently June 30) for each municipality which has not issued general obligation debt during the twelve months ended on such June 30, GDB will determine the ratio of the sum of the beginning balance of the municipality’s Redemption Fund for such fiscal year and the municipality’s actual Special Additional Tax collections, actual Basic Tax collections and Commonwealth Contributions for such fiscal year to maximum debt service on such municipality’s general obligation debt; and (ii) not later than three months prior to any interest or principal payment date on general obligation debt of any municipality, it will determine the balance in the Redemption Fund for such municipality.

GDB will also undertake that: (i) in the event the ratio calculated in clause (i) of the preceding paragraph or clause (ii) of the second preceding paragraph is less than two to one, it will immediately notify Moody's Investors Service, Inc. ("Moody's"), S&P and the applicable Trustee, and (ii) in the event that the determination in clause (ii) of the preceding paragraph shows that the balance in a municipality's Redemption Fund will not be sufficient to pay the principal of and interest on its general obligation debt on the next interest or principal payment date, GDB will immediately notify CRIM and the applicable Trustee in writing of such deficiency, and request that CRIM, as provided in Act No. 64, transfer to GDB any available moneys from Basic Taxes (which are subject to a first lien to cover general obligation debt of municipalities) and other available and unencumbered moneys in the Matching Fund sufficient to cover said deficiency. CRIM covenants that it will make such transfer not later than five business days prior to the applicable interest or principal payment date.

Each Trustee, CFIG, FSA, Moody's and S&P is given authority to enforce the provisions of the above agreement.



## MUNICIPAL TAX COLLECTIONS AND COMMONWEALTH CONTRIBUTIONS

The following table shows for each Municipal Issuer (i) the amount of property taxes collected from municipal taxpayers (excluding the Special Additional Tax) and (ii) the amount of funds contributed by the Commonwealth to each Municipal Issuer for each of the fiscal years indicated below.

### Fiscal Year Ended June 30,

Municipality	2003			2004			2005		
	From Commonwealth Appropriations	From Municipal Taxpayers	Total	From Commonwealth Appropriations	From Municipal Taxpayers	Total	From Commonwealth Appropriations	From Municipal Taxpayers	Total
Adjuntas	\$ 4,105,714	\$ 632,555	\$ 4,738,269	\$ 4,164,616	\$ 685,361	\$ 4,849,977	\$ 4,163,671	\$ 613,747	\$ 4,777,418
Aguada	4,269,376	2,045,634	6,315,010	4,361,329	2,075,817	6,437,146	4,332,630	2,142,463	6,475,093
Aguadilla	4,195,950	6,809,253	11,005,204	4,587,587	7,247,733	11,835,320	4,277,297	6,655,344	10,932,642
Aguas Buenas	4,447,139	966,513	5,413,652	4,480,204	1,088,799	5,569,004	4,419,346	1,108,492	5,527,839
Aibonito	3,763,819	1,513,801	5,277,620	3,725,814	1,725,330	5,451,144	3,806,393	1,531,848	5,338,241
Añasco	3,256,042	1,704,457	4,960,499	3,395,416	1,813,781	5,209,197	3,311,766	2,107,792	5,419,558
Arecibo	4,549,272	8,774,848	13,324,121	4,760,493	8,511,165	13,271,658	4,233,028	9,496,454	13,729,482
Arroyo	3,981,558	775,917	4,757,474	4,026,504	861,819	4,888,323	4,061,534	777,705	4,839,239
Barceloneta	1,482,303	5,103,149	6,585,452	888,678	7,034,247	7,922,925	1,976,955	5,233,511	7,210,465
Barranquitas	4,739,307	1,045,862	5,785,169	4,839,933	1,027,601	5,867,533	4,832,192	1,119,664	5,951,855
Bayamón	15,631,323	35,834,955	51,466,278	14,559,094	38,897,644	53,456,737	14,810,421	36,337,727	51,148,148
Cabo Rojo	3,405,078	4,386,791	7,791,869	3,410,457	4,470,880	7,881,336	3,123,548	4,926,349	8,049,897
Caguas	8,144,995	25,756,877	33,901,872	7,880,526	25,477,154	33,357,680	7,751,920	27,637,603	35,389,524
Camuy	4,273,680	1,362,342	5,636,022	4,295,356	1,868,564	6,163,919	4,346,965	1,336,372	5,683,337
Canóvanas	3,569,802	3,886,385	7,456,187	3,218,002	4,439,883	7,657,885	3,386,302	4,136,870	7,523,172
Carolina	13,721,973	36,839,979	50,561,952	13,228,702	40,117,642	53,346,344	13,406,685	38,399,174	51,805,859
Cataño	3,280,683	14,292,516	17,573,200	3,229,479	14,722,650	17,952,129	3,071,314	13,994,071	17,065,385
Cayey	2,058,062	6,594,181	8,652,243	2,226,035	6,081,073	8,307,109	1,991,863	6,692,305	8,684,168
Ceiba	3,698,508	755,404	4,453,912	3,739,493	819,200	4,558,693	3,727,266	784,023	4,511,290
Ciales	3,633,334	747,713	4,381,047	3,678,859	756,997	4,435,856	3,672,214	723,566	4,395,781
Cidra	3,101,036	3,146,469	6,247,505	3,055,035	3,035,135	6,090,169	2,979,707	3,361,677	6,341,383
Coamo	4,291,772	1,437,299	5,729,072	4,230,522	1,764,280	5,994,801	4,175,788	1,800,782	5,976,570
Comerio	5,118,477	568,193	5,686,670	5,201,227	610,562	5,811,789	5,246,108	541,535	5,787,643
Corozal	4,653,604	1,340,303	5,993,906	4,801,675	1,222,384	6,024,059	4,820,182	1,167,031	5,987,213
Culebra	1,677,689	282,493	1,960,183	1,682,580	315,861	1,998,441	1,681,227	327,554	2,008,782
Dorado	1,637,340	7,178,857	8,816,197	2,061,432	6,185,569	8,247,001	2,018,067	5,891,306	7,909,373
Fajardo	2,742,417	6,637,184	9,379,601	2,948,726	6,076,112	9,024,838	2,673,655	6,497,000	9,170,655
Florida	3,747,631	386,613	4,134,244	3,821,121	366,874	4,187,995	3,806,513	446,827	4,253,341
Guánica	3,905,104	777,471	4,682,575	3,946,779	823,802	4,770,580	3,956,667	789,582	4,746,249
Guayama	2,118,891	5,777,039	7,895,929	2,144,237	5,733,626	7,877,864	2,244,754	5,197,886	7,442,640
Guayanilla	3,322,483	1,344,443	4,666,926	3,320,996	1,616,037	4,937,032	3,390,226	1,277,151	4,667,378
Guaynabo	7,250,889	37,495,515	44,746,404	7,094,926	38,455,296	45,550,222	7,132,459	36,101,538	43,233,996
Gurabo	3,190,014	2,886,500	6,076,515	3,196,951	3,047,068	6,244,018	3,043,479	3,377,309	6,420,788
Hatillo	2,632,114	4,157,335	6,789,450	2,553,308	4,512,584	7,065,893	2,297,783	5,193,084	7,490,867
Hormigueros	2,558,793	2,189,642	4,748,435	2,565,961	2,217,491	4,783,452	2,552,786	2,291,281	4,844,067
Humacao	2,834,279	9,489,269	12,323,548	2,590,152	10,850,390	13,440,542	2,435,514	10,331,266	12,766,780
Isabela	3,793,647	2,967,361	6,761,008	3,767,436	3,209,073	6,976,509	3,675,143	3,332,405	7,007,548
Jayuya	3,653,748	749,422	4,403,170	3,627,933	904,136	4,532,069	3,658,550	851,820	4,510,370
Juana Díaz	4,292,250	2,306,323	6,598,572	4,399,359	2,197,768	6,597,126	4,275,973	2,472,258	6,748,231
Juncos	3,749,729	2,650,533	6,400,262	3,812,685	2,554,578	6,367,262	3,540,558	3,607,191	7,147,750
Lajas	3,485,065	1,495,220	4,980,285	3,514,880	1,596,389	5,111,269	3,492,256	1,583,363	5,075,619
Lares	4,750,674	1,101,719	5,852,393	4,827,925	1,135,547	5,963,472	4,798,508	1,173,750	5,972,257
Las Marías	3,678,334	374,407	4,052,741	3,707,458	433,759	4,141,217	3,732,356	397,137	4,129,494
Las Piedras	2,629,958	2,990,753	5,620,711	2,596,335	3,235,739	5,832,074	2,633,923	3,089,173	5,723,096
Loíza	5,161,929	825,911	5,987,840	5,225,976	869,568	6,095,544	5,229,465	808,632	6,038,097
Luquillo	2,651,871	2,221,337	4,873,208	2,736,185	2,141,700	4,877,885	2,545,755	2,515,833	5,061,588
Manatí	3,196,379	5,950,613	9,146,992	3,432,012	5,864,551	9,296,563	2,937,974	6,707,165	9,645,139
Maricao	2,975,082	418,972	3,394,054	3,002,697	463,740	3,466,437	3,013,317	457,386	3,470,703
Maunabo	4,184,923	375,644	4,560,566	4,128,396	591,025	4,719,420	4,203,453	378,096	4,581,549
Mayagüez	5,047,304	16,992,600	22,039,904	4,961,004	17,228,073	22,189,077	4,999,511	16,695,640	21,695,151
Moca	4,121,069	1,508,867	5,629,936	4,190,394	1,555,942	5,746,335	4,131,562	1,669,332	5,800,894
Morovis	4,904,018	756,223	5,660,241	4,996,689	782,138	5,778,826	4,998,770	801,747	5,800,517
Naguabo	3,693,009	1,202,762	4,895,770	3,697,606	1,375,805	5,073,410	3,738,873	1,138,235	4,877,107
Naranjito	4,897,905	1,015,253	5,913,158	4,984,941	1,074,542	6,059,483	4,975,043	1,183,406	6,158,449
Orocovis	5,141,147	641,247	5,782,394	5,215,899	689,382	5,905,281	5,167,050	820,573	5,987,623
Patillas	3,936,757	918,926	4,855,683	4,046,675	850,137	4,896,812	4,008,386	865,760	4,874,146
Peñuelas	2,910,251	2,775,976	5,686,226	2,799,370	3,163,106	5,962,476	2,527,198	3,206,258	5,733,456
Ponce	8,230,740	25,425,708	33,656,448	7,938,452	26,475,200	34,413,653	7,810,461	25,863,603	33,674,065
Quebradillas	3,844,193	1,146,008	4,990,200	3,924,363	1,159,800	5,084,163	3,901,333	1,161,440	5,062,773
Rincón	3,292,190	1,228,134	4,520,324	3,372,094	1,176,078	4,548,172	3,332,747	1,206,345	4,539,092
Río Grande	3,815,537	4,175,893	7,991,431	4,009,540	3,840,250	7,849,790	3,880,832	3,920,677	7,801,509
Sabana Grande	3,824,151	1,184,519	5,008,670	3,900,108	1,173,952	5,074,060	3,902,480	1,192,383	5,094,863
Salinas	3,961,786	1,544,177	5,505,963	4,001,841	1,674,771	5,676,612	3,933,874	1,604,803	5,538,677

**Fiscal Year Ended June 30,**

Municipality	2003			2004			2005		
	From Commonwealth Appropriations	From Municipal Taxpayers	Total	From Commonwealth Appropriations	From Municipal Taxpayers	Total	From Commonwealth Appropriations	From Municipal Taxpayers	Total
San Germán	3,512,135	3,066,551	6,578,686	3,470,552	3,244,241	6,714,793	3,607,241	2,783,580	6,390,821
San Juan	25,833,851	118,927,785	144,761,636	24,934,605	124,964,594	149,899,199	25,911,969	119,288,641	145,200,610
San Lorenzo	4,457,350	2,057,381	6,514,731	4,511,607	2,047,316	6,558,922	4,488,228	2,143,689	6,631,917
San Sebastián	4,053,067	2,539,306	6,592,373	4,121,290	2,542,931	6,664,221	4,042,452	2,620,183	6,662,634
Santa Isabel	3,089,368	1,078,940	4,168,309	3,094,599	1,270,611	4,365,210	3,079,008	1,303,795	4,382,803
Toa Alta	4,707,577	2,290,813	6,998,390	4,733,315	2,521,908	7,255,223	4,561,578	2,782,500	7,344,078
Toa Baja	7,012,475	9,939,856	16,952,331	6,470,770	11,545,877	18,016,648	6,526,518	11,008,657	17,535,175
Trujillo Alto	5,553,958	5,557,263	11,111,220	5,567,452	5,672,957	11,240,409	5,401,867	5,571,837	10,973,704
Utua	4,847,100	1,281,099	6,128,199	4,863,706	1,446,969	6,310,675	4,870,521	1,413,875	6,284,396
Vega Alta	3,181,595	3,097,441	6,279,036	2,894,798	3,798,294	6,693,091	2,882,397	3,740,981	6,623,377
Vega Baja	4,766,327	4,755,060	9,521,387	5,188,897	3,319,760	8,508,657	4,949,739	4,457,910	9,407,649
Vieques	3,005,594	598,359	3,603,953	3,021,248	635,320	3,656,568	2,952,651	696,651	3,649,302
Villalba	4,890,746	624,911	5,515,657	4,955,727	651,496	5,607,223	4,796,556	943,869	5,740,425
Yabucoa	4,166,070	1,351,488	5,517,558	4,084,969	1,940,171	6,025,140	4,041,098	1,998,246	6,039,344
Yauco	3,515,715	3,194,584	6,710,299	3,540,690	3,299,323	6,840,012	3,581,184	3,107,866	6,689,050
<b>TOTAL</b>	<u>\$351,407,024</u>	<u>\$490,229,104</u>	<u>\$841,636,128</u>	<u>\$350,184,677</u>	<u>\$512,874,923</u>	<u>\$863,059,600</u>	<u>\$347,896,587</u>	<u>\$502,914,581</u>	<u>\$850,811,167</u>
% of Total Revenues	41.75%	58.25%	100.00%	40.57%	59.43%	100.00%	40.89%	59.11%	100.00%

Source: CRIM

## SPECIAL ADDITIONAL TAX COLLECTIONS

The following table presents for each Municipal Issuer the Special Additional Tax Collections and debt service coverage ratio analysis based on collections and fund balances listed below for the fiscal year ended June 30, 2005.

**Fiscal Year Ended June 30, 2005**

Municipality	A Special Add'l Tax Collections	B Municipality's Redemption Fund	C Matching Fund	D=(B+C+E) Available for the Payment of G.O. Debt	E Debt Service Payments on G.O. Debt	Debt Service Coverage Ratio based on	
						F = D/E Available for The Payment of G.O. Debt	G = (B+E)/E Redemption Fund
						1	2
Adjuntas	\$ 197,511	\$ 290,378	\$ 4,917,203	\$ 5,402,791	\$ 195,211	27.68	2.49
Aguada	872,042	662,877	7,117,593	8,517,179	736,708	11.56	1.90
Aguadilla	2,892,888	3,124,009	13,243,811	19,397,377	3,029,557	6.40	2.03
Aguas Buenas	414,894	317,836	5,803,942	6,529,837	408,059	16.00	1.78
Aibonito	492,069	723,171	5,695,873	7,035,527	616,483	11.41	2.17
Añasco	626,494	1,030,248	5,920,603	7,629,346	678,495	11.24	2.52
Arecibo	3,927,745	5,151,745	16,980,705	26,061,423	3,928,973	6.63	2.31
Arroyo	278,334	217,673	4,994,940	5,507,602	294,989	18.67	1.74
Barceloneta	2,145,059	3,118,734	9,184,838	14,069,877	1,766,305	7.97	2.77
Barranquitas	311,477	1,284,796	6,203,261	7,751,785	263,728	29.39	5.87
Bayamón	16,246,321	12,653,932	63,528,458	92,983,394	16,801,004	5.53	1.75
Cabo Rojo	1,701,719	1,309,588	9,391,122	12,601,200	1,900,490	6.63	1.69
Caguas	13,292,033	12,501,610	46,813,726	68,385,918	9,070,581	7.54	2.38
Camuy	383,228	384,372	5,982,028	6,771,912	405,511	16.70	1.95
Canóvanas	1,504,058	2,195,438	8,821,712	12,375,188	1,358,037	9.11	2.62
Carolina	19,447,109	28,237,274	67,430,852	113,694,109	18,025,983	6.31	2.57
Cataño	6,048,896	18,781,792	22,964,161	47,027,221	5,281,268	8.90	4.56
Cayey	3,030,948	2,579,066	11,353,098	17,122,466	3,190,302	5.37	1.81
Ceiba	272,418	174,620	4,668,900	5,140,209	296,689	17.33	1.59
Ciales	218,345	242,002	4,548,503	4,997,972	207,467	24.09	2.17
Cidra	1,177,784	409,299	7,354,926	9,048,180	1,283,955	7.05	1.32
Coamo	636,207	818,617	6,507,595	7,926,017	599,806	13.21	2.36
Comerio	130,345	895,401	5,892,781	6,947,486	159,304	43.61	6.62
Corozal	287,479	1,086,430	6,226,480	7,652,590	339,680	22.53	4.20
Culebra	76,676	158,349	2,080,734	2,295,269	56,186	40.85	3.82
Dorado	2,493,696	2,628,301	10,108,333	15,701,493	2,964,858	5.30	1.89
Fajardo	2,112,489	3,698,603	10,769,480	16,065,501	1,597,418	10.06	3.32
Florida	121,582	22,928	4,349,821	4,507,707	134,959	33.40	1.17
Guánica	244,684	269,971	4,962,155	5,440,610	208,483	26.10	2.29
Guayama	1,877,343	3,358,441	9,005,792	14,704,868	2,340,636	6.28	2.43
Guayanilla	509,797	1,137,886	5,136,361	6,866,409	592,163	11.60	2.92
Guaynabo	16,493,220	11,425,655	58,449,781	82,909,528	13,034,093	6.36	1.88
Gurabo	1,111,490	2,244,863	7,328,297	10,198,405	625,244	16.31	4.59
Hatillo	1,655,677	1,900,916	9,023,746	12,068,912	1,144,250	10.55	2.66
Hormigueros	990,755	1,205,801	5,705,978	7,664,128	752,350	10.19	2.60
Humacao	3,835,015	6,072,240	16,107,102	25,139,565	2,960,223	8.49	3.05
Isabela	1,196,954	1,136,330	8,058,809	10,221,120	1,025,981	9.96	2.11
Jayuya	275,472	188,004	4,711,395	5,224,777	325,378	16.06	1.58
Juana Díaz	1,117,004	1,453,275	7,622,736	10,198,587	1,122,576	9.08	2.29
Juncos	1,486,801	1,411,648	8,467,161	11,002,272	1,123,464	9.79	2.26
Lajas	508,814	734,430	5,514,458	6,927,461	678,573	10.21	2.08
Lares	351,110	42,095	6,177,068	6,654,862	435,699	15.27	1.10
Las Marías	103,128	89,287	4,211,358	4,436,751	136,107	32.60	1.66
Las Piedras	1,236,999	1,251,048	6,757,477	9,329,499	1,320,974	7.06	1.95
Loíza	296,190	1,223,815	6,227,823	7,825,331	373,693	20.94	4.27
Luquillo	805,413	1,389,444	5,780,253	7,767,064	597,367	13.00	3.33
Manatí	2,131,877	1,867,888	11,371,883	15,791,889	2,552,119	6.19	1.73
Maricao	99,803	119,803	3,564,335	3,773,295	89,156	42.32	2.34
Maunabo	69,469	80,554	4,618,169	4,789,015	90,293	53.04	1.89
Mayagüez	5,399,061	7,557,108	26,247,980	40,333,788	6,528,701	6.18	2.16
Moca	483,516	479,303	6,178,103	7,153,987	496,582	14.41	1.97
Morovis	311,935	449,149	6,038,620	6,717,815	230,046	29.20	2.95
Naguabo	390,493	484,198	5,137,319	6,211,644	590,127	10.53	1.82
Naranjito	264,711	600,319	6,383,072	7,252,320	268,929	26.97	3.23
Orocovis	183,990	471,449	6,148,288	6,776,356	156,619	43.27	4.01
Patillas	311,445	794,461	5,110,919	6,320,098	414,718	15.24	2.92
Peñuelas	1,162,104	2,214,245	6,848,462	9,853,279	790,572	12.46	3.80
Ponce	9,046,268	11,137,265	41,532,612	62,101,062	9,431,186	6.58	2.18
Quebradillas	420,773	551,727	5,414,806	6,315,018	348,485	18.12	2.58
Rincón	423,019	285,686	4,862,072	5,525,064	377,306	14.64	1.76
Río Grande	1,651,575	6,662,508	9,031,027	17,119,546	1,426,012	12.01	5.67

**Fiscal Year Ended June 30, 2005**

Municipality	A Special Add'l Tax Collections	B Municipality's Redemption Fund	C Matching Fund	D=(B+C+E) Available for the Payment of G.O. Debt	E Debt Service Payments on G.O. Debt	Debt Service Coverage Ratio based on	
						F = D/E Available for The Payment of G.O. Debt	G = (B+E)/E Redemption Fund
		1	2	3	4	5	6
Sabana Grande	358,256	413,677	5,364,208	6,230,899	453,014	13.75	1.91
Salinas	592,989	1,052,291	6,008,664	7,673,212	612,257	12.53	2.72
San Germán	1,072,402	1,981,978	7,197,916	10,405,995	1,226,102	8.49	2.62
San Juan	47,545,443	20,685,090	189,333,747	256,491,624	46,472,787	5.52	1.45
San Lorenzo	907,989	895,375	7,287,955	9,074,505	891,175	10.18	2.00
San Sebastián	904,408	1,457,705	7,324,994	9,661,980	879,281	10.99	2.66
Santa Isabel	536,770	902,415	4,849,876	6,134,061	381,770	16.07	3.36
Toa Alta	1,188,765	839,326	8,182,941	10,265,882	1,243,615	8.25	1.67
Toa Baja	5,863,594	6,247,875	22,056,993	33,596,669	5,291,801	6.35	2.18
Trujillo Alto	2,176,478	2,578,266	12,320,015	17,287,300	2,389,020	7.24	2.08
Utuado	484,873	695,524	6,650,016	7,892,233	546,693	14.44	2.27
Vega Alta	1,422,390	3,713,867	7,929,478	12,451,153	807,809	15.41	5.60
Vega Baja	2,386,878	1,440,619	11,015,661	15,375,995	2,919,715	5.27	1.49
Vieques	210,956	387,204	3,835,445	4,397,239	174,590	25.19	3.22
Villalba	337,261	357,552	6,030,688	6,698,154	309,915	21.61	2.15
Yabucoa	807,825	1,220,437	6,709,273	8,597,405	667,695	12.88	2.83
Yauco	<u>1,102,555</u>	<u>795,992</u>	<u>7,617,489</u>	<u>9,824,276</u>	<u>1,410,795</u>	<u>6.96</u>	<u>1.56</u>
TOTAL	<u>\$205,685,583</u>	<u>\$220,655,093</u>	<u>\$1,026,306,254</u>	<u>\$1,441,819,483</u>	<u>\$194,858,136</u>	<u>7.40</u>	<u>2.13</u>

- (1) Funds on deposit or to be deposited in the Redemption Fund for the fiscal year ended June 30, 2005 after payment of general obligation debt due on January 1 and July 1, 2005.
- (2) Funds deposited in the Matching Fund during fiscal year ended June 30, 2005. Does not include moneys from the Redemption Fund.
- (3) Represents the sum of funds available in the Redemption Fund and Matching Fund during fiscal year 2005 for the payment of general obligation debt of the Municipalities.
- (4) Represents debt service payments due on each Municipality's general obligation debt on January 1, and July 1, 2005.
- (5) Debt service coverage ratio based on the amount of funds available in the Redemption Fund and the Matching Fund during fiscal year 2005 for the payment of general obligation debt of each Municipality.
- (6) Debt service coverage ratio based on the amount of funds available in the Redemption Fund during the fiscal year 2005 for the payment of general obligation debt of each Municipality.

Source: CRIM and GDB

## THE MUNICIPAL BONDS

The proceeds from the issuance and sale of the 2005 Series A Bonds will be used by the 2005 Trustee to purchase the 2005 Municipal Bonds from GDB. Upon the refunding of the 1997 Refunded Bonds, the 1997 Municipal Bonds will continue to be pledged by the Agency as security for the 1997 Indenture Bonds, including the 2005 Series B Refunding Bonds. Upon the refunding of the 1999 Refunded Bonds, the 1999 Municipal Bonds will continue to be pledged by the Agency as security for the 1999 Indenture Bonds, including the 2005 Series C Refunding Bonds. The Municipal Bonds listed below may include more than one issue of a Municipal Issuer.

	2005 Municipal Bonds to be Purchased				1997 Municipal Bonds				1999 Municipal Bonds			
	Principal Outstanding	Number of Municipal Bonds Outstanding	Final Maturity	% of Total Par	Principal Outstanding	Number of Municipal Bonds Outstanding	Final Maturity	% of Total Par	Principal Outstanding	Number of Municipal Bonds Outstanding	Final Maturity	% of Total Par
Adjuntas	\$ 0			0.00%	\$ 185,000	1	2009	0.14%	\$ 0			0.00%
Aguada	1,415,000	2	2028	0.35	0			0.00	4,050,000	4	2021	0.82
Aguadilla	8,255,000	7	2029	2.04	0			0.00	6,705,000	3	2023	1.36
Aguas Buenas	325,000	1	2010	0.08	745,000	1	2020	0.55	0			0.00
Aibonito	1,235,000	3	2030	0.30	845,000	1	2020	0.63	95,000	1	2007	0.02
Añasco	2,150,000	2	2028	0.53	175,000	1	2009	0.13	835,000	1	2009	0.17
Arecibo	390,000	1	2019	0.10	12,010,000	1	2020	8.91	245,000	1	2006	0.05
Arroyo	0			0.00	0			0.00	0			0.00
Barceloneta	14,635,000	2	2030	3.61	0			0.00	6,655,000	5	2022	1.35
Barranquitas	1,405,000	3	2029	0.35	0			0.00	400,000	1	2019	0.08
Bayamón	53,236,000	8	2030	13.12	4,715,000	1	2014	3.50	34,415,000	7	2023	6.96
Cabo Rojo	3,020,000	6	2030	0.75	2,240,000	5	2016	1.66	1,685,000	3	2023	0.34
Caguas	13,365,000	5	2029	3.30	10,915,000	1	2015	8.10	22,235,000	3	2016	4.50
Camuy	800,000	1	2012	0.20	215,000	2	2015	0.16	0			0.00
Canóvanas	4,230,000	2	2019	1.04	935,000	1	2009	0.69	255,000	1	2006	0.05
Carolina	0			0.00	20,330,000	2	2019	15.09	25,190,000	6	2022	5.10
Cataño	11,965,000	3	2024	2.95	0			0.00	25,320,000	2	2022	5.12
Cayey	11,035,000	27	2030	2.72	0			0.00	5,385,000	5	2022	1.09
Ceiba	200,000	1	2026	0.05	0			0.00	0			0.00
Ciales	50,000	1	2009	0.01	20,000	1	2006	0.01	0			0.00
Cidra	1,705,000	3	2029	0.42	0			0.00	885,000	3	2021	0.18
Coamo	0			0.00	160,000	1	2014	0.12	1,395,000	4	2017	0.28
Comerio	475,000	1	2027	0.12	0			0.00	0			0.00
Corozal	2,320,000	3	2029	0.57	0			0.00	0			0.00
Culebra	195,000	1	2011	0.05	0			0.00	0			0.00
Dorado	12,990,000	9	2023	3.20	1,845,000	1	2014	1.37	4,795,000	6	2013	0.97
Fajardo	0			0.00	0			0.00	9,355,000	3	2019	1.89
Florida	50,000	1	2010	0.01	0			0.00	0			0.00
Guánica	1,310,000	1	2025	0.32	815,000	1	2016	0.60	0			0.00
Guayama	11,295,000	6	2029	2.79	4,160,000	1	2020	3.09	1,840,000	1	2009	0.37
Guayanilla	3,600,000	5	2028	0.89	0			0.00	80,000	1	2008	0.02
Guaynabo	28,870,000	7	2029	7.12	21,755,000	1	2021	16.15	49,930,000	6	2023	10.10
Gurabo	0			0.00	0			0.00	0			0.00
Hatillo	1,595,000	2	2012	0.39	0			0.00	6,250,000	3	2023	1.26
Hormigueros	2,755,000	3	2030	0.68	320,000	1	2020	0.24	155,000	2	2021	0.03
Humacao	7,105,000	3	2030	1.75	1,065,000	2	2013	0.79	7,690,000	2	2018	1.56
Isabela	250,000	1	2029	0.06	0			0.00	0			0.00
Jayuya	95,000	1	2009	0.02	0			0.00	430,000	1	2022	0.09
Juana Díaz	3,020,000	3	2028	0.75	1,425,000	2	2016	1.06	2,330,000	2	2019	0.47
Juncos	3,765,000	5	2028	0.93	0			0.00	0			0.00
Lajas	0			0.00	260,000	1	2013	0.19	135,000	1	2008	0.03
Lares	0			0.00	0			0.00	1,135,000	2	2022	0.23
Las Marías	0			0.00	0			0.00	0			0.00
Las Piedras	2,250,000	4	2028	0.56	3,315,000	1	2014	2.46	415,000	2	2008	0.08
Loíza	580,000	3	2028	0.14	0			0.00	0			0.00
Luquillo	4,875,000	2	2027	1.20	0			0.00	0			0.00
Manatí	8,100,000	10	2030	2.00	200,000	1	2014	0.15	4,410,000	4	2022	0.89
Maricao	0			0.00	0			0.00	0			0.00
Maunabo	0			0.00	0			0.00	0			0.00
Mayagüez	12,755,000	3	2028	3.14	2,635,000	4	2019	1.96	8,690,000	5	2021	1.76
Moca	795,000	2	2027	0.20	2,110,000	1	2017	1.57	0			0.00
Morovis	2,010,000	1	2027	0.50	0			0.00	0			0.00
Naguabo	270,000	1	2027	0.07	0			0.00	135,000	2	2007	0.03
Naranjito	595,000	1	2010	0.15	0			0.00	0			0.00
Orocovis	385,000	1	2011	0.10	0			0.00	0			0.00
Patillas	640,000	3	2011	0.16	0			0.00	0			0.00
Peñuelas	6,995,000	4	2030	1.72	0			0.00	0			0.00
Ponce	0			0.00	0			0.00	10,255,000	4	2013	2.07
Quebradillas	0			0.00	0			0.00	0			0.00
Rincón	895,000	2	2012	0.22	0			0.00	0			0.00
Río Grande	0			0.00	2,220,000	2	2020	1.65	220,000	1	2012	0.04
Sabana Grande	1,235,000	1	2027	0.30	260,000	1	2021	0.19	295,000	3	2024	0.06

	2005 Municipal Bonds to be Purchased				1997 Municipal Bonds				1999 Municipal Bonds			
	Principal Outstanding	Number of Municipal Bonds Outstanding	Final Maturity	% of Total Par	Principal Outstanding	Number of Municipal Bonds Outstanding	Final Maturity	% of Total Par	Principal Outstanding	Number of Municipal Bonds Outstanding	Final Maturity	% of Total Par
Salinas	1,420,000	1	2027	0.35	0			0.00	0			0.00
San Germán	2,440,000	3	2028	0.60	2,400,000	1	2015	1.78	0			0.00
San Juan	90,325,000	8	2028	22.27	16,080,000	3	2011	11.93	206,860,000	6	2019	41.85
San Lorenzo	7,715,000	4	2030	1.90	0			0.00	1,855,000	3	2021	0.38
San Sebastián	1,820,000	2	2019	0.45	3,125,000	2	2016	2.32	1,550,000	1	2021	0.31
Santa Isabel	45,000	1	2010	0.01	515,000	1	2020	0.38	165,000	1	2022	0.03
Toa Alta	1,175,000	2	2012	0.29	1,235,000	3	2020	0.92	2,005,000	4	2022	0.41
Toa Baja	20,545,000	4	2027	5.07	2,990,000	2	2020	2.22	17,365,000	6	2020	3.51
Trujillo Alto	10,820,000	5	2030	2.67	0			0.00	11,625,000	2	2022	2.35
Utua	1,025,000	1	2028	0.25	590,000	2	2019	0.44	0			0.00
Vega Alta	3,310,000	2	2028	0.82	3,530,000	2	2020	2.62	515,000	1	2021	0.10
Vega Baja	5,105,000	6	2030	1.26	3,930,000	1	2012	2.92	7,390,000	4	2022	1.50
Vieques	525,000	1	2011	0.13	0			0.00	625,000	1	2023	0.13
Villalba	745,000	3	2029	0.18	0			0.00	0			0.00
Yabucoa	2,645,000	8	2030	0.65	1,325,000	1	2014	0.98	60,000	1	2006	0.01
Yauco	4,490,000	9	2028	1.11	3,140,000	1	2015	2.33	0			0.00
	<u>\$405,636,000</u>	<u>229</u>		<u>100.00%</u>	<u>\$134,735,000</u>	<u>58</u>		<u>100.00%</u>	<u>\$494,310,000</u>	<u>131</u>		<u>100.00%</u>

## BOND INSURANCE

### The FSA Bond Insurance Policy

The following information has been furnished by FSA for use in this Official Statement. Reference is made to *Appendix G* for a specimen of the FSA Insurance Policy. Concurrently with the issuance of the Bonds, FSA will issue the FSA Insurance Policy for the FSA Insured Bonds. The FSA Insurance Policy guarantees the scheduled payment of principal of and interest on the FSA Insured Bonds when due as set forth in the form of the FSA Insurance Policy included as *Appendix G* to this Official Statement.

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

*General.* 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 September 30, 2005, FSA’s combined policyholders’ surplus and contingency reserves were approximately \$2,451,658,000 and its total net unearned premium reserve was approximately \$1,773,571,000 in accordance with statutory accounting principles. At September 30, 2005, FSA’s consolidated shareholder’s equity was approximately \$2,867,978,000 and its total net unearned premium reserve was approximately \$1,448,209,000 in accordance with generally accepted accounting principles.

The financial statements of FSA included as exhibits to the annual, quarterly and current reports filed by Holdings with the SEC 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 FSA Insured Bonds. Copies of materials incorporated by reference will be provided upon request to Financial Security Assurance Inc., 31 West 52nd Street, New York, New York 10019, Attention: Communications Department (telephone (212) 826-0100).

The FSA Insurance Policy does not protect investors against changes in the market values of the FSA Insured Bonds, which market values 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 FSA Insured Bonds or the advisability of investing in the FSA 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 Agency the information presented under this caption for inclusion in this Official Statement.

### The CIFG Bond Insurance Policy

The following information has been furnished by CIFG for use in this Official Statement. Reference is made to *Appendix H* for a specimen of the CIFG Insurance Policy. Concurrently with the issuance of the Bonds, CIFG will issue the CIFG Insurance Policy for the CIFG Insured Bonds. The CIFG Insurance Policy guarantees the scheduled payment of principal of and interest on the CIFG Insured Bonds when due as set forth in the form of the CIFG Insurance Policy included as *Appendix H* to this Official Statement.

*General.* CIFG is a monoline, financial guaranty, insurance company incorporated under the laws of the State of New York. The address of the principal executive offices of CIFG is 825 Third Avenue, Sixth Floor, New York, New York 10022, its toll-free telephone number is (866) CIFG-212, and its general telephone number is (212) 909-3939.

CIFG is a member of the CIFG Group of financial guaranty companies, which also includes CIFG Europe, a French insurance company licensed to do business in the European Union, and CIFG Guaranty, a dedicated French reinsurance corporation. In addition to its capital and surplus as set forth below, CIFG is supported by a net worth maintenance agreement from CIFG Guaranty, which agreement provides that CIFG Guaranty will maintain CIFG's New York statutory capital and surplus at no less than \$80 million, and may cede a substantial portion (not to exceed 90%) of its exposure on each transaction to CIFG Guaranty through a facultative reinsurance agreement.

Each of CIFG, CIFG Europe and CIFG Guaranty has received an insurer financial strength rating of "AAA" from Fitch, Inc., an insurer financial strength rating of "Aaa" from Moody's, and an insurer financial enhancement rating of "AAA" from S&P, the highest rating assigned by each rating agency. Each such rating should be evaluated independently. The ratings reflect the respective rating agency's current assessment of each company's capacity to pay claims on a timely basis and are not recommendations to buy, sell or hold the CIFG Insured Bonds. Such ratings may be subject to revision or withdrawal at any time.

CIFG is licensed and subject to regulation as a financial guaranty insurance corporation under the laws of the State of New York, its state of domicile, and is licensed to do business in 44 jurisdictions, including the Commonwealth. CIFG is subject to Article 69 of the New York Insurance Law which, among other things, limits the business of such insurers to financial guaranty insurance and related lines, requires that such insurers maintain a minimum surplus to policyholders, establishes contingency, loss and unearned premium reserve requirements for such insurers, and limits the size of individual transactions and the volume of transactions that may be underwritten by such insurers. Other provisions of the New York Insurance Law applicable to non-life insurance companies such as CIFG regulate, among other things, permitted investments, payment of dividends, transactions with affiliates, mergers, consolidations, acquisitions or sales of assets and incurrence of liabilities for borrowings.

*Capitalization.* The following tables set forth the capitalization of CIFG on the basis of accounting principles generally accepted in the United States ("US GAAP") and statutory accounting practices prescribed or permitted by the New York State Insurance Department, respectively.

	US GAAP December 31, 2004 (in thousands of US dollars)
Total Assets	\$ 246,767
Total Liabilities	117,368
Shareholder's Equity	129,399
	Statutory Accounting Practices December 31, 2004 (in thousands of US dollars)
Admitted Assets	\$ 152,361
Liabilities	38,733
Capital and Surplus	113,628

The following table sets forth the capitalization of CIFG Guaranty on the basis of US GAAP.

	US GAAP December 31, 2004	
	(in thousands of euros)	(in thousands of US dollars) <sup>(1)</sup>
Assets	€ 621,431	\$ 847,632
Liabilities	107,816	147,061
Shareholder's Equity	513,615	700,571

(1) The translation of euros into dollars is presented solely for the convenience of the reader, using the observed exchange rate at December 31, 2004 of \$1.364 to €1.00.



For further information concerning CIFG and CIFG Guaranty, see the audited financial statements of both companies, including the respective notes thereto, prepared in accordance with US GAAP as of December 31, 2004 and 2003 and for each of the three years in the period ended December 31, 2004, and the unaudited interim financial statements of CIFG as of September 30, 2005 and for the nine-month period ended September 30, 2005, which are available on the CIFG Group's website at [www.cifg.com](http://www.cifg.com). Copies of the most recent audited annual and unaudited interim financial statements of CIFG prepared in accordance with accounting principles prescribed or permitted by the New York State Insurance Department, are also available on the website and may be obtained, without charge, upon request to CIFG at its address above, Attention: Finance Department.

Effective February 23, 2005, the Department of Insurance of the State of New York approved the change of CIFG's name to CIFG Assurance North America, Inc. Applications for approval of the name change are being filed with regulators in all other jurisdictions in which CIFG is licensed, including the Commonwealth, and in the event the name change is approved by the Commissioner of Insurance of the Commonwealth prior to the delivery date of the CIFG Insurance Policy, the CIFG Insurance Policy will be issued under CIFG's new name.

### **Certain Rights of the Bond Insurers**

As provided in the 2005 Indenture and in insurance agreements to be entered into by the Agency and the 1997 Trustee and the 1999 Trustee, as applicable, for the benefit of each of CIFG and FSA, concurrently with the delivery of their respective bond insurance policies, as long as CIFG and FSA shall not be in default on their respective obligations under their respective bond insurance policies, CIFG and FSA shall be deemed to be the owners of the Bonds insured by them in lieu of the registered or beneficial owners for purposes of, among other things (1) taking remedial actions under the respective Indentures, as applicable, and (2) the giving of consents to the execution of any supplemental indenture to the Indentures.

### **DEBT SERVICE REQUIREMENTS FOR THE BONDS**

The following table presents debt service requirements for the (i) 2005 Indenture Bonds; (ii) the outstanding 1997 Indenture Bonds, after giving effect to the issuance of the 2005 Series B Refunding Bonds and the defeasance of the 1997 Refunded Bonds; and (iii) the outstanding 1999 Indenture Bonds, after giving effect to the issuance of the 2005 Series C Refunding Bonds and the defeasance of the 1999 Refunded Bonds. Debt service requirements for each fiscal year, as shown in the following table, include principal and interest due on August 1 and February 1 of such fiscal year in the case of the 2005 Indenture Bonds and 1999 Indenture Bonds, and include principal and interest payments due on July 1 and January 1 of such fiscal year in the case of the 1997 Indenture Bonds.

**Puerto Rico Municipal Finance Agency  
Debt Service Requirements**

<b>2005 Indenture Bonds</b>		<b>1999 Indenture Bonds</b>		<b>1997 Indenture Bonds</b>	
	<b>Semi-Annual</b>		<b>Semi-Annual</b>		<b>Semi-Annual</b>
02/01/06	\$	02/01/06	\$ 8,394,246.88	01/01/06	\$ 2,687,087.50
08/01/06	28,395,248.15	08/01/06	74,007,935.98	07/01/06	18,967,935.88
02/01/07	9,648,133.75	02/01/07	13,450,826.88	01/01/07	3,675,955.00
08/01/07	28,508,133.75	08/01/07	62,330,826.88	07/01/07	15,465,955.00
02/01/08	9,308,653.75	02/01/08	12,117,076.88	01/01/08	3,325,675.00
08/01/08	29,028,653.75	08/01/08	55,382,076.88	07/01/08	15,125,675.00
02/01/09	8,835,870.00	02/01/09	10,962,139.38	01/01/09	3,032,058.75
08/01/09	28,560,870.00	08/01/09	51,837,139.38	07/01/09	15,262,058.75
02/01/10	8,360,085.00	02/01/10	9,841,076.88	01/01/10	2,727,598.75
08/01/10	28,480,085.00	08/01/10	46,151,076.88	07/01/10	15,372,598.75
02/01/11	7,868,110.00	02/01/11	8,823,373.75	01/01/11	2,397,130.00
08/01/11	26,458,110.00	08/01/11	48,843,373.75	07/01/11	15,997,130.00
02/01/12	7,419,700.00	02/01/12	7,677,242.50	01/01/12	1,991,890.00
08/01/12	24,479,700.00	08/01/12	49,647,242.50	07/01/12	13,196,890.00
02/01/13	7,011,368.75	02/01/13	6,476,336.25	01/01/13	1,658,545.00
08/01/13	21,466,368.75	08/01/13	57,271,336.25	07/01/13	12,823,545.00
02/01/14	6,675,253.75	02/01/14	5,184,043.75	01/01/14	1,353,667.50
08/01/14	21,900,253.75	08/01/14	36,754,043.75	07/01/14	13,133,667.50
02/01/15	6,309,836.25	02/01/15	4,394,793.75	01/01/15	1,094,342.50
08/01/15	21,804,836.25	08/01/15	35,164,793.75	07/01/15	11,204,342.50
02/01/16	5,999,936.25	02/01/16	3,643,143.75	01/01/16	887,087.50
08/01/16	22,239,936.25	08/01/16	40,468,143.75	07/01/16	7,577,087.50
02/01/17	5,593,936.25	02/01/17	2,722,518.75	01/01/17	711,475.00
08/01/17	22,733,936.25	08/01/17	29,032,518.75	07/01/17	6,966,475.00
02/01/18	5,165,436.25	02/01/18	2,031,881.25	01/01/18	547,281.25
08/01/18	23,160,436.25	08/01/18	25,601,881.25	07/01/18	6,922,281.25
02/01/19	4,715,561.25	02/01/19	1,413,168.75	01/01/19	379,937.50
08/01/19	27,475,561.25	08/01/19	20,213,168.75	07/01/19	7,214,937.50
02/01/20	4,146,561.25	02/01/20	919,668.75	01/01/20	200,518.75
08/01/20	20,341,561.25	08/01/20	11,174,668.75	07/01/20	5,530,518.75
02/01/21	3,745,646.25	02/01/21	650,475.00	01/01/21	64,181.25
08/01/21	19,930,646.25	08/01/21	9,785,475.00	07/01/21	2,509,181.25
02/01/22	3,341,021.25	02/01/22	410,681.25	01/01/22	
08/01/22	20,306,021.25	08/01/22	11,555,681.25	07/01/22	
02/01/23	2,916,896.25	02/01/23	118,125.00	01/01/23	
08/01/23	20,816,896.25	08/01/23	4,618,125.00	07/01/23	
02/01/24	2,447,021.25	02/01/24		01/01/24	
08/01/24	22,247,021.25	08/01/24		07/01/24	
02/01/25	1,927,271.25	02/01/25		01/01/25	
08/01/25	19,807,271.25	08/01/25		07/01/25	
02/01/26	1,464,308.75	02/01/26		01/01/26	
08/01/26	15,694,308.75	08/01/26		07/01/26	
02/01/27	1,108,957.50	02/01/27		01/01/27	
08/01/27	17,608,957.50	08/01/27		07/01/27	
02/01/28	696,911.25	02/01/28		01/01/28	
08/01/28	14,521,911.25	08/01/28		07/01/28	
02/01/29	351,671.25	02/01/29		01/01/29	
08/01/29	8,331,671.25	08/01/29		07/01/29	
02/01/30	152,432.50	02/01/30		01/01/30	
08/01/30	6,257,432.50	08/01/30		07/01/30	
02/01/31		02/01/31		01/01/31	
<b>TOTALS</b>	<b>\$655,766,408.15</b>		<b>\$769,070,327.90</b>		<b>\$210,004,710.88</b>

## RECENT DEVELOPMENTS RELATING TO THE COMMONWEALTH

*This section highlights certain important information about the Commonwealth's current fiscal situation. This summary, however, does not purport to be complete and is qualified in its entirety by reference to the more detailed information and descriptions about the Commonwealth's fiscal situation included in the Commonwealth Financial and Operating Data Report, dated December 1, 2005, attached hereto as Appendix A (the "Commonwealth Report"), which should be read in its entirety.*

### **Recent Developments Relating to the Commonwealth's Fiscal Year 2006 Budget and Efforts to Resolve its Budgetary Structural Imbalance**

In response to General Fund deficits over the last few fiscal years and an anticipated deficit for fiscal year 2006, the Commonwealth has recently taken legislative and executive actions intended to eliminate such deficits through a comprehensive tax and fiscal spending reform. See "Summary and Management's Discussion of General Fund Results – Commonwealth's Budget Structural Imbalance" under *Puerto Rico Taxes, Other Revenues, and Expenditures* in Appendix A. The combination of these actions, designed to increase recurring revenues and control government spending, is intended to eliminate the Commonwealth's structural budget deficit by fiscal year 2008. See "2006 Budget Approval Process" under *Budget of the Commonwealth of Puerto Rico* in Appendix A.

The discussion below provides details as to the actions being taken by the Commonwealth to address its budget imbalance and other fiscal challenges it currently faces.

*House Joint Resolution and the Governor's Executive Order.* On November 21, 2005, as a result of a joint effort by the two principal political parties to address the Commonwealth's structural budget imbalance and its other fiscal difficulties, the Legislative Assembly approved, and the Governor signed, Joint Resolution No. 321 (the "Joint Resolution"). On the same day, the Governor issued an Executive Order implementing the fiscal measures defined in the Joint Resolution (the "Fiscal Reform Executive Order"). The Joint Resolution and the Fiscal Reform Executive Order impose government-wide expenditure controls and set forth the basic principles and parameters that will govern the reform of the Commonwealth's tax system and fiscal policy and practices. The proposed tax reform is aimed at increasing revenues by expanding the tax base through the implementation of a broad-based tax on the retail sale of articles of use and consumption (the "consumption tax").

The Joint Resolution and the Fiscal Reform Executive Order come in the wake of expenditure controls previously implemented during fiscal year 2006 by the Governor, such as a reduction of appointed government positions, a limitation on the creation of new temporary employee positions, a hiring freeze, and a voluntary work week reduction program, as well as limitations on central government vehicle fleets and other expenses. If the proposed tax reform and expenditure controls are successfully implemented, the structural imbalance could be corrected by the end of fiscal year 2008. There is no assurance, however, that the structural imbalance will be corrected by such date.

*Proposed Tax Reform.* Generally, the proposed tax reform will follow three basic principles: (i) broaden the tax base through the implementation of the consumption tax, (ii) reduce individual income tax rates, and (iii) simplify administration of the tax system.

The proposed tax reform will (i) replace the Commonwealth's current excise tax with the consumption tax, (ii) include compensatory income tax credits in order to address any regressive effect the proposed consumption tax may have, (iii) eliminate the marriage penalty, (iv) establish an earned income tax credit, (v) increase the deduction for charitable contributions, (vi) restructure the estate tax system, (vii) provide incentives for investments in technological infrastructure and research and development activities, and (viii) adopt additional measures to foster individual savings.

Legislation with respect to the tax reform proposed by the Joint Resolution was introduced in the House of Representatives with a proposed effective date of July 1, 2006. Although the final structure of the tax reform, including the consumption tax, is under discussion, the Secretary of the Treasury expects that the tax reform will provide a net increase in the General Fund's annual revenues, after taking into consideration projected reductions in income taxes, in an amount sufficient to reduce and eventually eliminate the structural imbalance. See "Summary and Management's Discussion of General Fund Results – Commonwealth's Budget Structural Imbalance" under *Puerto Rico Taxes, Other Revenues, and Expenditures*" in *Appendix A*.

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

The Joint Resolution and the Fiscal Reform Executive Order also set forth guiding principles and parameters and impose certain expenditure controls as part of fiscal reform. The Joint Resolution and the Fiscal Reform Executive Order restrict layoffs of government employees as a means to reduce government expenditures, and impose a hiring freeze in government until the structural budget deficit has been eliminated. Fiscal discipline will be promoted by requiring each central government agency to implement a seven-year expense reduction plan, adopting a new public policy that distinguishes between unnecessary and indispensable expenses, proposing to enact certain limitations on the use of the Budgetary Fund, and providing that the budget may only be balanced through the use of recurring revenues. The proposed fiscal reform also mandates the reduction of advertising and travel expenses, promotes the use of electronic communications and document delivery, caps the purchase price of each government vehicle, and limits other non-payroll expenditures. Furthermore, the Legislative Assembly must approve any borrowings by the Secretary of the Treasury in order to finance any Commonwealth budget deficit with debt securities that are not repaid during the same fiscal year in which they are issued.

In an effort to address other fiscal challenges faced by the Commonwealth, the Joint Resolution and the Fiscal Reform Executive Order promote the adoption of certain measures to alleviate the significant unfunded liabilities of the various government retirement systems. See *Retirement Systems* in *Appendix A*. These measures include the transfer to the two main government retirement systems of Commonwealth assets and additional General Fund contributions from the revenues of the proposed tax reform in excess of the Commonwealth's current expenditures. Furthermore, the Joint Resolution and the Fiscal Reform Executive Order limit the implementation of early retirement programs for government employees by conditioning their implementation on receipt of an opinion from an independent actuary confirming that the retirement systems will not be adversely affected by such early retirement program.

The measures and efforts set forth in the Joint Resolution and the Fiscal Reform Executive Order and the Tax Reform proposal are broad in scope and have been designed to address and correct the Commonwealth's structural imbalance and other fiscal challenges that are described below.

*Fiscal Year 2006 Budget.* On March 16, 2005, the Governor of Puerto Rico, Aníbal Acevedo-Vilá, submitted to the Legislative Assembly of the Commonwealth a proposed balanced budget of revenues and expenditures for fiscal year 2006 providing for General Fund resources and expenditures of \$9.684 billion, representing an increase of \$476 million, or 5.2%, over estimated actual expenditures for fiscal year 2005 estimated at \$9.208 billion. The proposed budget package included several new revenue raising measures sufficient to cover budgeted expenditures, most of which required legislative approval. However, as mentioned below, the Legislative Assembly did not approve the budget proposed by the Governor.

On June 30, 2005, the Legislative Assembly, which is controlled by the principal opposition political party, approved a budget resolution for fiscal year 2006 that provided for General Fund expenditures of \$9.258 billion. Governor Acevedo-Vilá vetoed this budget resolution because the revenue measures contained therein, as estimated by the Secretary of Treasury, were insufficient to cover the budgeted expenditures as required by the Constitution. He did, however, sign into law certain revenue raising measures approved by the Legislative Assembly estimated to generate approximately \$130 million in new revenues. Although the revenue raising measures contained language conditioning their effectiveness on the approval by the Governor of the \$9.258 billion budget resolution, according to the Secretary of Justice, these revenue raising measures are enforceable regardless of such language. Although no legal action has been initiated thus far, no assurance can be given that the effectiveness of such revenue measures will not be challenged.

As a result of the Governor's veto, and in accordance with the Commonwealth's Constitution, the budget for fiscal year 2005 (with certain adjustments) carried over and will continue in effect for fiscal year 2006 unless another budget for fiscal year 2006 is approved by the Legislative Assembly and the Governor. At this time, it is not anticipated that a new budget for fiscal year 2006 will be approved prior to the end of the fiscal year, although it is possible that other appropriations for special purposes may be approved from time to time. For more details about the budget approval process for fiscal year 2006 and the content of the budget, see "2006 Budget Approval Process" under *Budget of the Commonwealth of Puerto Rico* in *Appendix A*.

On August 30, 2005, the Governor adopted Executive Order 2005-58 (the "Budget 2006 Executive Order"), in which he made certain additional adjustments to the budget in order to bring the total expenditures in line with the Secretary of Treasury's estimate of total revenues for fiscal year 2006 of \$8.945 billion, as required by Commonwealth law. These adjustments included, among others, a \$384 million reduction related to a portion of debt service for general obligation bonds due during fiscal year 2006 (the "Excluded Debt Service") which is being paid from a GDB line of credit already in place and may be paid ultimately from the proceeds of a Commonwealth bond issue.

*Projected Budget Deficit for Fiscal Year 2006.* Based on the spending rate experienced during the first two months of fiscal year 2006, total expenditures for the year are currently estimated to reach \$9.319 billion. Without considering any additional revenues, certain additional expenditures currently estimated to total approximately \$311 million (the "Additional Expenditures"), the Excluded Debt Service, or any other expenditures during fiscal year 2006, the difference between the aforementioned spending rate of \$9.319 billion and estimated revenues of \$8.945 billion is \$374 million. The Fiscal Reform Executive Order requires all central government agencies to operate within their assigned budgets for the remainder of fiscal year 2006. Accordingly, agencies must present a report to OMB outlining plans to avoid additional expenditures and finish the year within budget, no later than 30 days after the effectiveness of such Fiscal Reform Executive Order. This action is designed to reduce such difference of \$374 million and other Additional Expenditures. The reports required by the Fiscal Reform Executive Order must also be presented to the speaker of the House, and the President of the Senate, the House Ways and Means Committee and the House Budget Committee, who may determine, based on such reports, whether any additional revenue measures are warranted. In the event expenditures were still to exceed revenues, the Commonwealth estimates it would have available \$221 million from the Emergency Fund, the Budgetary Fund, and other non-recurring resources. For more details about the Additional Expenditures, see "Summary and Management's Discussion of General Fund Results" under *Puerto Rico Taxes, Other Revenues, and Expenditures* and "2006 Budget Approval Process" under *Budget of the Commonwealth of Puerto Rico* in *Appendix A*.

Although the Commonwealth is using its best efforts in order to maximize revenues and reduce expenditures, there is no assurance that revenues will be greater than the budgeted \$8.945 billion or that expenditures will not exceed the anticipated level of \$9.319 billion.

*Commonwealth's Budget Structural Imbalance.* The budget imbalance in fiscal year 2006 comes in the wake of several recent years during which the Commonwealth had insufficient recurring revenues to cover its expenditures. These imbalances have been covered in the past with loans from GDB, financing transactions (including long-term bond issues payable from the General Fund) and other non-recurring resources. During fiscal year 2005, the amount by which the Commonwealth's operating expenditures exceeded its recurring revenues (the so-called structural imbalance) was \$989 million. The Commonwealth estimates that during fiscal year 2006, the structural imbalance will

be reduced to approximately \$858 million. This amount represents the difference between expenditures of \$9.319 billion (at the spending rate of the first two months of fiscal year 2006), plus the Excluded Debt Service (\$384 million), for a total of \$9.703 billion, less recurring revenues of \$8.845 billion (which excludes \$100 million expected to be generated by an interest rate swap transaction). The Commonwealth expects to reduce this imbalance by financing the Excluded Debt Service (\$384 million), withdrawing from reserve funds and utilizing other non-recurring revenues (\$221 million), entering into an interest rate swap transaction (\$100 million), and implementing the Fiscal Reform Executive Order to reduce expenditures. See “2006 Budget Approval Process” under *Budget of the Commonwealth of Puerto Rico* in *Appendix A*. In addition to the Additional Expenditures, estimated amounts required to cover maintenance expenses incurred by Public Buildings Authority (“PBA”) (approximately \$75 million) may further increase the structural imbalance should the Commonwealth have to cover such maintenance expenses for PBA. Such estimated amounts are expected to be covered by a line of credit from GDB to PBA collateralized by real estate properties and accounts receivable, with payment to GDB expected from the sale of such real estate and/or the collection of such receivables pledged to GDB. As discussed above, the Commonwealth has recently taken action to address this budgetary structural imbalance.

*Other Fiscal Challenges.* The Commonwealth faces other fiscal challenges besides its current budgetary issues. The principal one involves resolving the increasing unfunded pension liability of the Employees Retirement System and the Teachers Retirement System. The Commonwealth expects to reduce the unfunded liability of the Employees Retirement System based on proposed legislation which provides for increased employer and employee contributions and the issuance of up to \$2 billion of pension obligation bonds, which would be payable from the Commonwealth’s General Fund. The Employees Retirement System and the Teachers Retirement System are also seeking reimbursement from the Commonwealth for certain special retirement benefits paid by them in prior fiscal years under legislation providing such retirement benefits. Part of these claims by the Teachers Retirement System (\$119 million) is not recognized by OMB as a Commonwealth liability and the difference is currently under inter-agency arbitration. Other claims (\$78 million for fiscal year 2005 and prior years and \$43 million for fiscal year 2006) are under consideration by OMB to determine the final amount that the Commonwealth may owe to the Employees Retirement System. For more details, see *Retirement Systems* in *Appendix A*.

## UNDERWRITING

The Underwriters have jointly and severally agreed, subject to certain conditions, to purchase the Bonds from the Agency at an aggregate discount of \$4,607,937.79 from the initial public offering prices of the Bonds set forth or derived from information set forth on the inside cover page hereof. The obligations of the Underwriters are subject to certain conditions precedent, and under a Purchase Contract with the Agency, the Underwriters will be obligated to purchase all the Bonds, if any Bonds are purchased. The Purchase Contract provides for indemnification of the Underwriters by the Agency, to the extent permitted by law, against certain civil liabilities. The Underwriters may offer to sell the Bonds to certain dealers and others at prices lower than the initial public offering prices (or at yields greater than such yields), and such offering prices (or yields) may be changed, from time to time, by the Underwriters.

Banc of America Securities LLC (“Banc of America Securities”), the senior managing underwriter, had previously entered into a written agreement with Oriental Financial Services Corp. (“Oriental Financial Services”), pursuant to which Oriental Financial Services had agreed to cooperate with Banc of America Securities in connection with Banc of America Securities’ provision of underwriting and investment banking services to the Agency with respect to the Bonds. This agreement has been terminated in accordance with Rule G-38 of the Municipal Securities Rulemaking Board. However, pursuant to this arrangement, the existence of which had been disclosed to the Agency and GDB, and as permitted by Rule G-38, Oriental Financial Services will be entitled to receive a portion of Banc of America Securities’ actual net profits, if any, in connection with the underwriting of the Bonds, for work done prior to the termination of the agreement. Other similar agreements with respect to the sharing of underwriting net profits had been previously entered into and disclosed to the Agency and GDB by the following Underwriters: Morgan Stanley & Co. Incorporated and Popular Securities, Inc.; Goldman, Sachs & Co. and FirstBank Puerto Rico, JP Morgan Securities, Inc. and R-G Investments Corporation; and Lehman Brothers, Inc. and Santander Securities Corporation.

## TAX EXEMPTION

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 the Agency and each Municipal Issuer must continue to meet after the issuance of the Bonds in order that interest on the Bonds is not 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 Agency and each Municipal Issuer have 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 Agency and/or any Municipal Issuer from complying with the requirements of the Code.

In the opinion of Bond Counsel, subject to continuing compliance by the Agency and each Municipal Issuer with the tax covenant and the requirements of the Code each 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 is not an item of tax preference for purposes of the federal alternative minimum tax imposed on individuals and corporations; however, interest on the Bonds will be includable in the computation of the alternative minimum tax on corporations imposed by the Code. No opinion is rendered by Bond Counsel 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 otherwise 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 are exempt from state, Commonwealth and local income taxation.

Ownership of tax-exempt obligations 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 corporations with excess passive income, individual recipients of Social Security or Railroad Retirements 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 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 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.

### **Discount Bonds**

The excess, if any, of the amount payable at maturity of any maturity of the Bonds over the issue price thereof constitutes original issue discount. The amount of original issue discount that has accrued and is properly allocable to an owner of any maturity of the Bonds with original issue discount (a "Discount Bond") will be excluded from gross income for federal income tax purposes to the same extent as interest on the Bonds. In general, the issue price of a maturity of the Bonds is the first price at which a substantial amount of Bonds of that maturity was sold (excluding sales to bond houses, brokers or similar persons or organizations acting in the capacity of underwriters, placement agents, or wholesalers) and the amount of original issue discount accrues in accordance with a constant yield method based on the compounding of interest. A purchaser's adjusted basis in a Discount Bond will be increased by the amount of such accruing discount for purposes of determining taxable gain or loss on the sale, redemption or other disposition of such Discount Bond for federal income tax purposes.

A portion of the original issue discount that accrues in each year to an owner of a Discount Bond that is a corporation will be included in the calculation of the corporation's federal alternative minimum tax liability. In addition, original issue discount that accrues in each year to an owner of a Discount Bond is included in the calculation of the distribution requirements of certain regulated investment companies and may result in some of the collateral federal income tax consequences discussed herein. Consequently, an owner of a Discount Bond should be aware that the accrual of original issue discount in each year may result in an alternative minimum tax liability, additional distribution requirements or other collateral federal income tax consequences although the owner of such Discount Bond has not received cash attributable to such original issue discount in such year.

The accrual of original issue discount and its effect on the redemption, sale or other disposition of any maturity of a Discount Bond that is not purchased in the initial offering at the first price at which a substantial amount of Discount Bonds of that maturity is sold to the public may be determined according to rules that differ from those described above. An owner of a Discount Bond should consult his tax advisor with respect to the determination for federal income tax purposes of the amount of original issue discount with respect to such Discount Bond and with respect to state, Commonwealth and local tax consequences of owning and disposing of such Discount Bond.

### **Premium Bonds**

The excess, if any, of the tax basis of a Bond to a purchaser (other than a purchaser who holds such Bond as inventory, stock in trade, or for sale to customers in the ordinary course of business) who purchases such Bond as part of the initial offering and at the initial offering price as set forth on the inside cover page over the amount payable at maturity of such Bond is "Bond Premium." Bond Premium is amortized over the term of such Bond for federal income tax purposes (or 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 a basis of a call date that results in the lowest yield on such bond). No deduction is allowed for such amortization of Bond Premium; however, United States Treasury regulations provide that Bond Premium is treated as an offset to qualified stated interest received on the Bond. 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 the state, Commonwealth and local tax consequences of owning and disposing of such Bond.

### **LEGAL MATTERS**

The authorization and issuance of the Bonds are subject to the approval of legality by Sidley Austin Brown & Wood LLP, New York, New York, Bond Counsel, whose proposed form of opinions is set forth in *Appendix F* hereto. Certain legal matters will be passed upon for the Underwriters by their counsel, Fiddler González & Rodríguez, P.S.C., San Juan, Puerto Rico.

### **LEGAL INVESTMENT**

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

### **VERIFICATION OF MATHEMATICAL COMPUTATIONS**

Causey Demgen & Moore Inc. will verify from the information provided to them the mathematical accuracy, as of the date of the closing on the 2005 Series B Refunding Bonds and the 2005 Series C Refunding Bonds, of the computations contained in the provided schedules to determine that the anticipated receipts from the securities and cash deposits listed in such schedules, to be held in escrow, will be sufficient to pay, when due, the principal of and interest, and redemption premium, if any, on the 1997 Refunded Bonds and the 1999 Refunded Bonds. Causey Demgen & Moore Inc. will express no opinion on the assumptions provided to them, nor as to the exclusion from gross income of the interest on the Bonds.



## GOVERNMENT DEVELOPMENT BANK FOR PUERTO RICO

As required by Act No. 272 of the Legislature of Puerto Rico, approved May 15, 1945, as amended, GDB has acted as financial advisor to the Agency in connection with the Bonds offered hereby. As financial advisor, GDB participated in the selection of the Underwriters of the Bonds. Certain of the Underwriters have been selected by GDB 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 GDB.

### RATINGS

The Bonds have been assigned ratings of “BBB” (with negative outlook) by S&P, and “Baa2” (with negative outlook) by Moody’s. Moody’s had lowered its rating on the Commonwealth’s outstanding general obligation bonds from “Baa1” to “Baa2” earlier in the year, and simultaneously had lowered its rating on the Agency’s outstanding bonds from “Baa1” to “Baa2.” The S&P rating also reflects a downgrade from the Agency’s previous “BBB+” rating. S&P had also lowered its rating on the Commonwealth’s general obligation bonds earlier in the year, but had not made any change to the Agency’s ratings at that time. See *Debt* in *Appendix A*. Moody’s and S&P are expected to give the Insured Bonds ratings of “Aaa” and “AAA,” respectively, based on the expected issuance by the Bond Insurers of their Insurance Policies.

The ratings reflect only the respective opinions of such rating agencies. Any explanation of the significance of such ratings must be obtained from the respective rating agency. There is no assurance that such ratings will remain in effect for any given period of time or that they will not be revised downward or withdrawn entirely by either or both of such rating agencies if, in the judgment of either or both, circumstances so warrant. Any such downward revision or withdrawal of such rating or ratings 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 SEC:

(a) the Commonwealth has covenanted for the benefit of the Beneficial Owners of the Bonds (generally, the tax owners of the Bonds): (i) to file, within 305 days after the end of each fiscal year of the Commonwealth, commencing with the fiscal year ending June 30, 2005, annual financial statements, prepared in accordance with U.S. generally accepted accounting principles, and operating data generally consistent with the Commonwealth Report and the Commonwealth Annual Financial Report, both of which have been incorporated by reference herein, with each NRMSIR and with any Commonwealth state information depository (“SID”), and (ii) to file, in a timely manner, with each NRMSIR or with the MSRB, and with any Commonwealth SID, notice of a failure by the Commonwealth to provide the financial statements and operating data described in clause (i) on or before the date specified above;

(b) San Juan has covenanted for the benefit of the Beneficial Owners of the 2005 Series A Bonds, the 2005 Series B Refunding Bonds and 2005 Series C Refunding Bonds: (i) to file, within 305 days after the end of each fiscal year of San Juan, commencing with the fiscal year ended June 30, 2005, annual financial statements prepared in accordance with U.S. generally accepted accounting principles and operating data generally containing the information set forth in the San Juan Continuing Disclosure Report, which has been incorporated by reference herein, and the other information included in *Appendix B* to this Official Statement, with each NRMSIR and with any Commonwealth SID, and (ii) to file, in a timely manner, with each NRMSIR or with the MSRB, and with any Commonwealth SID, notice of a failure by San Juan to provide the financial statements and operating data described in clause (i) on or before the date specified above;

(c) Bayamón has covenanted for the benefit of the Beneficial Owners of the 2005 Series A Bonds: (i) to file, within 305 days after the end of each fiscal year of Bayamón, commencing with the fiscal year ended June 30, 2005, annual financial statements prepared in accordance with U.S. generally accepted accounting principles and operating data generally containing the information set forth in the Bayamón Continuing Disclosure Report, which has been incorporated by reference herein, and the other information included in *Appendix B* to this Official Statement, with each NRMSIR and with any Commonwealth SID, and (ii) to file, in a timely manner, with each NRMSIR or with the MSRB, and with any Commonwealth SID, notice of a failure by Bayamón to provide the financial statements and operating data described in clause (i) on or before the date specified above;

(d) Carolina has covenanted for the benefit of the Beneficial Owners of the 2005 Series B Refunding Bonds: (i) to file, within 305 days after the end of each fiscal year of Carolina, commencing with the fiscal year ended June 30, 2005, annual financial statements prepared in accordance with U.S. generally accepted accounting principles and operating data generally containing the information set forth in *Appendix B* to this Official Statement, with each NRMSIR and with any Commonwealth SID, and (ii) to file, in a timely manner, with each NRMSIR or with the MSRB, and with any Commonwealth SID, notice of a failure by Carolina to provide the financial statements and operating data described in clause (i) on or before the date specified above;

(e) Guaynabo has covenanted for the benefit of the Beneficial Owners of the 2005 Series B Refunding Bonds and the 2005 Series C Refunding Bonds: (i) to file, within 305 days after the end of each fiscal year of Guaynabo, commencing with the fiscal year ended June 30, 2005, annual financial statements prepared in accordance with U.S. generally accepted accounting principles and operating data generally containing the information set forth in *Appendix B* to this Official Statement, with each NRMSIR and with any Commonwealth SID, and (ii) to file, in a timely manner, with each NRMSIR or with the MSRB, and with any Commonwealth SID, notice of a failure by Guaynabo to provide the financial statements and operating data described in clause (i) on or before the date specified above; and

(f) the Agency has covenanted for the benefit of the Beneficial Owners of the Bonds:

(i) to file, within 305 days after the end of each fiscal year, commencing with the fiscal year ending June 30, 2005, with each NRMSIR and with any Commonwealth SID, a report setting forth with respect to such fiscal year the following information: (1) the amount of all deposits to the credit of, and the amount of the withdrawals from, each fund or account created under the provisions of each Indenture; (2) a brief description of the Bonds issued, paid, purchased or redeemed under each Indenture during such fiscal year and the outstanding principal amount of the Bonds under each Indenture; (3) a brief description of the Municipal Bonds held by the applicable Trustee under each Indenture and the outstanding principal amount of the Municipal Bonds so held; and (4) a balance sheet as of the end of such fiscal year for each fund or account created under the provisions of each Indenture, which balance sheet shall set forth the amount held for the credit of each such fund or account at the end of such fiscal year;

(ii) to file, within 305 days after the end of each fiscal year, commencing with the fiscal year ending June 30, 2005, with each NRMSIR and with any Commonwealth SID, a report updating the information contained in the tables found on pages 22 through 25 of this Official Statement;

(iii) to file with each NRMSIR and with any Commonwealth SID, within 305 days after the end of each fiscal year commencing with the fiscal year ending June 30, 2005, in the event that at the end of any such fiscal year Municipal Bonds issued by any Municipal Issuer (other than San Juan, Bayamón, Carolina and Guaynabo) come to represent ten percent (10%) or more of the aggregate outstanding principal amount of the Municipal Bonds under any of the Indentures, annual financial statements for such Municipal Issuer, prepared in accordance with U.S. generally accepted accounting principles, for the most recently ended fiscal year of such Municipal Issuer and each fiscal year thereafter until such time that at the end of any such fiscal year Municipal Bonds issued by such Municipal Issuer come to represent less than ten percent (10%) of the aggregate outstanding principal amount of the Municipal Bonds under such Indenture;

(iv) to file, in a timely manner, with each NRMSIR or with the MSRB, and with any Commonwealth SID, notice of a failure by the Agency to provide any of the information required in clauses (i), (ii) or (iii) on or before the date specified above; and

(v) to file, in a timely manner, with each NRMSIR or with the MSRB, and with any Commonwealth SID, notice 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.

With respect to the following events:

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

Event f. For information on the tax status of the Bonds, see “TAX EXEMPTION” above.

Event h. The Agency does not undertake to provide 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” above, 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 the respective Indenture, and public notice of 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.

As of the date of this official statement, there was no Commonwealth SID, and the name and address of each NRMSIR is: Bloomberg Municipal Repository, 100 Business Park Drive, Skillman, New Jersey 08558; Standard & Poor’s Securities Evaluations Inc., 55 Water Street, 45<sup>th</sup> Floor, New York, New York 10041; FT Interactive Data, Attn.: NRMSIR, 100 William Street, 15<sup>th</sup> Floor, New York, New York 10038; and DPC Data Inc., One Executive Drive, Fort Lee, New Jersey 07024.

The Commonwealth expects to provide the information described in (a)(i) above by delivering the first bond official statement of the Commonwealth or of any instrumentality of the Commonwealth that includes its financial statements for the preceding fiscal year and operating data generally containing the information set forth in the Commonwealth Report or, if no official statement is issued by the 305-day deadline, by delivering such report and the Commonwealth Annual Financial Report by such deadline.

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

to the implementation of GASB 34. The Commonwealth's audited financial statements for the fiscal year ended June 30, 2004 were also filed after the Commonwealth's filing deadline of May 1, 2005, because various governmental agencies did not submit their audited financial statements to the central government's external auditors on time, thereby delaying the submission of the Commonwealth's audited financial statements.

The Agency 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 Agency, such other events are material and with respect to the Bonds, but the Agency does not undertake to provide any such notice of the occurrence of any material event except those listed above.

The Commonwealth, San Juan, Bayamón, Carolina, Guaynabo and the Agency acknowledge that their undertakings described above are intended to be for the benefit of the Beneficial Owners of the applicable series of Bonds, and shall be enforceable by any such Beneficial Owner, provided that the right to enforce the provisions of their respective undertakings shall be limited to a right to obtain specific performance of such provisions.

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, San Juan, Bayamón, Carolina, Guaynabo or the Agency, as applicable, written notice of any request to cure such breach, and the Commonwealth, San Juan, Bayamón, Carolina, Guaynabo or the Agency, as the case may be, shall have refused to comply within a reasonable time. All proceedings shall be instituted only in a Commonwealth court located in the Municipality of San Juan, for the equal benefit of all Beneficial Owners of the outstanding Bonds benefited by the Covenants, and no remedy shall be sought or granted other than specific performance of the Covenant at issue. Moreover, Proceedings filed by Beneficial Owners against the Commonwealth are subject to the sovereign immunity provisions of Section 2 of Act No. 104, approved June 19, 1955, as amended (32 L.P.R.A. §§ 3077 and 3077a), which governs the scope of legal actions 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, San Juan, Bayamón, Carolina, Guaynabo or the Agency, as the case may be, 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 parties unaffiliated with the Commonwealth, San Juan, Bayamón, Carolina, Guaynabo or the Agency, as the case may be; 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, San Juan, Bayamón, Carolina, Guaynabo or the Agency, as the case may be, elects that the Covenants shall be deemed amended accordingly.

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

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

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



**COMMONWEALTH OF PUERTO RICO**  
**Financial Information and Operating Data Report**  
**December 1, 2005**

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# COMMONWEALTH OF PUERTO RICO

## Financial Information and Operating Data Report December 1, 2005

### INTRODUCTION

#### Geographic Location and Demography

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

According to the United States Census Bureau, the population of Puerto Rico was 3,808,610 in 2000 (3,911,299 in 2005 according to a Census Bureau estimate), compared to 3,522,000 in 1990. As of 2000, the population of San Juan, the island's capital and largest city, was 434,375.

#### Relationship with the United States

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

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

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

The official languages of Puerto Rico are Spanish and English.

#### Governmental Structure

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

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

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

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

Ileana F. Fas Pacheco, Director of the Office of Management and Budget ("OMB"), took office in January 2005. She is a graduate of the University of Puerto Rico, where she obtained a Bachelor's degree in Science with a major in Electrical Engineering. She obtained a Master's degree in Business Administration in International Management from Thunderbird, the American Graduate School of International Management. From 2001 until assuming her current position, she worked in the public sector as Special Assistant to the Puerto Rico Secretary of State, legislative assistant to the Resident Commissioner, and Director of the Office of Federal Affairs of the Puerto Rico Department of Education. Prior to 2001, she worked as an electrical engineer at an electronics company.

Alfredo Salazar Conde became Acting President of Government Development Bank for Puerto Rico ("GDB") effective on August 19, 2005. Mr. Salazar is a private investor with over 30 years of experience in commercial banking. Mr. Salazar served as President of GDB from 1975 to 1976 and as Executive Director of Puerto Rico Industrial Development Company during 1990. Mr. Salazar has a Bachelor's degree in economics from Villanova University and pursued post graduate studies in finance at New York University and Harvard Business School.

## Political Trends

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

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

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



	<u>Senate</u>	<u>House</u>
Popular Democratic Party	9	18
New Progressive Party	17	32
Puerto Rico Independence Party	1	1
	<u>27</u>	<u>51</u>

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

## THE ECONOMY

### General

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

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

Personal income, both aggregate and per capita, has increased consistently each fiscal year from 1985 to 2004. In fiscal year 2004, aggregate personal income was \$46.8 billion (\$43.8 billion in 2000 prices) and personal income per capita was \$12,031 (\$11,260 in 2000 prices).<sup>\*</sup> 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 2004 were \$9.7 billion, of which \$7.5 billion, or 77%, represented entitlements to individuals who had previously performed services or made contributions to programs such as Social Security, Veterans' Benefits, Medicare, and U.S. Civil Service retirement pensions.

Total average annual employment (as measured by the Department of Labor and Human Resources Household Employment Survey) has also increased. From fiscal year 2000 to fiscal year 2005, annual employment increased from 1,150,291 to 1,237,593, an increase of 7.6%.

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 to manufacturing in contribution to the gross domestic product and leads all sectors in providing employment.

The following table shows the gross national product for the five fiscal years ended June 30, 2004.

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

**Commonwealth of Puerto Rico  
Gross National Product**

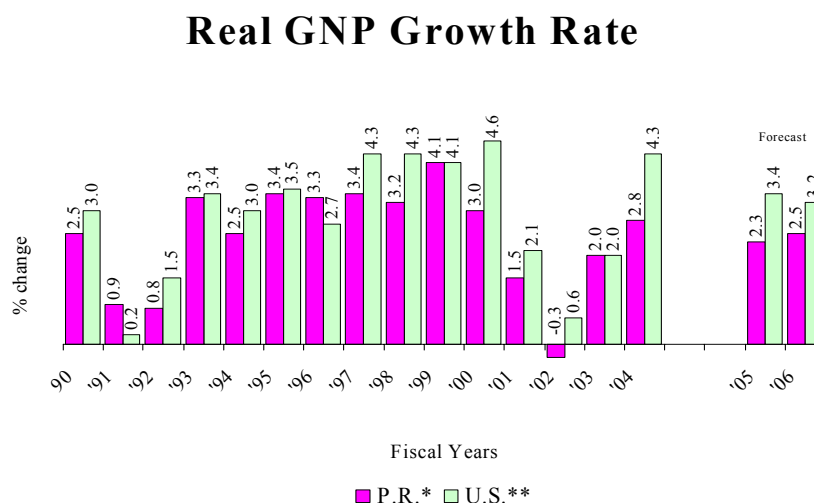
	<b>Fiscal Years Ended June 30</b>				
	<b>2000</b>	<b>2001</b>	<b>2002</b>	<b>2003</b>	<b>2004<sup>(1)</sup></b>
Gross national product - \$ millions <sup>(2)</sup>	\$41,419	\$44,047	\$45,071	\$47,439	\$50,320
Real gross national product - \$ millions (2000 prices)	41,419	42,044	41,901	42,756	43,937
Annual percentage increase in real gross national product (2000 prices)	3.0%	1.5%	(0.3%)	2.0%	2.8%
U.S. annual percentage increase in real gross national product (2000 prices)	4.6%	2.1%	0.7%	2.3%	4.6%

- (1) Preliminary. Puerto Rico Planning Board expects to certify these numbers by February 2006. Fiscal year 2004 data are the most recent available statistics.
- (2) In current dollars.

Sources: Puerto Rico Planning Board and Global Insight Inc.

The economy of Puerto Rico is closely linked to the United States economy. During fiscal year 2004 (from July 1, 2003 to June 30, 2004) approximately 82% of Puerto Rico's exports went to the United States mainland, which was also the source of approximately 45% of Puerto Rico's imports. 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 have also been reflected in the Puerto Rico economy, although to a lesser degree.

The following graph compares the growth rate of real gross national product for the Puerto Rico and United States economies since fiscal year 1990, and the forecast of the growth rate for fiscal years 2005 and 2006.



\* Puerto Rico Planning Board

\*\* Global Insight 11/05.

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 2004 are preliminary until the revised figures are released.

#### *Forecast for Fiscal Year 2006*

The Planning Board’s current real gross national product forecast for fiscal year 2006, released in February 2005, projects an increase of 2.5%. The most important short-term factors that could have an adverse effect on the economy include the persistent high level of oil prices, the upward trend in short-term interest rates, the depreciation of the United States dollar, which affects the value of imports to Puerto Rico, and the possibility of a deceleration of public investment due to the Commonwealth’s fiscal difficulties, which could reduce activity in construction and other sectors. The continued upward trend of interest rates may also contribute to a possible economic slowdown in general. The increase in oil prices coupled with other price increases, also serve to reduce disposable income and, therefore, overall economic activity. The Commonwealth is dependent on oil for approximately 70% of its power generation. Therefore, the increases in oil prices are expected to negatively affect the Commonwealth’s economy. On the other hand, it is expected that the implementation of the tax reform will positively affect economic activity of the Commonwealth. Although the current administration is working to maintain public investment, no assurance can be given that the Commonwealth will succeed in these efforts. For a discussion of the Commonwealth’s fiscal difficulties, see “Fiscal Year 2005 Budget,” and Budget for Fiscal Year 2006” under *Budget of the Commonwealth of Puerto Rico*.

#### *Fiscal Year 2005*

According to the Department of Labor and Human Resources Household Employment Survey (the “Household Survey”), total employment for fiscal year 2005 averaged 1,237,600, an increase of 2.7% compared to 1,205,600 for fiscal year 2004. The unemployment rate for fiscal year 2005 was 10.6%, a decrease from 11.4% for fiscal year 2004. As in the past, the economy of Puerto Rico followed the performance of the United States economy.

The Planning Board’s current real gross national product forecast for fiscal year 2005, released in February 2005, projected an increase of 2.3%. The major short-term factors that could have an adverse effect on the economy of Puerto Rico include the persistent high level of oil prices, the continued upward trend in short-term interest rates, and the devaluation of the United States dollar, which affects the value of imports to Puerto Rico.

#### *Fiscal Year 2004*

The Planning Board’s preliminary reports of the performance of the Puerto Rico economy during fiscal year 2004 indicate that the economy registered an increase of 2.8% in real gross national product. Nominal gross national product was \$50.3 billion in fiscal year 2004 (\$43.9 billion in 2000 prices), compared to \$47.4 billion in fiscal year 2003 (\$42.8 billion in 2000 prices). This represents an increase in nominal gross national product of 6.1%. Aggregate personal income increased from \$44.7 billion in fiscal year 2003 (\$42.4 billion in 2000 prices), to \$46.8 billion in fiscal year 2004 (\$43.8 billion in 2000 prices), and personal income per capita increased from \$11,566 in fiscal year 2003 (\$10,962 in 2000 prices), to \$12,031 in fiscal year 2004 (\$11,260 in 2000 prices). According to the Household Survey, total annual employment averaged 1,205,600 in fiscal year 2004 compared to 1,188,015 in fiscal year 2003, an increase of 1.5%. Concurrently, the unemployment rate also decreased from 12.1% during fiscal year 2003 to 11.4% during fiscal year 2004.

## **Economic Development Program for the Private Sector**

The Commonwealth's economic development program for the private sector is now focused on initiatives aimed at producing a more diversified and sustainable economic development. The three principal elements of these initiatives are the following: (i) the promotion of foreign investment focused on life sciences and communications and information technology; (ii) the promotion of local entrepreneurial investment that builds upon the Commonwealth's competitive advantages in, among other areas, life sciences, tourism, commerce, and services; and (iii) investment in infrastructure and human capital to complement the promotion of foreign and local investment and focus on the current and future needs for human capital.

The Commonwealth has formulated a strategic plan to enhance its competitiveness in knowledge-based economic sectors, such as research and development of science and technology products. Four major components of this strategic plan are: (i) building on the strong presence in Puerto Rico of multinational companies in the science and technology sectors; (ii) building on Puerto Rico's skilled workforce to promote the expansion of research and development facilities by companies currently operating in Puerto Rico; (iii) attracting new companies in such sectors; and (iv) providing incentives for companies and entrepreneurs to engage in the process of innovation and commercialization of new products and to establish research and development facilities in Puerto Rico. The last initiative includes the creation of the Puerto Rico Science & Technology Trust, a government-sponsored trust, that will provide grants and financing to companies, entrepreneurs, and universities that engage in these activities.

The Commonwealth is also providing incentives to promote the establishment of distribution and call centers, the acquisition and development of patents, and the development of a local entrepreneurial class. Distribution and call centers located in the Commonwealth will benefit from special incentives such as: (i) an excise tax exemption on machinery and equipment acquired by a call center; and (ii) a preferential tax rate of 4% for call centers located in Puerto Rico if they offer services to Latin America and a preferential tax rate of 2% if they offer hemisphere or worldwide services. The Commonwealth has decided to focus on this type of industry because it is labor intensive, presents no environmental concerns, and is generally able to start operations quickly.

With respect to the acquisition and development of patents, under newly enacted legislation, the Secretary of the Treasury may (i) negotiate the payment of taxes on patent royalties; and (ii) reduce the tax rate on patent royalties to a rate as low as 2%. These incentives are in addition to those already enacted for research and development carried out in the Commonwealth. To further develop a local entrepreneurial class, the Commonwealth has enacted legislation providing local entrepreneurs with the following benefits: (i) tax incentives to retailers that use their distribution channels to sell products made in Puerto Rico in other jurisdictions; (ii) require that at least 15% of products and services purchased by public agencies be locally manufactured or provided; and (iii) the use of government-sponsored financing, marketing and/or training to promote the production of economically feasible products or services for Puerto Rico markets.

### *Puerto Rico Tax Incentives*

One of the benefits enjoyed by the Commonwealth is that corporations operating in Puerto Rico (other than corporations organized in the United States with a local branch) and individuals residing in Puerto Rico generally are not subject to federal income taxes. 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 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 Puerto Rico tax liability is also provided to investors that contribute cash to such exempted business for the construction or improvement of its physical plant and the purchase of machinery and equipment. The amount of the credit is equal to 50% of the cash invested for such purposes, not to exceed \$5,000,000 per exempted business. The credits are subject to approval by the Secretary of the Treasury, and the maximum amount of such credits for any fiscal year is \$15,000,000.

For fiscal year 2005, the Commonwealth enacted a “sunset provision” that lowered all long-term capital gains tax rates by 50%. In particular, gains realized from July 1, 2004 to June 30, 2005 from the sale or exchange of a capital asset by resident individuals, if held for more than six months, are taxed at a rate of 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. As part of the package of legislative measures proposed to increase General Fund revenues for fiscal years 2006 and 2007, however, the preferential long-term capital gains rates have been eliminated, and all long-term capital gains realized during taxable years that commenced after June 30, 2005 will be taxed at a rate of 12.5%, in the case of individuals, estates and trusts; and 20% in the case of corporations and partnerships. See “Summary and Management’s Discussion of General Fund Results” under *Puerto Rico Taxes, Other Revenues, and Expenditures*.

The 1998 Tax Incentives Act permits income tax rates lower than 2% for companies that establish operations in Puerto Rico in “core pioneer industries” which utilize innovative technology not used in Puerto Rico prior to January 1, 2000; (ii) granting tax credits with respect to eligible investments made in the construction or substantial rehabilitation of housing units to be rented to low income families; (iii) reducing to 7% the capital gains rate applicable to gains realized in taxable years that started on or before June 30, 2005 from the sale of the stock of Puerto Rico corporations acquired in an initial public offering made after June 30, 1997, 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.

#### *Reduction of the Costs of Doing Business*

The Commonwealth believes that, to make Puerto Rico more competitive and foster investment, it needs to reduce the cost of doing business in Puerto Rico. In order to accomplish this, the Commonwealth proposes to (i) promote the creation of more cogeneration power plants to diversify energy fuel sources and reduce oil imports for electric power generation; (ii) streamline the permitting process to accelerate and reduce the cost of investment in Puerto Rico; and (iii) create a multi-agency task force to expedite critical projects in the life sciences sector.

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

## Federal Tax Incentives

In connection with the phase-out of Sections 30A and 936 of the U.S. Internal Revenue Code of 1986, as amended (the “U.S. Code”) (see “Tax Incentives – Incentives Under the U.S. Code” below), the United States Senate requested the Joint Commission on Taxation (“JCT”) and the General Accounting Office (“GAO”) to study the economic impact of such phase-out and present recommendations on alternative tax incentives for U.S.-based companies operating in Puerto Rico. In anticipation of the final phase-out of Sections 30A and 936 of the U.S. Code, most U.S.-based companies operating under Sections 30A and 936 of the U.S. Code have converted from United States corporations to Controlled Foreign Corporations (“CFCs”), thus lessening the impact of the phase-out of those sections. Currently, the United States Congress is considering legislation that would extend to production activities that take place in Puerto Rico section 199 of the U.S. Code, which provides a three-point reduction in the federal income tax rate, phased-in over five years (from 35% to 31.85% after 2009). The Commonwealth is also seeking the extension of additional sections of the U.S. Code that provide a dividends received deduction for a percentage of profits generated in Puerto Rico by CFCs, as well as deductions that would encourage investments in research and development activities.

## Employment and Unemployment

The number of persons employed in Puerto Rico during fiscal year 2005 averaged 1,237,600, a 2.7% increase from 1,205,600 in fiscal year 2004. Unemployment, although at relatively low historical levels, remains above the United States average. The average unemployment rate decreased from 11.4% in fiscal year 2004 to 10.6% in fiscal year 2005.

The following table presents annual statistics of employment and unemployment for fiscal year 2000 through fiscal year 2005. 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<sup>(1)</sup> (persons age 16 and over) (in thousands)

Fiscal Years Ended June 30	Labor Force	Employed	Unemployed	Unemployment Rate <sup>(2)</sup>
	<b>(Annual Average)</b>			
2000.....	1,292	1,150	142	11.0%
2001.....	1,277	1,144	134	10.5%
2002.....	1,309	1,152	158	12.1%
2003.....	1,352	1,188	164	12.1%
2004.....	1,360	1,206	155	11.4%
2005.....	1,385	1,238	147	10.6%

(1) Totals may not add due to rounding.

(2) Unemployed as percentage of labor force.

Source: Department of Labor and Human Resources - Household Survey

## Economic Performance by Sector

From fiscal year 2000 to fiscal year 2004, the manufacturing and services sectors generated the largest portion of gross domestic product. The three sectors of the economy that provide the most employment are manufacturing, services and government.

The following table presents annual statistics of gross domestic product by sector and gross national product for the five fiscal years ended June 30, 2000 through 2004.

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

	<b>Fiscal Years Ended June 30</b>				
	<b>2000</b>	<b>2001<sup>(1)</sup></b>	<b>2002<sup>(1)</sup></b>	<b>2003</b>	<b>2004<sup>(2)</sup></b>
Manufacturing	\$24,079	\$29,037	\$31,243	\$32,501	\$34,078
Services <sup>(3)</sup>	24,920	26,615	26,913	28,688	30,505
Government <sup>(4)</sup>	5,478	5,992	6,303	7,006	7,389
Transportation, communication and public utilities	4,237	4,698	4,948	5,205	5,350
Agriculture, forestry and fisheries	529	348	277	314	435
Construction <sup>(5)</sup>	1,875	1,802	1,648	1,614	1,741
Statistical discrepancy	585	717	292	(493)	(654)
Total gross domestic product <sup>(6)</sup>	<u>\$61,702</u>	<u>\$69,208</u>	<u>\$71,624</u>	<u>\$74,834</u>	<u>\$78,842</u>
Less: net payment abroad	<u>(20,283)</u>	<u>(25,162)</u>	<u>(26,552)</u>	<u>(27,396)</u>	<u>(28,522)</u>
Total gross national product <sup>(6)</sup>	<u>\$41,419</u>	<u>\$44,046</u>	<u>\$45,071</u>	<u>\$47,439</u>	<u>\$50,320</u>

(1) Calendar years 2001 and 2002 are under revision by the Bureau of Labor Statistics of the Department of Labor and Human Resources.

(2) Preliminary. Puerto Rico Planning Board expects to certify these numbers by February 2006. Fiscal year 2004 data are the most recent available statistics.

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

(4) 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.

(5) Includes mining.

(6) 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 2005.

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

	<b>Fiscal Years Ended June 30</b>					
	<b>2000</b>	<b>2001</b>	<b>2002</b>	<b>2003</b>	<b>2004</b>	<b>2005<sup>(2)</sup></b>
Natural Resources and Construction	74,917	75,184	70,499	67,673	69,124	67,516
Manufacturing						
Durable Goods	57,383	56,249	49,348	49,032	50,991	51,616
Non-Durable Goods	85,550	82,236	72,595	68,236	67,606	65,626
Sub Total	217,850	213,669	192,442	184,941	187,721	184,758
Trade, Transportation, Warehouse & Utilities						
Wholesale Trade	32,000	32,327	31,489	31,783	33,261	33,725
Retail Trade	131,817	133,821	127,716	128,567	131,624	131,055
Transportation, Warehouse & Utilities	19,458	19,285	17,603	17,112	17,153	18,464
Sub Total	183,275	185,433	176,808	177,462	182,037	183,245
Information	21,108	20,597	21,943	21,332	22,067	23,343
Finance	45,583	44,974	43,963	44,103	46,402	46,309
Professional & Business	96,750	97,164	95,223	97,266	102,102	102,155
Educational & Health	80,692	84,202	84,452	91,318	97,951	98,889
Leisure & Hospitality	65,942	66,435	64,273	67,073	70,512	70,979
Other Services	17,408	17,330	16,602	18,588	20,643	22,137
Government	286,133	282,723	288,679	297,709	303,137	309,594
Total Non-Farm	1,014,742	1,012,528	984,385	999,790	1,032,573	1,041,407

(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. Calendar years 2001 and 2002 are under revision by the Bureau of Labor Statistics of the Department of Labor and Human Resources.

(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 2004 manufacturing generated \$34.1 billion or 43.2% of gross domestic product. During fiscal year 2005, payroll employment for the manufacturing sector was 117,242, a decrease of 1.1% compared with fiscal year 2004, with most of the job losses occurring in labor-intensive industries. Most of the island's manufacturing output is shipped to the United States mainland, which is also the principal source of semi-finished manufactured articles on which further manufacturing operations are performed in Puerto Rico. The United States minimum wage laws are applicable in Puerto Rico. As of June 2005, the average hourly manufacturing wage rate in Puerto Rico was 65.8% of the average mainland United States rate.



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

The following table sets forth gross domestic product by manufacturing sector for the five fiscal years ended June 30, 2000 through June 30, 2004.

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

	2000	2001	2002	2003	2004 <sup>(1)</sup>
Pharmaceuticals	\$13,580	\$16,620	\$18,681	\$19,072	\$20,138
Machinery and metal products:					
Machinery, except electrical	2,031	3,376	3,845	3,528	3,499
Electrical machinery	1,525	1,874	1,757	1,915	1,821
Professional and scientific instruments	1,758	2,100	2,191	3,026	3,325
Other machinery and metal products	341	316	312	291	313
Food products	1,912	1,974	2,092	2,289	2,332
Other chemical and allied products	777	765	578	496	475
Apparel	610	569	530	466	620
Other <sup>(2)</sup>	1,543	1,444	1,258	1,418	1,555
Total gross domestic product of manufacturing sector <sup>(3)</sup>	<u>\$24,079</u>	<u>\$29,037</u>	<u>\$31,243</u>	<u>\$32,501</u>	<u>\$34,078</u>

(1) Preliminary. Puerto Rico Planning Board expects to certify these numbers by February 2006. Fiscal year 2004 data are the most recent available statistics.

(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 2005.

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

Industry Group	Fiscal Years Ended June 30					
	2000	2001 <sup>(1)</sup>	2002 <sup>(1)</sup>	2003	2004	2005 <sup>(2)</sup>
<b><u>Durable Goods</u></b>						
Nonmetallic Mineral Products Manufacturing	4,833	4,726	4,429	4,385	4,692	4,606
Fabricated Metal Products	7,267	7,218	6,379	6,127	6,519	6,569
Computer and Electronic Electrical Equipment	14,958	14,316	11,464	11,483	10,761	11,094
Miscellaneous Manufacturing	8,917	8,225	7,064	7,331	7,753	7,529
Other Durable Goods Manufacturing	11,725	12,046	11,757	12,149	13,037	13,920
<b>Total - Durable Goods</b>	<b>57,383</b>	<b>56,249</b>	<b>49,348</b>	<b>49,032</b>	<b>50,991</b>	<b>51,616</b>
<b><u>Non-Durable Goods</u></b>						
Food Manufacturing	17,417	17,109	14,515	13,466	13,232	12,428
Beverage and Tobacco Products	3,425	3,571	3,403	3,112	3,078	3,307
Apparel Manufacturing	17,517	16,265	11,715	8,870	8,099	6,966
Chemical Manufacturing	29,450	29,124	30,363	30,792	30,448	30,317
Plastics and Rubber Products	4,108	3,820	3,393	3,293	3,208	2,958
Other Non-Durable Goods Manufacturing	13,633	12,347	9,206	703	9,541	9,650
<b>Total - Non-Durable Goods</b>	<b>85,550</b>	<b>82,236</b>	<b>72,595</b>	<b>60,236</b>	<b>67,606</b>	<b>65,626</b>
<b>Total Manufacturing Employment</b>	<b>142,933</b>	<b>138,485</b>	<b>121,943</b>	<b>109,268</b>	<b>118,597</b>	<b>117,242</b>

\* Totals may not add due to rounding.

(1) Calendar years 2001 and 2002 are under revision by the Bureau of Labor Statistics of the Department of Labor and Human Resources.

(2) Preliminary.

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

Total employment in the manufacturing sector decreased by 25,691 from fiscal year 2000 to fiscal year 2005. This reduction in manufacturing employment was coupled with a significant increase in manufacturing productivity and investment as shown by the expansion in real manufacturing output and in the growth of exports. 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<sup>†</sup>

<u>Employment 2,500 and over</u>	<u>Product</u>	<u>Employment 200 to 499</u>	<u>Product</u>
Abbot Laboratories	Pharmaceuticals	Alcan Finance (BDA) LTC	Plastics
Baxter International, Inc.	Medical Devices	Atlantron Inc.	Computers
Johnson and Johnson	Surgical Products	Atento Teleservicios	Transportation
Pfizer Pharmaceuticals LLC	Pharmaceuticals	Bacardí Limited	Food
Wyeth	Pharmaceuticals	Biovail Corporation International	Pharmaceuticals
Zimmer Holdings, Inc.	Pharmaceuticals	CEMEX	Cement
<b><u>Employment 1,000 to 2,499</u></b>			
Altadis	Cigars	Centennial Communication	Communications
Amgen, Inc.	Pharmaceuticals	Checkpoint Systems Inc.	Electronic Instruments
Atento Teleservicios	Communications	Coca Cola Company	Food
Eaton Corporation	Electronic Instruments	Colgate-Palmolive Company	Consumer Products
Edwards Lifesciences LLC	Surgical Instruments	C.R. Bard	Surgical Instruments
Eli Lilly and Company	Pharmaceuticals	Curtis Instruments Inc.	Electrical Instruments
General Electric Industrial Systems	Electronic Instruments	Davis Creek Managing Partners	Metal Products
Glaxo Smithkline	Pharmaceuticals	E.I. DuPont de Nemours & Co.	Chemicals
Atento Teleservicios	Transportation	Eastern Canvas Products	Textile Products
Hewlett-Packard Co.	Computers	Espace Europee de Lenterprise	Pharmaceuticals
Medtronic Europe SA	Surgical Instruments	Essilor International	Ophthalmic Products
Merck & Co., Inc.	Pharmaceuticals	Garguilo	Transportation
Propper International Company	Apparel	Hershey Foods Corp.	Food
Sara Lee Corp	Apparel	ICN Pharmaceuticals Inc.	Pharmaceuticals
Schering Plough Corporation	Pharmaceuticals	IDT Dutch Holding, BV	Communications
The Cooper Companies	Ophthalmic Products	Loctite Corporation	Chemicals
Tyco International	Surgical Products	Lutron Electronics Co. Inc.	Electronic Instruments
<b><u>Employment 500 to 999</u></b>			
Advanced Medical Optics, Inc.	Ophthalmic Products	Millipore Corporation	Surgical Instruments
Astra Zeneca PLC	Pharmaceuticals	Mylan Laboratories, Inc.	Chemicals
Becton-Dickinson & Co.	Surgical Instruments	Northrop Grumman Corporation	Electrical Instruments
Bumble Bee Seafoods	Food	Novartis Holding AG	Ophthalmic Products
Cardinal Health, Inc.	Surgical Instruments	Nyro International	Medical Devices
Grupo Gloria	Food	Owens Illinois Inc.	Glass and Plastics
Guidant Corp.	Medical Instruments	Packaging Coordinators Inc.	Packaging Products
Hamilton Sundstrand Corp.	Electrical Instruments	PepsiCo, Inc.	Food
Hubbel Incorporated	Electrical Instruments	Pilgrim's Pride Corporation	Food
Ingersoll-Rand Co.	Electrical Instruments	Positronic Industries, Inc.	Electronics
Ivax Pharmaceutical	Pharmaceuticals	Rocky Shoes & Boots	Footwear
Pall Corporation	Ophthalmic Filters	Siemens AG	Electrical Instruments
Patheon Inc.	Pharmaceuticals	Sitnasuak Native Corporation	Apparel
Procter & Gamble Co.	Pharmaceuticals	Solectron Corporation	Electronic Instruments
Stryker Corp.	Surgical Instruments	St. Jude Medical, Inc.	Surgical Instruments
Unilever PLC	Consumer Products	Standard Motor Products Inc.	Motor Vehicle Parts
Warner-Lambert Company	Pharmaceuticals	Storage Technology Corp.	Electronics
Wellco Enterprises, Inc.	Footwear	SwissAir Services Corp.	Transportation
		Symmetricom Inc.	Electronic Equipment
		Thomas & Betts Corporation	Electrical Instruments
		Timberland Company	Leather
		Warner Chilcott	Pharmaceuticals
		Watson Pharmaceutical, Inc.	Pharmaceuticals

<sup>†</sup> Based on the last employment figures reported by each company to PRIDCO.

## 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 2000 and 2004, the gross domestic product in this sector, in nominal terms, increased at an average annual rate of 5.2%, 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 2004, services generated \$30.5 billion of gross domestic product, or 38.7% of the total. Services employment grew from 510,758 in fiscal year 2000 to 547,057 in fiscal year 2005 (representing 52.5% of total non-farm payroll employment). This represents a cumulative increase of 6% during such period. Wholesale and retail trade, finance, insurance and real estate experienced significant growth in fiscal years 2000 to 2004, as measured by gross domestic product. From fiscal year 2000 to 2004, gross domestic product increased in wholesale and retail trade from \$8.3 billion to \$9.6 billion, and in finance, insurance, and real estate from \$10.0 billion to \$13.0 billion. There are sixteen commercial banks and trust companies currently operating in Puerto Rico. Total assets of these institutions as of June 30, 2005 were \$100.0 billion. As of June 30, 2005, there were approximately thirty-five international banking entities operating in Puerto Rico licensed to conduct offshore banking transactions with total assets of \$72.8 billion.

The following tables set forth service sector gross domestic product for fiscal years 2000 to 2004 and employment for the services sector for fiscal years 2000 to 2005.

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

	<b>Fiscal Years Ended June 30</b>				
	<b>2000</b>	<b>2001</b>	<b>2002</b>	<b>2003</b>	<b>2004<sup>(1)</sup></b>
Wholesale and retail trade	\$ 8,340	\$ 8,338	\$ 8,623	\$ 9,005	\$ 9,582
Finance, insurance and real estate	9,977	11,294	11,212	12,425	13,024
Other services <sup>(2)</sup>	6,603	6,982	7,078	7,257	7,899
<b>Total</b>	<b>\$24,920</b>	<b>\$26,615</b>	<b>\$26,913</b>	<b>\$28,688</b>	<b>\$30,505</b>

\* Totals may not add due to rounding.

(1) Preliminary. Puerto Rico Planning Board expects to certify these numbers by February 2006. Fiscal year 2004 data are the most recent available statistics.

(2) Includes tourism.

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

	<b>Fiscal Years Ended June 30</b>					
	<b>2000</b>	<b>2001<sup>(1)</sup></b>	<b>2002<sup>(1)</sup></b>	<b>2003</b>	<b>2004</b>	<b>2005<sup>(2)</sup></b>
Wholesale Trade	32,000	32,327	31,489	31,783	33,261	33,725
Retail Trade	131,817	133,821	127,716	128,567	131,624	131,055
Transportation, Warehouse & Utilities	19,458	19,285	17,603	17,112	17,153	18,464
Trade, Transportation, Warehouse & Utilities	183,275	185,433	176,808	177,461	182,037	183,245
Information	21,108	20,597	21,943	21,332	22,067	23,343
Finance	45,583	44,974	43,963	44,103	46,402	46,309
Professional and Business	96,750	97,164	95,223	97,266	102,102	102,155
Educational & Health	80,692	84,202	84,452	91,318	97,951	98,889
Leisure & Hospitality	65,942	66,435	64,273	67,073	70,512	70,979
Other Services	17,408	17,330	16,602	18,588	20,643	22,137
<b>Total</b>	<b>510,758</b>	<b>516,135</b>	<b>503,264</b>	<b>517,141</b>	<b>541,714</b>	<b>547,057</b>

\* Totals may not add due to rounding.

(1) Calendar years 2001 and 2002 are under revision by the Bureau of Labor Statistics of the Department of Labor and Human Resources.

(2) Preliminary.

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

*Hotels and Related Services - Tourism*

During fiscal year 2005, the number of persons registered in tourist hotels, including residents of Puerto Rico and tourists staying in more than one hotel during their visit, was 1,842,400, an increase of 3.1% over the number of persons registered during the same period in fiscal year 2004. The number of non-resident tourists registered in tourist hotels during fiscal year 2005 increased 2.8% compared to fiscal year 2004 due to new hotel rooms from tourist developments opened in 2005. Hotel rooms available during fiscal year 2005 increased 5.3% compared to fiscal year 2004. The average number of rooms rented in tourist hotels increased 3.1% during fiscal year 2005 compared to fiscal year 2004. The average occupancy rate in tourist hotels during fiscal year 2005 was 70.8% compared to 72.4% for fiscal year 2004. The decrease in the occupancy rate in tourist hotels during fiscal year 2005 was due to the addition of new hotel rooms.

During fiscal year 2004, the number of persons registered in tourist hotels, including residents of Puerto Rico and tourists staying in more than one hotel during their visit, was 1,787,300, an increase of 3.2% over the number of persons registered during 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. The average number of rooms available in tourist hotels decreased 1.6% during fiscal year 2004 compared to 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, 2004.

**Commonwealth of Puerto Rico**  
**Tourism Data<sup>(1)</sup>**  
**Number of Visitors**

<b>Fiscal Years Ended June 30</b>	<b>Tourist Hotels<sup>(2)</sup></b>	<b>Cruise Ship</b>	<b>Other<sup>(3)</sup></b>	<b>Total</b>	<b>Total Visitors' Expenditures (in millions)</b>
2000.....	1,050,100	1,224,600	2,291,300	4,566,000	\$2,387.90
2001.....	1,186,800	1,356,600	2,364,400	4,907,800	2,728.10
2002.....	1,147,800	1,277,000	1,939,300	4,364,100	2,486.40
2003.....	1,239,200	1,163,900	1,999,200	4,402,300	2,676.60
2004.....	1,307,000	1,348,200	2,234,000	4,889,200	3,024.00

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

(2) Includes visitors in guesthouses.

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

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

The Commonwealth, through the Convention Center District Authority, is in the process of finishing the development of the largest convention center in the Caribbean, and the centerpiece of a 100-acre private development, including hotels, restaurants, cinemas, office space and housing. The convention center district is being developed at a total cost of \$1.3 billion to improve Puerto Rico's competitive position in the convention and group travel segments. The convention center opened on November 17, 2005, and 17 conventions have already been booked for the first year of operations.

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

### *Government*

The government sector of Puerto Rico plays an important role in the economy. In fiscal year 2004, the government accounted for \$7.4 billion of Puerto Rico's gross domestic product, or 9.4% of the total. The government is also a significant employer, providing jobs for 309,594 workers, or 29.7% of total non-farm payroll employment in fiscal year 2005.

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

On August 3, 2005, the Governor issued an Executive Order requiring most Executive Branch agencies to establish a voluntary employee hourly reduction program. The purpose of the program is to reduce salary expenditures by the government. The program establishes two hourly alternatives with different pay incentives: (1) one day per week work reduction (approximately 7.5 hours or 20% of the work week) with a 15% reduction in salary and (2) 50% reduction in the regular hourly work week with a 35% reduction in salary (for those employees with 5 years or less before retirement, the second option will only entail a 25% reduction in salary). Participation in this voluntary program will not result in any payroll contribution reductions to the Government Employees Retirement System. See "Budget for Fiscal Year 2006" under *Budget of the Commonwealth of Puerto Rico*.

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

The island's major cities are connected by a modern highway system, which, as of December 31, 2004, totaled approximately 4,608 miles. The highway system comprises 379 miles of primary system highways, which are the more important interregional traffic routes and include the PR-52, the PR-22, PR-53 and PR-20 toll highways, 230 miles of primary urban system highways, 959 miles of secondary system highways serving the needs of intra-regional traffic and 3,041 miles of tertiary highways and roads serving local, intra-regional traffic.

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

The Port of the Americas Authority ("PAA") is responsible for the development and operation of the Port of the Americas, a deep draft port on the south coast of Puerto Rico. The first phase of the Port of the Americas was completed in fiscal year 2004. This initial phase included the improvement of piers 4, 5 and 6 of the Port and the acquisition of heavy equipment at a cost of \$40 million. During calendar year 2005, the PAA began its second phase of the Port which is expected to be completed by the end of calendar year 2007. Completion of this second phase will provide capacity to handle up to 250,000 Twenty-Foot Equivalent Units ("TEU"). This second phase includes (i) dredging the entrance channel and adjacent areas of the Port to a depth of 50 feet; (ii) reconstruction of container terminals; (iii) commencement of certain required environmental risk mitigation procedures; and (iv) preparation of final construction schematics. With respect to these tasks, dredging is 28% complete, the final design contract has been awarded, acquisition of environmental risk mitigation land is underway, and the contract for reconstruction at the container terminal is expected to be awarded during the first quarter 2006.

PAA has borrowed a total of \$250 million, including a \$70 million line of credit from GDB, for the Port which is expected to be capable of providing capacity for up to 700,000 TEUs when the third phase is completed. This debt is payable from annual legislative appropriations until the PAA starts generating revenues sufficient to cover debt service. Partial operation of the Port of the Americas, at a capacity of up to 250,000 TEUs per year, could begin early 2008.

## *Construction*

Although the construction industry represents a relatively small segment of the economy compared to other sectors, it has made significant contributions to the growth of economic activity. However, during the period from fiscal year 2000 through fiscal year 2004, real construction investment decreased 3.3%. This decline is relatively small when compared to the high levels of construction activity previously recorded.

The total value of construction permits increased 21.2% for the same 5-year period. Public investment has been an important component of construction investment. During fiscal year 2004, approximately 41% of the total investment in construction was related to public projects. During fiscal year 2005, the total value of construction permits increased 0.1% compared with fiscal year 2004. Average payroll employment in the construction sector during fiscal year 2005 was 67,516, a decrease of 2.3% from fiscal year 2004.

During fiscal year 2005, total sales of cement, including imports, decreased 0.1% compared with fiscal year 2004.

Total construction investment for fiscal year 2004 increased (in real terms) by 1.5%, which was the first increase in 3 years. For fiscal years 2005 and 2006, the Planning Board forecasts construction investment increases (in real terms) of 1.3% for each year. Public investment will be primarily in housing, new schools (and school reconstruction programs), water projects, and other public infrastructure projects. However, public investment in construction could be negatively affected by the Commonwealth's fiscal difficulties.

### *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 2004, gross income from agriculture was \$780.7 million, an increase of 2.8% compared with fiscal year 2003. 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 2004, traditional crops, livestock products, starchy vegetables, ornamental plants and other products contributed a higher percentage of the sector's income than in the previous fiscal year.

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

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

### **Higher Education**

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

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**

<b>Academic Year</b>	<b>Commonwealth of Puerto Rico</b>			<b>Mainland United States</b>		
	<b>Population 18-24 Years of Age</b>	<b>Higher Education Enrollment</b>	<b>Percent<sup>(1)</sup></b>	<b>Population 18-24 Years of Age</b>	<b>Higher Education Enrollment</b>	<b>Percent<sup>(1)</sup></b>
1970	341,448 <sup>(2)</sup>	57,340	16.8%	23,714,000 <sup>(2)</sup>	8,580,887	36.2%
1980	397,839 <sup>(2)</sup>	130,105	32.7%	30,022,000 <sup>(2)</sup>	12,096,895	40.3%
1990	417,636 <sup>(2)</sup>	156,147	37.4%	26,961,000 <sup>(2)</sup>	13,621,000	50.5%
2000	428,892 <sup>(2)</sup>	176,015	41.0%	27,143,455 <sup>(2)</sup>	15,312,000	56.4%
2001	426,194 <sup>(3)</sup>	185,015	43.4%	27,968,162 <sup>(3)</sup>	15,928,000	56.7%
2002	423,852 <sup>(3)</sup>	190,776	45.0%	28,442,293 <sup>(3)</sup>	16,612,000	58.4%
2003	420,295 <sup>(3)</sup>	199,842	47.6%	28,923,731 <sup>(3)</sup>	16,910,000	58.5%
2004	416,020 <sup>(3)</sup>	206,791	49.7%	29,245,102	17,095,000	58.4%

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

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

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

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

The University of Puerto Rico, the only public university in Puerto Rico, has eleven campuses located throughout the island. The University's total enrollment for academic year 2003-2004 was approximately 68,000 students. Statistics for academic year 2004-2005 are still not available. The Commonwealth is legally bound to appropriate annually for the University of Puerto Rico an amount equal to 9.60% of the average annual revenue from internal sources for each of the two fiscal years immediately preceding the current fiscal year.

In addition to the University of Puerto Rico, there are 40 public and private institutions of higher education located in Puerto Rico. Such institutions have a current enrollment of approximately 138,700 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 factor that has promoted and continues to promote the development of the manufacturing sector in Puerto Rico is the various local and federal tax incentives available, particularly those under Puerto Rico's Industrial Incentives Program and, until recently, Sections 30A and 936 of the U.S. Code. Tax and other incentives have also been established to promote the development of the tourism industry. These incentives are summarized below.

### *Industrial Incentives Program*

Since 1948, Puerto Rico has had various industrial incentives laws designed to stimulate industrial investment in the island. Under these laws, 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 (the "Tourism Incentives Act"), provides partial exemptions from income, property, and municipal license taxes for a period of up to ten years. The Tourism Incentives Act also provides certain tax credits for qualifying investments in tourism activities, including hotel and condo-hotel development projects. Recently enacted legislation provides further tourism incentives by granting certain tax exemptions on interest income received from permanent or interim financing of tourism development projects and fees derived from credit enhancements provided to the financing of such projects. See "Government Development Bank for Puerto Rico-Tourism Development Fund" under *Public Corporations*.

As part of the incentives to promote the tourism industry, the Commonwealth established the Tourism Development Fund as a subsidiary of GDB with the authority to (i) make investments in or provide financing to entities that contribute to the development of the tourism industry and (ii) provide financial guarantees and direct loans for financing hotel development projects. To date, the Fund has provided direct loans and financial guarantees for loans made or bonds issued to finance the development of seventeen hotel projects representing over 3,800 new hotel rooms.

### *Incentives under the U.S. Code*

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

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

As a result of amendments to Section 936 of the U.S. Code made in 1996 (the “1996 Amendments”), 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 U.S. 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 on or after January 1, 2006.

The Section 30A Credit is limited to the sum of (i) 60% of qualified possession wages as defined in the U.S. 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 U.S. 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 of the U.S. Code, 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 of the U.S. Code; (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 of the U.S. Code. 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 on or after January 1, 2006.

## *Controlled Foreign Corporations*

Because of the credit limitations and impending phase out of Sections 30A and 936 of the U.S. Code, 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 120 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 30A and 936 of the U.S. Code. In many cases, they are allowed to attribute a larger share of this income to their Puerto Rico operation but must make a royalty payment “commensurate with income” to their U.S. affiliates. Section 936 Corporations were exempted from Puerto Rico withholding taxes on any cost sharing payments they might have opted to make, but CFCs are subject to a 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. 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 deposited into the Treasury (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, and motor vehicle fuel taxes and license fees, which are allocated to the Highway and Transportation Authority, are not included as internal revenues for the purpose of calculating the debt limit, although they may be available for the payment of debt service. Future maximum annual debt service for the Commonwealth’s outstanding general obligation debt is \$705,522,695 in the fiscal year ending June 30, 2006 (based on the assumption that the Public Improvement Refunding Bonds, Series 2004 A bear interest at their actual rate per annum through July 1, 2012 and thereafter at 12% per annum, and the Public Improvement Refunding Bonds, Series 2004 B bear interest at 12% per annum). Debt service for the PRASA guaranteed bonds paid by the Commonwealth during fiscal year 2005 (including, for this purpose, debt service payments due and paid on July 1, 2005) was \$30,127,367.50. The sum of those amounts (\$735,650,063) is equal to 9.45% of \$7,781,435,000, which is the average of the adjusted internal revenues for the fiscal year ended June 30, 2004 and the currently estimated adjusted internal revenues for the fiscal year ended June 30, 2005. If bonds refunded with non-eligible investments described in the preceding sentence were treated as not being outstanding, and the interest on the Public Improvement Refunding Bonds, Series 2004 B was calculated using the effective fixed interest rate payable by the Commonwealth under the interest rate exchange agreements entered into in respect thereof, the percentage referred to in the preceding sentence would be 8.82%. The Commonwealth’s policy has been and continues to be to maintain the amount of such debt prudently below the constitutional limitation. Debt of municipalities, other than bond anticipation notes, is supported by real and personal property taxes and municipal license taxes. Debt of public corporations, other than bond anticipation notes, is generally supported by the revenues of such corporations from rates charged for services or products. See *Public Corporations*. However, certain debt of public corporations is supported, in whole or in part, directly or indirectly, by Commonwealth appropriations or taxes.

Direct debt of the Commonwealth is issued pursuant to specific legislation approved in each particular case. Debt of the municipalities is issued pursuant to 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 September 30, 2005. Excluded from the table is debt not primarily payable from either Commonwealth or municipal taxes, Commonwealth appropriations or rates charged by public corporations for services or products, some of which debt is set forth in footnote 4 below. Also excluded from the table is debt the inclusion of which would reflect double counting including, but not limited to, \$1.1 billion of outstanding bonds (as of September 30, 2005) issued by the Municipal Finance Agency to finance its purchase of bonds of Puerto Rico municipalities, and \$2.6 billion of obligations of the Public Finance Corporation issued to purchase certain Commonwealth public sector debt.

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

	<u>September 30, 2005</u>
Puerto Rico direct debt <sup>(1)</sup>	\$ 9,631,658
Municipal debt	2,119,995
Public corporations debt	
Puerto Rico guaranteed debt <sup>(2)</sup>	666,921
Debt supported by Puerto Rico appropriations or taxes <sup>(3)</sup>	16,807,326
Other non-guaranteed debt <sup>(4)</sup>	7,964,106
Total public corporations debt	25,438,353
Total public sector debt	\$37,190,006

- (1) Includes general obligation bonds, tax and revenue anticipation notes, and lines of credit provided by GDB. 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 \$508.2 million of bonds issued by the Aqueduct and Sewer Authority and \$158.7 million of State Revolving Fund Loans, incurred under various federal water laws. Excludes Public Buildings Authority bonds in the principal amount of \$2.9 billion as of June 30, 2005 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 the following: \$1.1 billion of Infrastructure Financing Authority bonds, which are payable solely from the investment income of funds on deposit in the Infrastructure Development Fund consisting of proceeds from the sale of a controlling interest in Puerto Rico Telephone Company; \$1.2 billion of Children's Trust bonds which are payable solely from the payments to be received pursuant to the tobacco litigation settlement; \$663 million of Housing Finance Authority bonds, which are payable from Puerto Rico Housing Administration's annual allocation of Public Housing Capital Funds from the United States Department of Housing and Urban Development; \$153 million of Special Facilities Revenue Bonds issued by the Highway and Transportation Authority, which are payable from net toll revenues collected from the Teodoro Moscoso Bridge; \$155 million of Special Facilities Bonds issued by the Ports Authority, which are solely payable from by the pledge of certain payments made by a private corporation under a special facilities agreement; \$97 million of Qualified Zone Academy Bonds issued by the Public Finance Corporation, which are payable from securities purchased with funds assigned by the Children's Trust to the Department of Education; \$87 million of Educational Facilities Revenue Bonds, 2000 Series A (University Plaza Project) issued by the Industrial, Tourist, Educational, Medical and Environmental Control Facilities Financing Authority, which are payable from rent payments made by the University of Puerto Rico; and approximately \$113.4 million of bonds issued by the Industrial, Tourist, Educational, Medical and Environmental Control Facilities Financing Authority to finance the construction of various government infrastructure projects, which are payable from rent payments made by various government entities. References collectively to the bonds listed in this footnote are subsequently called the "Excluded Bonds." If the principal amounts of the Excluded Bonds were included in the above table, total public corporations debt would be \$28,341,753,000 and total public sector debt would be \$40,093,406,000.

*Source:* Government Development Bank for Puerto Rico

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**

The following table presents the debt service requirements for Commonwealth general obligation bonds outstanding as of June 30, 2005.

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 described above. In addition, the interest in the table is calculated in respect of certain variable rate general obligation bonds as to which the Commonwealth has entered into interest rate exchange agreements by using the respective fixed rates of interest that the Commonwealth is paying under said agreements. Had such economically (but not legally) defeased bonds been included in the table and the interest in respect of such variable rate bonds been calculated by treating them as bearing interest at the maximum rate permitted by law (currently an effective rate of 12% per annum), maximum annual principal and interest on all outstanding general obligation bonds during the fiscal year ending June 30, 2006 would equal \$705,522,695. 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)**

<b>Fiscal Year Ending June 30</b>	<b>Outstanding Bonds</b>		<b>Total Debt Service<sup>(1)</sup></b>
	<b>Principal</b>	<b>Interest</b>	
2006 <sup>(2)</sup>	\$ 174,484	\$ 387,535	\$ 562,019
2007	161,722	400,175	561,897
2008	200,027	371,611	571,638
2009	238,840	328,465	567,304
2010	252,795	314,693	567,488
2011	264,197	300,913	565,110
2012	283,795	281,166	564,961
2013	301,335	263,690	565,025
2014	299,023	268,096	567,119
2015	313,125	254,313	567,437
2016	328,230	239,472	567,702
2017	343,802	224,283	568,084
2018	361,120	208,346	569,466
2019	394,356	175,751	570,107
2020	452,165	148,395	600,560
2021	322,480	126,181	448,661
2022	247,400	111,409	358,809
2023	214,650	100,363	315,013
2024	200,845	90,886	291,731
2025	209,670	82,365	292,035
2026	209,880	73,792	283,672
2027	219,380	64,555	283,935
2028	229,265	54,947	284,212
2029	239,770	44,716	284,486
2030	251,355	33,301	284,656
2031	263,020	21,752	284,772
2032	96,645	9,518	106,163
2033	68,080	5,111	73,191
2034	33,105	1,655	34,760
	<b>\$7,174,559</b>	<b>\$4,987,455</b>	<b>\$12,162,014</b>

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

(1) Since fiscal year 1997, the Commonwealth has been paying approximately \$30 million annual debt service on PRASA bonds guaranteed by the Commonwealth. Beginning with the debt service payment due January 1, 2006, the Commonwealth will stop making such payments since PRASA will resume making all payments due on and after such date from anticipated increased revenues received from its rate increase. See "Other Public Corporations - Aqueduct and Sewer Authority" under *Public Corporations* below.

(2) This amount is contemplated to be refinanced to lower the debt service payments due from the Commonwealth on outstanding general obligation bonds for fiscal year 2006. See "Commonwealth's Budget Structural Imbalance" under *Puerto Rico Taxes, Other Revenues, and Expenditures* and "2006 Budget Approval Process" under *Budget of the Commonwealth of Puerto Rico*.

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



In May 2005, Moody's Investors Service ("Moody's") and Standard & Poor's Rating Services, a division of The McGraw-Hill Companies, Inc. ("S&P"), each announced downgrades to the Commonwealth's general obligation debt rating. Moody's and S&P lowered their respective ratings on the Commonwealth's general obligation debt from "Baa1" to "Baa2" and from "A-" to "BBB." Among the reasons given by the rating agencies for the reduction in the ratings were, among others, the concern over the Commonwealth's financial performance, particularly the current structural imbalance in its budget, the low funding ratio of the Employees Retirement System of the Commonwealth and its instrumentalities (the "Employees Retirement System"), the uncertainty surrounding the approval of a budget for fiscal year 2006 and the availability of additional recurring revenue sources. See "Commonwealth's Budget Structural Imbalance" under *Puerto Rico Taxes, Other Revenues, and Exemptions*. See also *Retirement Systems and Budget of the Commonwealth of Puerto Rico*. For more information relating to the rating downgrades please refer to [www.moody.com](http://www.moody.com) and [www.standardandpoors.com](http://www.standardandpoors.com).

On October 21, 2005, S&P further lowered GDB's long-term counterparty credit rating to "BBB" from "BBB+" and affirmed its short-term, counterparty rating of "A-2." S&P's rating reduction of GDB was made in order to further align GDB's rating to that of the Commonwealth given GDB's high balance of public sector loans on its balance sheet. See "Government Development Bank" below.

The Commonwealth and GDB have each been assigned a negative ratings outlook by the rating agencies.

The Commonwealth is currently addressing the structural imbalance referenced above through the simultaneous control of expenses and generation of other resources. See *Budget of the Commonwealth of Puerto Rico*. The rating agencies have requested that the Commonwealth develop a multi-year fiscal plan that demonstrates the achieving of financial stability. The Commonwealth is preparing such plan. Until the successful implementation of such plan, the rating agencies may further downgrade their respective ratings of the Commonwealth's debt.

### **Commonwealth Guaranteed Debt**

As of September 30, 2005, \$2.9 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 September 30, 2005, \$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 September 30, 2005, the aggregate outstanding principal amount of obligations of PRASA guaranteed by the Commonwealth was \$292 million. On January 2, 1997, the Commonwealth began to make debt service payments under the Commonwealth guaranty and continuously made payments through fiscal year 2005. Beginning with the debt service payment due January 1, 2006, the Commonwealth will stop making debt service payments required on these revenue bonds. PRASA will resume payment of this debt from increased revenues it expects to receive as part of its newly revised tariff structure. See "Other Public Corporations - Aqueduct and Sewer Authority" under *Public Corporations* below.

As of September 30, 2005, the principal amount outstanding on the bonds issued by PRASA to the United States Department of Agriculture, Rural Development, also guaranteed by the Commonwealth, was \$216.2 million and the principal amount outstanding of the loans by the State Revolving Funds for the benefit of PRASA was \$158.7 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 National Product (in current dollars) for the five fiscal years ended June 30, 2005 and the first three months of fiscal year 2006. As of September 30, 2005, outstanding short-term debt, relative to total debt, was 7.7%.

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

June 30	Public Sector Debt				Gross National Product <sup>(1)</sup>		
	Long Term <sup>(2)</sup>	Short Term <sup>(3)</sup>	Short Term as % of Total	Total	Rate of Increase	Amount	Rate of Increase
2001 .....	\$22,345	\$2,870 <sup>(4)</sup>	11.4%	\$25,215	5.8%	\$44,047	6.3%
2002 .....	26,737	1,250 <sup>(5)</sup>	4.5%	27,987	11.0%	45,071	2.3%
2003 .....	28,102	1,605 <sup>(5)</sup>	5.4%	29,707	6.1%	47,439	5.3%
2004 .....	31,767	2,175 <sup>(5)</sup>	6.4%	33,942	14.3%	50,320	6.1%
2005 .....	34,789	1,914 <sup>(5)</sup>	5.2%	36,703	8.1%	N/A	N/A
September 30, 2005 ..	34,341	2,849	7.7%	37,190	1.3%	N/A	N/A

\* Totals may not add due to rounding.

(1) In current dollars.

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

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

(4) 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.

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

Source: Government Development Bank for Puerto Rico

The following table shows the trend of public sector debt by major category for the five fiscal years ended June 30, 2005 and the first three months of fiscal year 2006.

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

June 30	Commonwealth			Municipalities			Public Corporation <sup>(1)</sup>			Total		
	Long Term <sup>(2)</sup>	Short Term <sup>(3)</sup>	Total	Long Term	Short Term <sup>(3)</sup>	Total	Long Term	Short Term <sup>(3)</sup>	Total	Long Term	Short Term <sup>(3)</sup>	Total
2001.....	\$5,674	\$164 <sup>(4)</sup>	\$5,838	\$1,469	\$163	\$1,632	\$15,201	\$2,543	\$17,744	\$22,345	\$2,870	\$25,215
2002.....	6,025	91 <sup>(5)</sup>	6,116	1,618	177	1,795	19,094	982	20,076	26,737	1,250	27,987
2003.....	6,709	177 <sup>(5)</sup>	6,886	1,754	201	1,955	19,639	1,227	20,866	28,102	1,605	29,707
2004.....	7,758	761 <sup>(5)</sup>	8,519	1,820	226	2,046	22,190	1,187	23,377	31,768	2,174	33,942
2005.....	8,761	257 <sup>(5)</sup>	9,018	1,927	254	2,181	24,101	1,403	25,504	34,789	1,914	36,703
September 30, 2005	8,682	950	9,632	1,882	238	2,120	23,777	1,661	25,438	34,341	2,849	37,190

\* Totals may not add due to rounding.

- (1) Includes Commonwealth guaranteed debt; does not include the Excluded Bonds.
- (2) Includes the Transferred Debt from Urban Renewal and Housing Corporation ("CRUV").
- (3) Obligations (other than bonds) issued with an original maturity of three years or less and lines of credit with a remaining maturity of three years or less are considered short-term debt.
- (4) Consists of a 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.
- (5) 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.

Source: Government Development Bank for Puerto Rico

## PUBLIC CORPORATIONS

In Puerto Rico, many governmental or quasi-governmental functions are performed by public corporations. These are governmental entities created by the Legislative Assembly 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 September 30, 2005 ("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**  
**September 30, 2005**  
**(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	\$ 507,669	\$ -	\$ 507,669	\$158,696	\$ 366,135 <sup>(1)</sup>	\$ 524,831	\$ 666,365	\$ 366,135 <sup>(1)</sup>	\$ 1,032,500
Electric Power Authority	-	5,246,707	5,246,707	-	263,546	263,546	-	5,510,253	5,510,253
Highway and Transportation Authority	-	5,689,439 <sup>(2)</sup>	5,689,439	-	453,000	453,000	-	6,142,439	6,142,439
Housing Finance Authority <sup>(3)</sup>	-	603,383	603,383	-	88,237	88,237	-	691,620	691,620
Industrial Development Company	-	285,234	285,234	-	38,931	38,931	-	324,165	324,165
Infrastructure Financing Authority	-	1,450,418 <sup>(4)</sup>	1,450,418	-	10,371	10,371	-	1,460,789	1,460,789
Public Buildings Authority	2,884,487	-	2,884,487	-	15,417	15,417	2,884,487	15,417	2,899,904
Public Finance Corporation	-	4,230,942 <sup>(5)</sup>	4,230,942	-	-	-	-	4,230,942	4,230,942
Ports Authority	-	70,735 <sup>(6)</sup>	70,735	-	420,547	420,547	-	491,282	491,282
University of Puerto Rico	-	391,853 <sup>(7)</sup>	391,853	-	54,145	54,145	-	445,998	445,998
Others	-	-	-	-	2,273,928	2,273,928	-	2,273,928	2,273,928
<b>Total<sup>(8)</sup></b>	<b><u>\$3,392,156</u></b>	<b><u>\$17,968,711</u></b>	<b><u>\$21,360,867</u></b>	<b><u>\$158,696</u></b>	<b><u>\$3,918,790</u></b>	<b><u>\$4,077,486</u></b>	<b><u>\$3,550,852</u></b>	<b><u>\$21,887,501</u></b>	<b><u>\$25,438,353</u></b>

- (1) Principal of and interest on this debt is reimbursed from Commonwealth appropriations.
- (2) Excludes \$153 million of Special Facilities Revenue Bonds issued by the Highway and Transportation Authority, which are payable from net toll revenues collected from the Teodoro Moscoso Bridge.
- (3) Excludes the \$663 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.
- (4) Excludes \$1.1 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.
- (5) Payable primarily from Commonwealth appropriations. Excludes \$97 million of Qualified Zone Academy Bonds issued by the Public Finance Corporation, which are payable from securities purchased with funds assigned by the Children's Trust to the Department of Education.
- (6) Excludes \$155 million of Special Facilities Bonds issued by the Ports Authority, which are solely payable from by the pledge of certain payments made by a private corporation under a special facilities agreement.
- (7) Excludes \$87 million of Educational Facilities Revenue Bonds, 2000 Series A (University Plaza Project) issued by the Industrial, Tourist, Educational, Medical and Environmental Control Facilities Financing Authority, which are payable from rent payments made by the University of Puerto Rico.
- (8) Excludes accretion of interest from the respective issuance dates on capital appreciation bonds. Also excludes \$1.2 billion original principal amount of Children's Trust Tobacco Settlement Asset-Backed Bonds, Series 2002, 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 for Puerto Rico.

## **Government Development Bank for Puerto Rico**

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

As of September 30, 2005, \$1.704 billion of bonds and notes of GDB were outstanding, consisting of \$267 million in Commonwealth guaranteed GDB bonds and \$1.437 billion of GDB commercial paper. 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 September 30, 2005. As of said date, GDB also had \$6.6 billion in loans outstanding to the central government of the Commonwealth and its public corporations and municipalities.

Act No. 82 of 2002 ("Act No. 82") amended GDB's Charter to authorize GDB to transfer annually to the General Fund, beginning with fiscal year 2001, up to 10% of its audited net income or \$10,000,000, whichever is greater. GDB is not required by Act No. 82 to transfer any funds. GDB made payments to the General Fund of \$11.6 million for fiscal year 2003 and \$18.3 million for fiscal year 2004. GDB did not make a payment to the General Fund under Act No. 82 for fiscal year 2005, and none is expected to be made in fiscal year 2006.

Act No. 271 of November 21, 2002, requires GDB to make a special capital contribution to the Special Communities Trust of \$500 million and to provide the Trust with a \$500 million non-revolving line of credit. In December 2004, GDB transferred to the Trust the required \$500 million capital contribution and an additional \$270.7 million, which represented the remaining undisbursed balance of the \$500 million line of credit. The amounts transferred to the Trust were deposited in two investment accounts held by GDB for the benefit of the Trust. As of June 30, 2005, the Trust had repaid \$73 million of its line of credit and had an outstanding balance of \$427 million. The line of credit is payable from legislative appropriations.

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

*Housing Finance Authority.* Housing Finance Authority (formerly known as Housing Finance Corporation) was created to provide needed rental-housing units and stimulate the construction industry under federally subsidized programs. Effective February 8, 2002, Housing Finance Corporation became Housing Finance Authority and the Housing Bank and Finance Agency was dissolved and its powers transferred to the Housing Finance Authority. Housing Finance Authority provides financing for rental housing units, stimulates the construction industry under federally subsidized programs and provides interim financing for low-income housing projects and single-family homeownership programs. It is also engaged in insuring and servicing mortgages originated by the former Housing Bank and Finance Agency. As of September 30, 2005, Housing Finance Authority's total outstanding loans to the private sector for development of housing projects targeted to low-and moderate-income families were \$70.1 million. The Authority's mortgage loans to low and moderate income homeowners represented an additional \$87.8 million as of the same date.

Housing Finance Authority has outstanding tax-exempt revenue bonds and notes that were issued to finance the construction of housing units approved for federal rental subsidies and to finance home ownership of single family housing units. Such bonds and notes are limited obligations of the Housing Finance Authority payable solely from revenues collected in respect of such housing units. As of September 30, 2005, \$673 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 September 30, 2005, the Authority also had outstanding \$612 million of bonds issued to fund certain payments of the Commonwealth under its mortgage subsidy program for low and moderate income families, and to guarantee certain insurance obligations of the former Housing Bank and Finance Agency.

As of September 30, 2005, the Authority had total notes and bonds outstanding of \$1.4 billion (including \$141 million of debt outstanding under GDB lines of credit) and total unrestricted net assets of \$463 million (unaudited).

*Tourism Development Fund.* Tourism Development Fund was created in November 1993 to promote Puerto Rico's hotel and tourism industry by making available direct loans and guarantees to secure the payment of private financing used for new hotel development projects. Tourism Development Fund is also authorized to make capital investments in tourism related projects. As of September 30, 2005, Tourism Development Fund had outstanding direct loans in an aggregate principal amount of \$259.9 million and guarantees issued in the outstanding amount of \$167.5 million to finance hotels and tourism-related projects.

Tourism Development Fund has made payments under its guarantees and letters of credit in the aggregate amount of approximately \$313.4 million with respect to several projects, including \$282 million disbursed to pay in full the bonds issued to finance three projects, which bonds had been declared due and payable at the direction of Tourism Development Fund due to the failure of the borrowers of such projects to comply with their obligations under the related reimbursement agreements. Of the total amount disbursed, Tourism Development Fund has been able to recover approximately \$199.7 million from the borrowers. After taking these payments and all related recoveries into consideration, the unrestricted net assets of Tourism Development Fund as of September 30, 2005 were approximately \$99.3 million (unaudited), and its allowance for loan losses on guarantees, loans, other real estate owned and letters of credit was approximately \$36.8 million (unaudited).

*Capital Fund.* GDB Capital Fund (the "Capital Fund") was created in November 1992 for the purpose of investing and trading in debt obligations and publicly traded shares of domestic and foreign corporations separate from GDB's general investment operations. As of September 30, 2005, the Capital Fund had assets of \$73.1 million, which were all invested in an equity index fund that invests mainly in growth stocks.

*Development Fund.* Puerto Rico Development Fund (the "Development Fund") was established 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 is also authorized to guarantee obligations of these enterprises and invest in their equity securities. As of September 30, 2005, the Development Fund had \$17 million in such investments.

*Public Finance Corporation.* Puerto Rico Public Finance Corporation ("Public Finance Corporation") was established to provide agencies and instrumentalities of the Commonwealth with alternate means of meeting their financing requirements. The Public Finance Corporation currently holds notes payable by the Commonwealth, the Maritime Shipping Authority, the Office for the Improvement of Public Schools, the Department of Health, and the Aqueduct and Sewer Authority, among others. As of September 30, 2005, the Public Finance Corporation had \$4.2 billion aggregate principal amount of bonds outstanding. All such bonds are limited non-recourse obligations of the Public Finance Corporation payable solely from Commonwealth appropriations made to pay the notes held by the Public Finance Corporation.

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

## **Other Public Corporations**

*Aqueduct and Sewer Authority.* PRASA owns and operates 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. PRASA issues revenue bonds 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, the Commonwealth currently guarantees the principal and interest payments to the bondholders of all outstanding revenue bonds issued by PRASA, all outstanding bonds issued by PRASA to the United States Department of Agriculture, Rural Development, and all loans granted by the Clean Water and Drinking Water State Revolving Funds for the

benefit of PRASA. The guaranty covers additional debt obligations issued by PRASA until 2010. The total debt of PRASA was \$1.03 billion as of September 30, 2005.

From May 1995 until March 2004, the operation, management, repair, and maintenance of PRASA's systems were undertaken by private companies under operation and management contracts. 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's operation and management.

As part of the plan returning the operation 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 in order to provide continuity to top management and better implement, supervise and revise as needed the ten-year plan and goals identified for PRASA in 2002. Further powers granted include the authority to make certain determinations and take certain actions with respect to compliance of the water and sewer systems with various federal environmental laws.

PRASA has reported operational deficits of \$209.7 million and \$282.5 million during fiscal years 2003 and 2004, respectively. In fiscal year 2005, it is expected that PRASA will have incurred another significant operational loss. PRASA has covered these operational deficits with legislative appropriations from the Commonwealth General Fund. Beginning in fiscal year 2006, the Commonwealth will cease to provide financial assistance to PRASA. As a first significant step towards acquiring fiscal independence from the Commonwealth, in October 2005, PRASA approved a new tariff structure which provides for rate increases for virtually all customers in two phases: effective October 2005 and in July 2006. Rate increases in the first phase will average 65% depending on the type of client (residential, commercial/government or industrial) and on the consumption bracket of the client for the invoiced period. In the second phase, rate increases will average 35% based on these same factors. The new structure also includes changes from bi-monthly to monthly invoicing of residential customers. During the implementation of this first phase, GDB will provide financial assistance to PRASA with a \$100 million line of credit payable from future PRASA revenues. In order to achieve full fiscal independence, however, PRASA will have to implement various other changes, such as (i) significant cost savings programs; and (ii) a new and aggressive enforcement policy to identify and process delinquent customers. Although PRASA will require GDB financial assistance until these measures are fully implemented, the measures are intended to allow PRASA to become financially independent in the future.

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

Children's Trust issued \$1.2 billion aggregate principal amount of Tobacco Settlement Asset-Backed Bonds in October 2002. The bond proceeds were used, among other things, to pay the cost of certain capital expenses of the Commonwealth and certain capital and working capital expenses of PRASA. On June 30, 2005, the Children's Trust issued its \$108.2 million Tobacco Settlement Asset-Backed Bonds, Series 2005-A and 2005-B, to pay working capital expenses of the Commonwealth. As of September 30, 2005, the outstanding principal amount of the Trust's bonds was \$1.2 billion. These bonds and any other additional senior bonds issued by Children's Trust are secured by a statutory pledge of the payments made and to be made by 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* (“CCD 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 Convention Center opened on November 17, 2005. The CCD Authority currently has lines of credit with GDB totaling \$415.7 million, of which \$310.9 million was outstanding as of September 30, 2005 payable from a portion of the tax imposed on hotel stays earmarked to the CCD Authority.

The Industrial, Tourist, Educational, Medical and Environmental Control Facilities Financing Authority (“AFICA”) financed the construction of a multi-purpose coliseum in San Juan, known as the Jose Miguel Agrelot Coliseum, with a line of credit provided by GDB. The Jose Miguel Agrelot Coliseum was completed and transferred to the CCD Authority on August 2004. Pursuant to Act No. 185 of August 3, 2004, AFICA also transferred the line of credit to the CCD Authority. As of September 30, 2005, the line of credit had an outstanding balance of \$153.1 million. It is anticipated that this line of credit and the CCD Authority line of credit for the Convention Center will be refinanced in fiscal year 2006. The source of repayment for Coliseum debt will be revenues from Coliseum activities and appropriations for the Coliseum refinancing. The source of repayment for all other CCD Authority debt will consist of a portion of the tax imposed on hotel stays earmarked to the CCD Authority.

*Electric Power Authority* owns and operates the island’s electric system. The capital improvement program for the five-year period ending June 30, 2010, 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 September 30, 2005, the Authority’s total debt was \$5.5 billion, including \$5.2 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. 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 eight designated regions of the island and pays such insurance company the insurance premium for each eligible beneficiary within such region. The Administration is currently negotiating new contracts with the insurance companies. These negotiations could result in an increase in premiums in excess of the amounts budgeted for fiscal year 2006. The health insurance system covers all of the municipalities, and approximately 1.5 million persons were covered by the system during fiscal year 2005.

The total cost of the health insurance program for fiscal year 2006 is estimated at \$1.5 billion, compared to \$1.455 billion for fiscal year 2005 and \$1.37 billion for fiscal year 2004. For fiscal year 2005, the General Fund covered \$984 million of the total cost of the health insurance program, while the remaining \$471 million was paid from federal, municipal and other sources. For fiscal year 2006, it is expected that \$984 million of the cost of the health insurance program will again be covered from the General Fund, with the remainder expected to be paid from federal, municipal and other sources. See *Budget of the Commonwealth of Puerto Rico*.

*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. In September 2005, the Authority issued bonds in an



amount of \$1.5 billion to finance various highway projects and refund certain of the Authority's revenue bonds. As of September 30, 2005, the Authority's total debt was \$6.1 billion, including \$5.7 billion of bonds outstanding.

The Authority has completed the first phase of a new mass transit system, known as Tren Urbano, to serve a portion of metropolitan San Juan. 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 was \$2.25 billion, which cost was financed by Federal Transit Administration grants, other federal funding sources and the Authority's own resources, including bond financings. Tren Urbano commenced operations in June 2005. This project is now fully operational on a regular basis. Tren Urbano is expected eventually to serve the municipalities of Carolina and Caguas as well.

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 September 30, 2005, 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.

The Authority raised its highway tolls by approximately 43% in September 2005.

*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 September 30, 2005, the Company's total debt was \$324 million. The Company is currently restructuring its operations in order to allow it to react more quickly to changing business situations. Part of this restructuring includes a significant reduction in its employees.

*Industrial, Tourist, Educational, Medical and Environmental Control Facilities Financing Authority* was created in June 1977. The Authority has issued revenue bonds to finance industrial, tourist, educational, medical, and environmental control facilities in Puerto Rico for the use of private companies, non-profit entities, or government agencies. The bonds are payable solely from payments to be made to 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 September 30, 2005, approximately \$2.1 billion of the Authority's bonds were outstanding.

*Infrastructure Financing Authority* was created in June 1988 to provide financial, administrative, consulting, technical, advisory, and other types of assistance to other public corporations, governmental instrumentalities, political subdivisions and municipalities (collectively, "Benefited Entities") authorized to develop infrastructure facilities and to establish alternate means for financing 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 Benefited Entities. 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. Rum is the only article currently produced in Puerto Rico subject to federal excise taxes, the proceeds of which are required to be returned to the Treasury. The Authority is using these amounts to provide financial support for various infrastructure and other projects. As of September 30, 2005, the Authority's total debt was \$1.5 billion.

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

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 were 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 September 30, 2005, was \$328.5 million (not including accreted values of capital appreciation bonds outstanding). The bonds are payable from funds to be appropriated annually by the Legislative Assembly 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 Legislative Assembly, which appropriation is authorized but not legally required to be made. To date no such payments have been required. As of September 30, 2005, the Agency had \$1.1 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. As of September 30, 2005, the Authority had \$491.3 million in debt, including \$302.9 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 September 30, 2005, \$2.884 billion of such bonds of the Authority was outstanding (not including accretion of interest from the respective issuance dates on capital appreciation bonds). As of September 30, 2005, PBA's line of credit with GDB had an outstanding balance of \$15.4 million.

*Special Communities Perpetual Trust* is an irrevocable and permanent trust created in November 2002 as a public corporation. The Trust's principal purpose is to fund development projects which address the infrastructure and housing needs of underprivileged communities. Act No. 271 of November 21, 2002, requires GDB to provide the Trust with a \$500 million line of credit and to make a capital contribution to the Trust of \$500 million. In December 2004, GDB transferred to the Trust the \$500 million capital contribution as required by law and \$270.7 million, the amount remaining in the GDB \$500 million line of credit. The amounts transferred to the Trust were deposited in two investment accounts held by GDB for the benefit of the Trust, of which \$320 million had been disbursed to the Trust as of September 30, 2005. As of September 30, 2005, the Trust's line of credit with GDB had an outstanding balance of \$425.1 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 approximately 68,000 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 September 30, 2005, the University's total debt was \$446 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 is leased to the University for a term equal to the term of the bonds with University lease payments being sufficient to pay debt service on said bonds as they become due.

*Other public corporations* (not described above) have outstanding debt in the aggregate amount of \$1.1 billion as of September 30, 2005. Debt service on \$587.7 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 PRASA, 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, the Puerto Rico System of Annuities and Pensions for Teachers (the "Teachers Retirement System"), the Commonwealth Judiciary Retirement System (the "Judiciary Retirement System"), the Retirement System of the University of Puerto Rico (the "University Retirement System"), and the Employees Retirement System of Puerto Rico Electric Power Authority (the "Electric Power Authority Retirement System").

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

The Teachers Retirement System covers public school teachers and certain private school teachers as well as teachers working in administrative positions. Act No. 91 of March 29, 2004 established that (i) all new teachers hired from that date and thereafter are covered by the Teachers Retirement System; and (ii) current employees of the Teachers Retirement System as of that date may elect to participate in the Teachers Retirement System or in the Employees Retirement System. The Judiciary Retirement System covers judges, and the Employees Retirement System covers all other employees of the Commonwealth, its municipalities and instrumentalities. As of September 30, 2005, the total number of active members of the three systems was as follows: Employees Retirement System, 284,690; Teachers Retirement System, 78,500; and Judiciary Retirement System, 690. 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 employers and employees are determined by law rather than by actuarial requirements. For the Employees Retirement System, required employer contributions consist of approximately 9.275% of applicable payroll. Required employee contributions for the Employees Retirement System vary according to salary and how the individual employee's retirement benefits are coordinated with social security benefits. For the Judiciary Retirement System, required contributions consist of 20% of applicable payroll for the employer and 8% for the employees. For the Teachers Retirement System, required contributions consist of 8.5% of applicable payroll for the employer and 9.0% 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, 2003, the total pension benefit obligation for the Employees Retirement System and Judiciary Retirement System was \$11.2 billion and \$166.7 million, respectively. The unfunded pension benefit obligation of the Employees Retirement System and Judiciary Retirement System for the same period was \$9.2 billion and \$105 million, respectively, representing a funding ratio of 17.4% and 37.1%, respectively. Any amounts receivable from the Commonwealth with respect to benefits under special benefits laws (discussed below) are considered in the actuarial evaluation process to determine the unfunded liability of the Employees Retirement System to the extent receivables are recognized as such by the Employees Retirement System. The June 30, 2003 actuarial valuation was completed in accordance with the "Projected Unit Credit" method and assumed an investment return of 8.5% per year and a salary increase of 5% per year. Insofar as the statutorily mandated annual deposit to the Employees Retirement System and Judiciary Retirement System is insufficient to cover the actuarial pension liability, the unfunded pension benefit obligation will continue to increase in the short term, and additional funding from the Commonwealth may ultimately be necessary to cover such unfunded liability.

Various special benefits laws enacted in previous years provided for additional benefits for the Employees Retirement System, Teachers Retirement System, and Judiciary Retirement System. More specifically, in the case of the Employees Retirement System, Act No. 10 of May 21, 1992 provided for special benefit increases of 3% every three years. The first 3% increase was granted to retirees who had been receiving their annuities for three or more years as of that date. The second 3% increase was granted to retirees who had been receiving their annuities for three or more years as of January 1, 1995. This increase is being financed by additional contributions from the employers. The third 3% increase was granted to retirees who had been receiving their annuities for three or more years as of January 1, 1998. This third increase is being partially funded with additional contributions from some of the employers. In June 2001, the Legislative Assembly approved a 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 Legislative Assembly 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 express approval of the System's Board of Trustees and the Legislative Assembly, and must provide a funding source. In the case of the Judiciary Retirement System, Act No. 41 of June 13, 2001 provided a 3% special benefit increase in annuity payments, commencing on January 1, 2002 and every three years thereafter, to retirees who have been receiving their annuities for three or more years as of that date. This increase will be funded by the General Fund.

In connection with the special benefit laws applicable to the Teachers Retirement System, it is seeking reimbursement from the Commonwealth in the amount of \$119 million for special benefits paid by the System to its beneficiaries for previous fiscal years through 2005. OMB disputes the Teachers Retirement System's interpretation of these special benefit laws as requiring the Commonwealth's reimbursement of such special benefits paid, and this claim is currently under inter-agency arbitration proceedings. The Employees Retirement System is also seeking reimbursement from the Commonwealth (in connection with other special benefits laws applicable to its beneficiaries) in the amount of \$57.8 million, representing cumulative benefits paid to beneficiaries through June 30, 2004. The Employees Retirement System projects additional shortfalls of \$20 million for fiscal year 2005 (currently under audit) and \$43 million for fiscal year 2006, in connection with special benefits law payments. OMB believes that the basis of the claims from the Employees Retirement System is valid but that the amounts claimed still remain to be verified and reconciled. With respect to the shortfall for fiscal year 2006, OMB is also evaluating the requested amount by the Employees Retirement System needed to cover its shortfall over the budgeted amounts for fiscal year 2006. See "Fiscal Year 2006 Budget" under *Budget of the Commonwealth of Puerto Rico*.

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 contributions to the System and limited the retirement benefits for new employees by increasing the length of employment required for the vesting of certain benefits and reducing the level of benefits in the case of early retirement. The legislation also reduced the level of occupational disability benefits and death benefits received by new employees.

In 1999, the organic act of the Employees Retirement System was further amended to change it, prospectively, from a defined benefit system to a defined contribution system. This amendment provides for the establishment of an individual account for each employee hired by the Commonwealth after December 31, 1999 and for those current employees who elect to transfer from the existing defined benefit system. The individual account of each current employee is credited initially with an amount equal to his aggregate contributions to the Employees Retirement System, plus interest. Current employees who did not elect to transfer to the new defined contribution system will continue accruing benefits under the current defined benefit system. The individual account of each participant of the new defined contribution system is credited monthly with the participant's contribution and is credited semiannually with a rate of return based on either of two notional investment returns. Such accounts are not credited with any contribution by the employer. Instead, employer contributions will now be used completely to reduce the accumulated unfunded pension 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 2003, 2004, and 2005 exceeded contributions and investment income for those years. The cash shortfall for fiscal year 2003 was covered with a portion of the proceeds from the sale to Verizon of the 15% stock ownership in PRTC and a loan received from the Treasury. The cash shortfall for fiscal year 2004 was covered with a loan received from the Treasury. Balances owed to the Treasury and other pending working capital needs through fiscal year 2005 were refinanced through a repurchase agreement with a financial institution in an amount of \$138 million collateralized with the Employees

Retirement System assets. A cash shortfall, which will be covered either by a sale of assets, a loan received from the Treasury, or other financial market transactions, is also expected for fiscal year 2006.

The Employees Retirement System anticipates that its future cash flow needs for disbursement of benefits to participants is likely to exceed the sum of the employer and employee contributions received and its investment and other recurring income. Also under evaluation by the Employees Retirement System is the sale of the remaining shares of PRTC stock. The proceeds to be generated by this transaction may be used to fund any cash flow imbalance, or portion thereof, in the next few years. The Employees Retirement System is also evaluating other measures to improve its cash flows and funding ratio. Some of these measures include, but are not limited to, the establishment of a maximum salary to calculate pension benefits, aggressive collection efforts with respect to employer contributions owed by the Commonwealth, the municipalities and public corporations, the transfer to the Employees Retirement System of any amounts remaining in the Children's Trust after payment of all the outstanding bonds, and the assignment to the Employees Retirement System of a percentage of General Fund revenues and/or excess proceeds derived from the proposed tax reform being considered by the Commonwealth. See "Proposed Tax Reform" under *Puerto Rico Taxes, Other Revenues, and Expenditures*.

In addition, legislation has been submitted that, if enacted, will authorize the issuance of pension obligation bonds ("POBs"). The POBs will contribute approximately \$2 billion in assets to the Employees Retirement System and will be payable solely from the Commonwealth's General Fund. While the POBs are outstanding and the Commonwealth is paying debt service, General Fund transfers to the Employees Retirement System in any fiscal year will be reduced by an amount equal to the lesser of \$100 million and the debt service on the POBs payable in such fiscal year. The proposed legislation also includes a measure that would increase employee and employer contributions to the Employees Retirement System from 8.275% and 9.275%, respectively, to 10% each. The Employees Retirement System projects that current contributions, together with investment and other recurring income, earnings on the \$2 billion that would be raised by the issuance of the POBs, and the proposed increase in employee and employer contributions will allow it to improve its funding ratio. It is uncertain, however, if and when the legislation submitted will be considered and approved.

According to the most recent actuarial valuation of the Teachers Retirement System submitted by a firm of independent consulting actuaries, as of June 30, 2004 the accrued actuarial liability of the system was \$4.7 billion and the value of its assets amounted to \$2.4 billion, representing a funding ratio of 51%, and the resulting unfunded accrued liability was \$2.3 billion. This funding ratio takes into account the recent turn-around in the equities market and the restructuring of the portfolio's asset composition. The actuarial valuation assumed an investment return of 8%, yearly salary increases of 5%, employee and employer contributions of 9% and 8.5%, respectively, and a remaining amortization period of 16 years for the unfunded accrued liability. The actuarial accrued liability does not include benefits paid under special benefits laws (described above) and will not include the obligation with respect to the prospective payments under special benefits laws because these are not obligations of the Teachers Retirement Fund, and the funding for such benefits will originate from the Commonwealth's General Fund. Insofar as the statutorily mandated annual deposit to the Teachers Retirement System is insufficient to cover the actuarial pension liability, the unfunded pension benefit obligation will continue to increase in the short term, and additional funding from the Commonwealth may ultimately be necessary to cover such unfunded liability.

The following tables present the Statement of Plan Net Assets and Statement of Changes in Plan Net Assets of the Employees Retirement System, the Judiciary Retirement System, and the Teachers Retirement System for fiscal years 2003, 2004, and 2005.

**The Commonwealth of Puerto Rico**  
**Employees Retirement System**  
**Statement of Plan Net Assets\***  
**As of June 30, 2005, 2004 and 2003**

	2005 <sup>(1)</sup>	2004	2003
<b>ASSETS</b>			
Cash and Investments:			
Cash and Cash Equivalents:			
Deposits at commercial banks	\$ 24,585,761	\$ 12,672,927	\$ 35,038,118
Deposited with GDB:			
Unrestricted	13,196,092	31,852,889	28,112,466
Restricted	1,577,829	1,139,837	652,637
Total Cash	39,359,683	45,665,654	63,803,223
Marketable Securities:			
Notes and Bonds	20,786,293	106,440,889	218,092,563
Stocks	1,200,131,525	1,162,761,632	944,904,356
Master Repo	145,186,563	-	-
Alternative investments	41,243,583	41,632,679	34,089,407
Total Cash and Investments	<b>1,407,347,965</b>	<b>1,310,835,201</b>	<b>1,197,086,327</b>
LOANS TO PLAN MEMBERS:			
Mortgage	82,769,119	72,375,251	65,435,904
Personal	367,732,209	281,231,806	203,082,715
Cultural Trips	20,589,836	15,596,225	13,277,170
Total Loans to Plan Members	<b>471,091,165</b>	<b>369,203,283</b>	<b>281,795,789</b>
Investment in PRTA Holdings	486,080,000	404,390,000	362,670,000
Total cash, investments and loans to plan members	<b>2,403,878,814</b>	<b>2,130,094,138</b>	<b>1,905,355,340</b>
RECEIVABLES:			
Employer	34,655,581	32,655,770	31,256,878
General Fund of the Commonwealth	21,483,869	11,013,923	10,967,574
The Commonwealth of PR Judiciary	1,376,260	3,471,665	2,178,758
Investment Sales	2,090,012	605,886	572,683
Accrued Interest	1,303,273	2,288,387	4,051,724
Other	27,725,288	36,662,026	17,567,254
Total Receivables	88,634,287	88,697,659	66,594,873
PROPERTY:	8,410,789	8,330,293	7,583,372
OTHER ASSETS:	7,764,040	7,824,497	9,811,479
Total Assets	<b>2,508,687,932</b>	<b>2,234,946,589</b>	<b>1,989,345,064</b>
<b>LIABILITIES</b>			
Book overdraft	-	58,028,695	-
Short Term Obligations	138,000,000	-	-
Escrow Funds to plan Members and Guarantee Insurance	20,502,138	19,886,502	18,231,988
Investment Purchases	2,078,940	1,202,112	1,348,888
Other Liabilities	15,112,796	14,387,381	22,362,558
Total Liabilities	<b>175,693,875</b>	<b>93,504,691</b>	<b>41,943,435</b>
<b>Net Assets Held in Trust for Pension Benefits</b>	<b>\$2,332,994,056</b>	<b>\$2,141,441,898</b>	<b>\$1,947,401,629</b>

\* Totals may not add due to rounding.

(1) Financial information for fiscal year 2005 is unaudited.

**The Commonwealth of Puerto Rico  
Employees Retirement System  
Statement of Plan Net Assets\*  
As of June 30, 2005, 2004 and 2003**

	2005 <sup>(1)</sup>	2004	2003
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**The Commonwealth of Puerto Rico  
Employees Retirement System  
Statement of Changes in Plan Net Assets\*  
As of June 30, 2005, 2004 and 2003**

	2005 <sup>(1)</sup>	2004	2003
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<b>ADDITIONS:</b>			
Contributions:			
Employer	\$ 374,661,488	\$ 330,335,460	\$ 312,472,902
Employees	332,236,585	294,013,459	276,346,849
Special	14,730,754	14,553,107	17,930,529
Total Contributions	<b>721,628,828</b>	<b>638,902,028</b>	<b>606,750,281</b>
Investment Income:			
Realized Gain or Loss	35,170,888	22,990,043	(209,864,923)
Unrealized Gain or Loss	151,623,890	235,712,185	173,426,231
Dividend Income	19,111,464	6,692,664	42,561,011
Interest Income	49,011,603	43,795,352	43,309,670
Total	<b>254,917,847</b>	<b>309,190,244</b>	<b>49,430,990</b>
Less Investment Expense	(3,297,066)	(3,058,129)	(3,425,599)
Other Income	13,769,263	6,860,191	11,126,916
Net Investment Income	<b>265,390,044</b>	<b>312,992,306</b>	<b>57,132,307</b>
Total Additions	<b>987,018,872</b>	<b>951,894,334</b>	<b>663,882,588</b>
<b>DEDUCTIONS:</b>			
Annuities	714,454,966	672,578,372	614,500,062
Special	14,730,754	14,553,107	17,930,529
Death Benefits	10,894,649	11,098,998	12,371,185
Refunds:			
Employer	1,734,048	1,220,244	2,727,922
Employees	17,782,305	18,768,598	19,861,204
Administrative Expenses	35,869,989	31,527,570	28,768,227
Net Adjustment in the conversion to a new loan application	-	8,107,173	-
Total Deductions	<b>795,466,714</b>	<b>757,854,066</b>	<b>696,159,131</b>
Net Increase	<b>191,552,158</b>	<b>194,040,268</b>	<b>(32,276,542)</b>
Net Assets Held in Trust for Pension Benefits:			
Beginning of the Year	2,141,441,898	1,947,401,629	1,979,678,171
End of Year	<b>\$2,332,994,056</b>	<b>\$2,141,441,898</b>	<b>\$1,947,401,629</b>

\* Totals may not add due to rounding.

(1) Financial information for fiscal year 2005 is unaudited.



**The Commonwealth of Puerto Rico**  
**Judiciary Retirement System**  
**Statement of Plan Net Assets\***  
**As of June 30, 2005, 2004 and 2003**

	<b>2005<sup>(1)</sup></b>	<b>2004</b>	<b>2003</b>
<b>ASSETS</b>			
Cash and Investments:			
Cash and Cash Equivalents	\$ 1,803,777	\$ 1,028,749	\$2,555,092
Cash Deposited with GDB			
Unrestricted	921,430	222,120	990,357
Restricted	871	762	-
Total Cash	<u>2,726,079</u>	<u>1,251,632</u>	<u>3,545,449</u>
Receivables:			
Accrued Interest	252,862	304,442	349,600
Investment Sales	102,365	27,036	32,451
Other	48,657	45,230	46,004
Total Receivables	<u>403,885</u>	<u>376,709</u>	<u>428,056</u>
Marketable Securities:			
Notes and Bonds	20,031,133	20,781,506	19,772,751
Stock	49,360,624	48,943,697	40,057,519
Total Marketable Securities	<u>69,391,458</u>	<u>69,725,203</u>	<u>59,830,271</u>
<b>LOANS TO PLAN MEMBERS</b>			
Mortgage	435,247	48,344	31,219
Personal	173,292	119,990	306,908
Cultural Trips	34,453	43,495	51,191
Total Loans to Plan Members	<u>251,269</u>	<u>211,831</u>	<u>389,319</u>
Total cash, investments and loans to plan members	<u>72,772,692</u>	<u>71,565,376</u>	<u>64,193,096</u>
<b>LIABILITIES</b>			
Book overdraft	827,661	3,471,665	2,178,758
Due to the Employees Retirement System of the Government of Puerto Rico	1,376,260	129,282	125,630
Escrow Funds to Plan Members and Guarantee Insurance	130,022	129,282	125,630
Investment Purchases	123,315	65,300	59,197
Other Liabilities	47,639	48,880	48,762
Total Liabilities	<u>2,504,899</u>	<u>3,715,128</u>	<u>2,412,348</u>
<b>Net Assets Held in Trust for Pension Benefits</b>	<u><b>\$70,267,792</b></u>	<u><b>\$67,850,247</b></u>	<u><b>\$61,780,747</b></u>

\* Totals may not add due to rounding.

(1) Financial information for fiscal year 2005 is unaudited.

**The Commonwealth of Puerto Rico**  
**Judiciary Retirement System**  
**Statement of Changes in Plan Net Assets\***  
**As of June 30, 2005, 2004 and 2003**

	2005 <sup>(1)</sup>	2004	2003
<b>ADDITIONS:</b>			
Contributions:			
Employer	\$ 6,469,432	\$ 5,556,053	\$ 5,536,328
Employees	2,775,268	2,577,924	2,478,483
Total Contributions	<b>9,244,701</b>	<b>8,133,978</b>	<b>8,014,811</b>
Investment Income:			
Realized Gain or Loss	1,997,588	1,160,917	2,414,484
Unrealized Gain or Loss	2,247,722	6,931,720	-
Dividend Income	206,323	158,457	168,083
Interest Income	1,158,023	1,177,090	1,803,760
Total	<b>5,609,657</b>	<b>9,428,185</b>	<b>4,386,327</b>
Less Investment Expense	(190,134)	-	(255,737)
Other Income	3,645	579	-
Net Investment Income	<b>5,423,169</b>	<b>9,428,765</b>	<b>4,130,590</b>
Total Additions	<b>14,667,871</b>	<b>17,562,743</b>	<b>12,145,401</b>
<b>DEDUCTIONS:</b>			
Annuities	10,758,894	9,927,398	9,330,594
Refunds:			
Employer	135,074	-	-
Employees	124,296	-	-
Administrative Expenses	1,232,060	1,348,717	1,474,138
Net Adjustment in the conversion to a new loan application	-	217,127	-
Total Deductions	<b>12,250,325</b>	<b>11,493,243</b>	<b>10,804,732</b>
Net Increase	<b>2,417,545</b>	<b>6,069,499</b>	<b>1,340,668</b>
Net Assets Held in Trust for Pension Benefits:			
Beginning of the Year	67,850,247	61,780,747	60,440,079
End of the Year	<b>\$70,267,792</b>	<b>\$67,850,247</b>	<b>\$61,780,747</b>

\* Totals may not add due to rounding.

(1) Financial information for fiscal year 2005 is unaudited.

**The Commonwealth of Puerto Rico**  
**Annuities and Pension for Teachers**  
**Statement of Plan Net Assets\***  
**As of June 30, 2005, 2004 and 2003**  
**(in thousands)**

	<b>2005</b>	<b>2004</b>	<b>2003</b>
<b>ASSETS</b>			
Cash:			
Cash and cash equivalents	\$ 79,017	\$ 67,113	\$ 204,886
Cash with fiscal agent	2,853	-	-
Cash restricted	1,595	2,396	2,236
Cash deposited with GDB	3,536	3,717	4,199
Total Cash	<u>87,001</u>	<u>73,226</u>	<u>211,321</u>
Investments, at fair value:			
Bonds and notes	257,030	280,747	737,913
Stocks	1,833,168	1,678,679	971,014
Total investment at fair value	<u>2,090,198</u>	<u>1,959,426</u>	<u>1,708,927</u>
Other investments:			
Mortgage notes acquired from third parties	-	-	7
Private equity investments	44,747	43,660	34,728
Total investments	<u>2,134,945</u>	<u>2,003,086</u>	<u>1,743,662</u>
Loan to plan members:			
Mortgage	109,605	110,293	113,116
Personal	234,335	233,342	235,118
Cultural trips	1,338	1,148	1,210
Total loans to plan members	<u>345,278</u>	<u>344,783</u>	<u>349,444</u>
Total investments and loans	<u>2,567,224</u>	<u>2,421,095</u>	<u>2,304,427</u>
Accounts receivable:			
Receivable for investments sold	10,516	5,535	124,400
Accrued interest and dividends receivable	4,449	5,380	9,705
Other	2,593	2,500	1,845
Total accounts receivable	<u>17,558</u>	<u>13,415</u>	<u>135,950</u>
Property and equipment, net	26,206	24,332	24,964
Other assets	600	619	597
Total Assets	<u><b>2,611,588</b></u>	<u><b>2,459,461</b></u>	<u><b>2,465,938</b></u>
<b>LIABILITIES</b>			
Investments purchased	14,262	10,567	238,883
Cash overdraft in cash with fiscal agent	-	7,812	42,210
Accounts payable	3,768	2,570	2,296
Obligation under capital lease	78	96	-
Accrued expenses	4	3,071	2,785
Line of credit	4,314	240	-
Escrow fund of mortgage loans and guarantee insurance reserve for loans to plan members	6,069	9,911	11,311
Bonds payable	21,285	22,090	22,943
Other liabilities	669	109	2,848
Total liabilities	<u><b>50,449</b></u>	<u><b>56,466</b></u>	<u><b>323,276</b></u>
<b>Net Assets Held in Trust for Pension Benefits</b>	<u><b>\$2,561,139</b></u>	<u><b>\$2,402,995</b></u>	<u><b>\$2,142,662</b></u>

\* Totals may not add due to rounding.

**The Commonwealth of Puerto Rico**  
**Annuities and Pensions for Teachers**  
**Statement of Changes in Plan Net Assets\***  
**As of June 30, 2005, 2004 and 2003**  
**(in thousands)**

	<b>2005</b>	<b>2004</b>	<b>2003</b>
<b>ADDITIONS:</b>			
Contributions:			
Employees	\$ 131,481	\$ 118,743	\$ 112,774
Employer	120,887	110,548	104,403
Special	60,853	40,409	27,490
Total contributions	<b>313,221</b>	<b>269,700</b>	<b>244,667</b>
Investment Income:			
Interest income	47,577	55,878	82,210
Dividend Income	20,339	17,264	16,513
Net appreciation in fair value of investments	161,685	240,732	(42,227)
	<b>229,601</b>	<b>313,874</b>	<b>56,496</b>
Less investment expense	4,986	4,986	5,508
Net investment income	224,615	308,916	50,988
Other income	1,167	32,397	1,010
Total additions	<b>539,003</b>	<b>611,013</b>	<b>296,665</b>
<b>DEDUCTIONS:</b>			
Benefit paid to participants:			
Annuities and death benefits	313,551	292,401	276,096
Special benefits	38,592	32,210	22,433
Refunds of contributions	2,912	3,432	3,021
Administrative expenses	25,804	22,637	19,544
Total deductions	<b>380,859</b>	<b>350,680</b>	<b>321,094</b>
Net increase in net assets held in trust for pension benefits	158,144	260,333	(24,429)
Net assets held in trust for pension benefits			
Beginning of year	2,402,995	2,142,662	2,167,091
End of year	<b>\$2,561,139</b>	<b>\$2,402,995</b>	<b>\$2,142,662</b>

\* Totals may not add due to rounding.

**COMMONWEALTH FINANCIAL STATEMENTS**

For fiscal year 2004, 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 independent auditors whose reports were furnished to KPMG LLP, and its opinion on the basic financial statements, insofar as it relates to the amounts included in the basic financial statements pertaining to such activities, funds and component units, was based solely on the reports of the other auditors.

The Comprehensive Annual Financial Report of the Commonwealth (“CAFR”) for fiscal year 2004, which includes the basic financial statements of the Commonwealth for fiscal year 2004, was filed by the Commonwealth with each nationally recognized municipal securities information repository on May 17, 2005. The CAFR for fiscal year 2005 is expected to be released during the first quarter of calendar year 2006.

## 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 actual revenues and expenditures of the General Fund on a cash basis for fiscal year 2002 through fiscal year 2004, the preliminary revenues and expenditures for fiscal year 2005, and the budgeted revenues and expenditures for fiscal year 2006, which, with certain exceptions, were capped at fiscal year 2005 levels as discussed under *Budget of the Commonwealth of Puerto Rico*. The information relating to fiscal year 2005 is based on the preliminary figures of revenues and expenditures for such fiscal year. The information relating to fiscal year 2006 reflects the revenues projected by the Treasury and the expenditures included in the fiscal year 2005 budget, which carried over to fiscal year 2006 as a result of the failure to enact a new budget by June 30, 2005 as mandated by the Constitution of the Commonwealth, as such expenditures were adjusted pursuant to an Executive Order of the Governor, dated August 30, 2005, and other actions. For a discussion of the expenditures included in the budget for fiscal year 2006, the adjustments made by the Governor, and the anticipated budget imbalance for fiscal year 2006, see “Budget for Fiscal Year 2006” under *Budget of the Commonwealth of Puerto Rico*.

The amounts shown in the following table as expenditures may be different than those reflected in the budget or in the Commonwealth’s financial statements because the table shows only cash disbursements, while the budget includes all authorized expenditures, regardless of when the related cash is actually disbursed. In addition, transfers to the Redemption Fund (used to pay debt service on the Commonwealth’s bonds), which are included in the budget under “debt service,” are shown as a deduction from total revenues in calculating “adjusted revenues” in the table and are not included under “expenditures.” Finally, certain expenditures incurred in excess of budgeted amounts may not be reflected in the table as expenditures to the extent they are paid from reserve funds, such as moneys in the Budgetary Fund. For example, in fiscal years 2003, 2004, and 2005, there were approximately \$150 million, \$85 million, and \$80 million, respectively, of such expenditures that are not reflected in the table. A discussion of the budget for fiscal year 2005 and the budget for fiscal year 2006 appears below under *Budget of the Commonwealth of Puerto Rico*.

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

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

	<u>2002</u>	<u>2003</u>	<u>2004</u>	<u>2005<sup>(p)</sup></u>	<u>2006<sup>(e)</sup></u>
Beginning cash balance	\$ 125,154	\$ 350,284	\$ 179,058	\$ 108,512	\$ 44,264
Revenues from internal sources:					
Income Taxes:					
Individuals	2,449,982	2,517,678	2,720,920	2,919,198	3,093,000
Corporations	1,706,137	1,776,985	1,831,027	1,871,919	2,143,000
Partnerships	2,670	2,101	3,005	3,245	3,000
Withheld from non-residents	583,256	517,141	631,100	612,006	628,000
Tollgate taxes	59,515	45,321	31,579	22,973	17,000
Interest	14,310	11,278	10,108	10,490	11,000
Dividends	62,548	49,790	70,192	80,398	74,000
Total income taxes	<u>4,878,418</u>	<u>5,170,294</u>	<u>5,297,931</u>	<u>5,520,229</u>	<u>5,969,000</u>
Commonwealth excise taxes:					
Alcoholic beverages	249,705	299,582	296,302	298,235	316,000
Cigarettes	116,055	149,487	144,733	146,527	152,000
Motor vehicles	418,024	499,252	551,181	606,662	614,000
Other excise taxes	681,344	703,029	701,129	732,803	798,000
Total Commonwealth excise taxes	<u>1,465,128</u>	<u>1,651,350</u>	<u>1,693,345</u>	<u>1,784,227</u>	<u>1,880,000</u>
Property taxes	-	-	-	3,910	-
Inheritance and gift taxes	1,962	2,825	15,691	7,129	2,000
Licenses	82,575	85,876	84,231	87,416	110,000
Other:					
Lottery	61,358	67,621	65,387	49,633	63,000
Electronic Lottery	57,897	89,443	86,115	68,011	83,000
Miscellaneous non-tax revenues	562,213 <sup>(1)</sup>	438,457	379,501	420,315	462,000 <sup>(8)</sup>
Total Other	<u>681,468</u>	<u>595,521</u>	<u>531,003</u>	<u>537,959</u>	<u>608,000</u>
Total revenues from internal sources	<u>7,109,551</u>	<u>7,255,866</u>	<u>7,622,201</u>	<u>7,940,870</u>	<u>8,569,000</u>
Revenues from non-Commonwealth sources:					
Federal excise taxes <sup>(2)</sup>	314,253	309,958	328,921	341,093	350,000
Customs	30,595	25,918	34,266	25,037	26,000
Total revenues from non-Commonwealth sources	<u>344,848</u>	<u>335,876</u>	<u>363,187</u>	<u>366,130</u>	<u>376,000</u>
Total net revenues	<u>7,454,399</u>	<u>7,841,742</u>	<u>7,985,388</u>	<u>8,307,000</u>	<u>8,945,000</u>
Other Income (refunds) <sup>(3)</sup>	111,411	(78,927)	62,789	(55,409)	(42,632)
Transfers to Redemption Fund <sup>(4)</sup>	(274,773)	(331,925)	(341,538)	(369,985)	(484,812)
Proceeds of notes and other borrowings <sup>(5)</sup>	1,161,856	2,259,775	3,940,397	4,925,595	2,951,000 <sup>(9)</sup>
Repayment of notes and other borrowings <sup>(6)</sup>	(1,201,084)	(2,021,832)	(3,713,634)	(3,909,434)	2,346,000
Adjusted revenues	<u>7,251,622</u>	<u>7,418,833</u>	<u>7,933,402</u>	<u>8,897,767</u>	<u>9,022,556</u>
Expenditures:					
Grants and subsidies	2,862,288	3,773,579	3,468,531	3,617,386	2,716,644

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

	<u>2002</u>	<u>2003</u>	<u>2004</u>	<u>2005<sup>(p)</sup></u>	<u>2006<sup>(c)</sup></u>
Personal services	2,884,636	3,119,476	3,951,387	4,783,567	5,597,632
Other services	764,655	583,343	400,594	389,346	557,939 <sup>(10)</sup>
Materials and supplies	106,294	80,491	73,757	72,411	147,527
Equipment purchases	20,397	33,170	20,572	20,707	45,446
Capital outlays and other debt service	73,806	-	675	78,598	-
Transfers to agencies <sup>(7)</sup>	314,416	-	-	-	-
Prior year disbursements	-	-	88,432	-	-
Total expenditures	<u>7,026,492</u>	<u>7,590,059</u>	<u>8,003,948</u>	<u>8,962,015</u>	<u>9,065,188</u>
Adjusted revenues less expenditures	<u>225,130</u>	<u>(171,226)</u>	<u>(70,546)</u>	<u>(64,248)</u>	<u>(42,632)</u>
Ending cash balance	<u>\$ 350,284</u>	<u>\$ 179,058</u>	<u>\$ 108,512</u>	<u>\$ 44,264</u>	<u>\$ 1,632</u>

(p) Preliminary.

(c) Current Budget.

(1) Includes certain non-recurring revenues totaling \$244.1 million.

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

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

(4) 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.

(5) Consists of proceeds of Commonwealth tax and revenue anticipation notes and borrowings from GDB.

(6) Consists of repayment of Commonwealth tax and revenue anticipation notes and borrowings from GDB.

(7) "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.

(8) Includes revenues from an interest rate swap transaction amounting to \$100 million.

(9) Includes \$221 million from the Budgetary Fund, Emergency Fund, and other sources.

(10) Does not include possible payments relating to previous years' debt with vendors, estimated at \$268 million.

Source: Department of the Treasury

*Fiscal Year 2006*

General Fund total revenues for fiscal year 2006 are projected to be \$8.945 billion, which represents an increase of \$638 million from fiscal year 2005 net revenues. Projected increased revenues for fiscal year 2006 include: (i) increases in income taxes from individuals of \$173.8 million; (ii) increases in income taxes from corporations of \$271.1 million; and (iii) increases in total excise taxes of \$95.8 million. The \$8.945 billion amount includes \$100 million from an interest rate swap transaction that the Commonwealth anticipates undertaking during fiscal year 2006.

The projection of General Fund revenues for fiscal year 2006 is based on a projected nominal growth in gross national product of 5.9% and additional revenues of \$130 million from the following new transitional legislation: (i) an increase in income taxes applicable to regular corporations (\$68 million); (ii) an increase in license fees for luxury cars (\$17 million); (iii) a surtax on insurance companies (\$16 million); and (iv) an increase in capital gains rates (\$29 million). These tax increases are scheduled to expire during fiscal year 2008 after the changes in the tax reform proposal currently being discussed are fully implemented. See "Proposed Tax Reform" below. The projected revenues also assume the receipt of \$95 million from the following administrative measures: (i) an intensification of efforts to detect excise tax evasion using recently acquired x-ray machines to monitor ship containers at ports of entry; (ii) the implementation of a program to improve all tax collections; and (iii) heightened scrutiny on the payment of excise taxes on crude oil and its derivatives.

General Fund estimated total revenues for the first quarter of fiscal year 2006 were \$2.1 billion, which exceeded the amount originally budgeted by \$56 million. The quarterly increase is attributable to an increase in income taxes from individuals (\$48 million), withholding tax revenues from non-residents (\$48 million) and external revenues (\$3 million), coupled with decreases in income taxes from corporations (\$16 million), excise taxes (\$19 million) and non-tax revenues (\$8 million). Also, total revenues for this first quarter showed an increase of \$264.4 million or 14% when compared to the same period in fiscal year 2005. This increase, in comparison with fiscal year 2005, was attributable to increases in income taxes from individuals (\$69.6 million), corporations (\$41.3 million), taxes withheld from non-residents (\$158.8 million) and external revenues (\$16.1 million), together with decreases in excise taxes (\$2.7 million), and non-tax revenues (\$18.7 million). The increase in revenues from individual income taxes is mainly attributable to administrative measures. The increase in the withholding tax on non-residents for this first quarter in fiscal year 2006, included an extraordinary \$125 million payment from one taxpayer, which payment had been taken into consideration in the revenue projections for fiscal year 2006.

Budgeted expenditures for fiscal year 2006 are \$8.945 billion. Estimated expenditures for fiscal year 2006 amount to \$9.319 billion. For a discussion of the difference between the budgeted expenditures, estimated expenditures and the measures that the Commonwealth has identified to cover the estimated budget imbalance, see “Budget for Fiscal Year 2006” and “2006 Budget Approval Process” under *Budget of the Commonwealth of Puerto Rico*.

#### *Fiscal Year 2005 (Preliminary)*

General Fund final total net revenues for fiscal year 2005 were \$8.307 billion, representing an increase of \$322 million or 4%, from fiscal year 2004 net revenues. This amount excludes proceeds of a loan of \$550 million obtained from GDB, which is included as part of “Proceeds of notes and other borrowings.” The major changes in revenues from fiscal year 2004 were: (i) increases in total income taxes of \$222 million, mainly resulting from increases in income taxes collected from individuals of \$198 million and in income taxes collected from corporations of \$40 million; (ii) increases in total excise taxes of \$90.8 million; and (iii) increases in other revenues of \$6.9 million, mainly as a result of an increase in miscellaneous non-tax revenues of \$40.8 million.

Preliminary total cash expenditures for fiscal year 2005 are estimated at \$9.208 billion, which exceeded budgeted expenditures by \$354 million, attributed mainly to increases in the area of education (\$303 million), public safety and protection (\$23 million), health (\$15 million), welfare (\$10 million), and economic development (\$3 million). This amount also excludes approximately \$80 million of additional expenditures that were not originally budgeted. Various financing transactions were entered into to cover this imbalance. For more detailed information, see “Fiscal Year 2005 Budget” under *Budget of the Commonwealth of Puerto Rico*.

#### *Fiscal Year 2004*

General Fund total net revenues for fiscal year 2004 were \$7.985 billion, representing an increase of \$143 million, or 1.8%, from fiscal year 2003 net revenues. This amount excludes proceeds of a loan of \$233 million obtained from GDB, which is included as part of “Proceeds of notes and other borrowings.” This amount also excludes \$88 million of additional non-recurring revenues. The major changes in revenues from fiscal year 2003 were: (i) increases in total income taxes of \$128 million, mainly resulting from increases in income taxes from individuals of \$203 million and in income taxes withheld from non-residents of \$114 million; (ii) increases in total excise taxes of \$42 million; and (iii) decreases in other revenues of \$65 million, mainly as a result of a decrease in miscellaneous non-tax revenues of \$59 million. Approximately \$170 million of the increase in total income taxes for fiscal year 2004 relates to the collection of past taxes as a result of an incentives plan implemented by the Treasury.



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

### *Fiscal Year 2003*

General Fund total revenues for fiscal year 2003 were \$7.841 billion, representing an increase of \$387 million, or 5.2%, from actual fiscal year 2002 revenues. This amount excludes proceeds of a loan of \$250 million obtained from GDB, which is included as part of “Proceeds of notes and other borrowings.” The major changes from fiscal year 2002 were: (i) increases in income taxes from individuals of \$67 million and in corporate income taxes of \$71 million; (ii) increases in excise taxes on alcoholic beverages and cigarettes of \$83 million, and an increase in motor vehicles excise taxes of \$81 million; (iii) an increase in electronic lottery revenues of \$32 million; and (iv) a decrease in miscellaneous non-tax revenues of \$124 million and in income taxes withheld from non-residents of \$66 million. The decrease in miscellaneous non-tax revenues relates to certain special administrative measures that had been implemented by the Secretary of the Treasury in fiscal year 2002 and that did not apply to fiscal year 2003.

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

### *Commonwealth’s Budget Structural Imbalance*

The Commonwealth is currently experiencing a budget imbalance in fiscal year 2006 which comes in the wake of several recent fiscal years during which the Commonwealth had insufficient recurring revenues to cover its expenditures. These imbalances have been covered in the past with loans from GDB, financing transactions (including long-term bond issues) and other non-recurring resources. During fiscal year 2005, the amount by which the Commonwealth’s operating expenditures exceeded its recurring revenues (the so-called structural imbalance) was \$989 million. The Commonwealth estimates that during fiscal year 2006, the structural imbalance will be \$858 million. This amount represents the difference between (A) recurring revenues of \$8.845 billion (which excludes the \$100 million expected to be generated by the interest rate swap transaction mentioned below); and (B) \$9.703 billion, which is comprised of the sum of (i) anticipated expenditures of \$9.319 billion; and (ii) the mandated appropriation of \$384 million of Excluded Debt Service (as defined in “2006 Budget Approval Process” under *Budget of the Commonwealth of Puerto Rico*) related to a portion of the debt service due during fiscal year 2006 on the Commonwealth’s general obligation bonds, which is being paid from a GDB line of credit already in place and ultimately will be paid from the proceeds of a Commonwealth bond issuance. See “2006 Budget Approval Process” under *Budget of the Commonwealth of Puerto Rico*. As discussed in further detail below, the Commonwealth expects to cover the fiscal year 2006 structural imbalance by financing the Excluded Debt Service (\$384 million), implementing procedures to reduce expenditures, withdrawing funds from the Budgetary and Emergency Funds and utilizing other non-recurring revenues (\$221 million), and entering into an interest rate swap transaction (\$100 million). Although the Commonwealth is using its best efforts in order to fully implement these cost reducing measures, there is no assurance that it will be able to do so.

There are certain expenditures not included in the amount of estimated expenditures for fiscal year 2006 (\$9.319 billion), however, that may increase the structural imbalance. These expenditures consist of the following items, among others, (i) possible increases (in excess of the amount already budgeted) in health insurance premiums payable by the Commonwealth in fiscal year 2006 under its health reform program, which premiums are currently being negotiated (approximately \$102 million); (ii) increases in the budget of the Legislative Assembly, the State Elections Commission, and the Office of the Ombudsman, whose budget reductions are being challenged in court, were such challenges to be successful (approximately \$30 million); (iii) amounts required to be contributed by the Commonwealth to the Employees Retirement System relating to the costs of providing special benefits to retired employees, which amounts are not included in the fiscal year 2006 budget (approximately \$43 million); (iv) potential additional expenditures in connection with the Medical Services Administration (approximately \$30 million); (v) other potential additional operational expenditures (non-payroll related) (approximately \$106 million); and (vi) previous years' debts with vendors (such items collectively, the "Additional Expenditures"). In addition to the Additional Expenditures, estimated amounts required to cover maintenance expenses incurred by Public Buildings Authority ("PBA") (approximately \$75 million) may further increase the structural imbalance should the Commonwealth have to cover such maintenance expenses for PBA. Such estimated amounts are expected to be covered by a line of credit from GDB to PBA collateralized by real estate properties and accounts receivable, with payment to GDB expected from the sale of such real estate and/or the collection of such receivables pledged to GDB. See "2006 Budget Approval Process" under *Budget of the Commonwealth of Puerto Rico*.

The Commonwealth is also considering new revenue sources to address the structural imbalance beyond fiscal year 2006. In this regard, the Commonwealth is proposing to implement a new consumption tax and reductions in recurring expenditures as part of a comprehensive tax and fiscal reform, as discussed below. See "Proposed Tax Reform" and "Appropriations" under *Budget of the Commonwealth of Puerto Rico*.

## **Major Sources of General Fund Revenues**

### *Income Taxes*

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

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

Gain realized from the sale or exchange of a capital asset by resident individuals, if held for more than six months, is taxed at a rate of 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 on or before December 31, 2005 by Puerto Rico resident individuals, trusts and estates from the sale of stock of certain Puerto Rico corporations that was acquired in an initial public offering made after June 30, 1997 are subject to a special capital gains rate of 7%. Act No. 40 of August 1, 2005 ("Act No. 40"), however, was enacted to change to 12.5% the tax applicable to long-term capital gains for taxable years starting after June 30, 2005.

On August 22, 2004, the Governor signed into law Act No. 226 to provide a temporary reduction in the long-term capital gains tax rate that was applicable before the enactment of Act No. 40. Act No. 226 reduced 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 was reinvested in Puerto Rico.

Interest income in excess of \$2,000 on deposit with Puerto Rico financial institutions is taxed at a rate of 17%; the first \$2,000 of interest income from such institutions is exempt from taxation. Interest income on certain qualifying debt obligations issued by Puerto Rico corporations and certain qualifying foreign corporations and paid to resident individuals, trusts, 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 P.R. Code provides for six income tax brackets for corporations and partnerships, with the highest rate (39%) applicable to net taxable income in excess of \$300,000. Also, Act No. 41 of August 1, 2005 was enacted to impose a temporary additional tax of 2.5% on corporations and partnerships with a net taxable income of \$20,000 or more. 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. However, Act No. 40 was enacted to change to 20% the tax rate on long-term capital gains for taxable years starting after 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 when the corporation or partnership making the distribution is organized in Puerto Rico. A special tax rate of 17% is applicable to dividend distributions of REITs received by corporations. Interest income on certain qualifying debt obligations issued by Puerto Rico corporations and certain qualifying foreign corporations and paid to resident corporations and partnerships qualifies for a special tax rate of 10%.

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

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

Interest from Puerto Rico sources paid to non-resident non-affiliated corporate recipients is not subject to any income or withholding tax. Interest paid to certain related non-resident recipients is subject to a withholding tax of 29%. Dividends paid to non-resident corporate recipients are subject to a withholding tax of 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.

### *Excise Taxes*

The P.R. 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 P.R. 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. Recent legislation was enacted to increase license fees on luxury vehicles.

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

Revenues from non-Commonwealth sources include customs duties collected in Puerto Rico and excise taxes on shipments of rum from the island to the United States mainland. The customs duties and excise taxes on shipments are imposed and collected by the United States and returned to the Commonwealth. The excise tax on shipments of rum from Puerto Rico and other rum producing countries is \$13.50 per gallon. Of this amount, \$13.25 per proof gallon has been or will be returned to the Treasury during the period from July 1, 1999 to December 31, 2005. Effective January 1, 2006, the amount returned will be reduced to the lesser of \$10.50 per proof gallon and the actual excise tax imposed. Legislation is currently pending in both houses of the United States Congress, however, that would increase the amount of federal excise taxes per proof gallon transferred to the Commonwealth to \$13.50 after December 31, 2005 and before January 1, 2007. This legislation would also allocate \$0.50 of the total tax so returned to the Conservation Trust Fund, a charitable trust established in 1968 pursuant to a Memorandum of Understanding between the United States Department of the Interior and the Commonwealth whose mission is to protect natural resources in Puerto Rico.

### *Property Taxes*

Personal property, which accounts for approximately 49% of total collections of taxable property, is self-assessed. Real property taxes are assessed based on 1958 property values. No real property reassessment has been made since 1958, and construction taking place after that year has been assessed on the basis of what the value of the property would have been in 1958. Accordingly, the overall assessed valuation of real property for taxation purposes is substantially lower than the actual market value. Also, an exemption on the first \$15,000 of assessed valuation in owner-occupied residences is available.

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

The following table presents the assessed valuations and real and personal property taxes collected for fiscal years ending June 30, 2000 through June 30, 2005.

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

<b>Fiscal Years Ended June 30,</b>	<b>Assessed Valuations<sup>(1)</sup></b>	<b>Taxes Levied</b>	<b>Collections of Current Year</b>	<b>Collections of Previous Years</b>	<b>Total Collections<sup>(2)</sup></b>
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
2004	23,540,237	836,734	706,677	79,772	786,449
2005	25,877,795	899,893	738,074	50,751	788,825

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

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

*Source:* Municipal Revenues Collection Center

**Collections of Income and Excise Taxes**

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

**Proposed Tax Reform**

On November 21, 2005, as a result of a joint effort by the two principal political parties to address the Commonwealth's structural budget imbalance and its other fiscal difficulties, the Legislative Assembly approved, and the Governor signed, Joint Resolution No. 321 (the "Joint Resolution"). On the same day, the Governor issued an executive order implementing the fiscal measures defined in the Joint Resolution (the "Fiscal Reform Executive Order"). The Joint Resolution and Fiscal Reform Executive Order impose government-wide expenditure controls and set forth the basic principles and parameters that will govern the reform of the Commonwealth's tax system and fiscal policy and practices. The proposed tax reform is aimed at increasing revenues by expanding the tax base through the implementation of a broad-based tax on the retail sale of articles of use and consumption (the "consumption tax").

The Joint Resolution and Fiscal Reform Executive Order come in the wake of expenditure controls previously implemented during fiscal year 2006 by the Governor, such as a reduction of appointed government positions, a limitation on the creation of new temporary employee positions, a hiring freeze, and a voluntary work week reduction program, as well as limitations on central government vehicle fleets and other expenses. If the proposed tax reform and expenditure controls are successfully implemented, the structural imbalance could be corrected by the end of fiscal year 2008. There is no assurance, however, that the structural imbalance will be corrected by such date.

Generally, the proposed tax reform will follow three basic principles: (i) broaden the tax base through the implementation of the consumption tax, (ii) reduce individual income tax rates, and (iii) simplify the administration of the tax system.

The proposed tax reform will (i) replace the Commonwealth's current excise tax with the consumption tax, (ii) include compensatory income tax credits in order to address any regressive effect the proposed consumption tax may have, (iii) eliminate the marriage penalty, (iv) establish an earned income tax credit, (v) increase the deduction for charitable contributions, (vi) restructure the estate tax system, (vii) provide incentives for investment in technological infrastructure and research and development activities, and (viii) adopt additional measures to foster individual savings.

Legislation with respect to the tax reform proposed by the Joint Resolution was introduced in the House of Representatives with a proposed effective date of July 1, 2006. Although the final structure of the tax reform, including the consumption tax, is under discussion, the Secretary of the Treasury expects that the tax reform will provide a net increase in the General Fund's annual revenues, after taking into consideration projected reductions in income taxes, in an amount sufficient to reduce and eventually eliminate the structural imbalance. See "Summary and Management's Discussion of General Fund Results – Commonwealth's Budget Structural Imbalance" above.

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

The Joint Resolution and the Fiscal Reform Executive Order also set forth guiding principles and parameters and impose certain expenditure controls as part of fiscal reform. The Joint Resolution and the Fiscal Reform Executive Order restrict layoffs of government employees as a means to reduce government expenditures, and impose a hiring freeze in government until the structural budget deficit has been eliminated. Fiscal discipline will be promoted by requiring each central government agency to implement a seven-year expense reduction plan, adopting a new public policy that distinguishes between unnecessary and indispensable expenses, imposing certain limitations on the use of the Budgetary Fund, and providing that the budget may only be balanced through the use of recurring revenues. The proposed fiscal reform also mandates the reduction of advertising and travel expenses, promotes the use of electronic communications and document delivery, caps the purchase price of each government vehicle, and limits other non-payroll expenditures. Furthermore, the Legislative Assembly must approve any borrowings by the Secretary of the Treasury in order to finance any Commonwealth budget deficit with debt securities that are not repaid during the same fiscal year in which they are issued.

In an effort to address other fiscal challenges faced by the Commonwealth, the Joint Resolution and the Fiscal Reform Executive Order promote the adoption of certain measures to alleviate the significant unfunded liabilities of the various government retirement systems. See *Retirement Systems* above. These measures include the transfer to the two main government retirement systems of Commonwealth assets and additional General Fund contributions from the revenues of the proposed tax reform in excess of the Commonwealth's current expenditures. Furthermore, the Joint Resolution and the Fiscal Reform Executive Order limit the implementation of early retirement programs for government employees by conditioning their implementation on receipt of an opinion from an independent actuary confirming that the retirement systems will not be adversely affected by such early retirement program.

The measures and efforts set forth in the Joint Resolution, the Fiscal Reform Executive Order and the Tax Reform proposal are broad in scope and have been designed to address and correct the Commonwealth's structural imbalance and other fiscal challenges that are described below.

### **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 \$5.279 billion for fiscal year 2006, an increase of \$83.5 million, or 1.6%, from fiscal year 2005. The following table presents revenues from federal grants by broad program areas, which are accounted in the central accounting system of the Treasury. The figures for fiscal years 2002, 2003, and 2004 are actual figures. The estimated figures for fiscal years 2005 and 2006 are based on the information submitted by each agency to OMB.

<b>Commonwealth of Puerto Rico</b>					
<b>Federal Grants</b>					
<b>(in thousands)</b>					
	<b>2002</b>	<b>2003</b>	<b>2004</b>	<b>2005<sup>(1)</sup></b>	<b>2006<sup>(1)</sup></b>
Education	\$ 734,917	\$ 828,992	\$1,081,236	\$ 992,658	\$1,046,439
Social Services	1,711,360	1,848,910	1,792,203	1,884,298	1,878,945
Health	333,154	367,916	444,348	478,068	489,556
Labor and Human Resources <sup>(2)</sup>	376,119	334,350	204,679	214,679	208,973
Crime	15,689	32,479	37,988	29,313	29,593
Housing <sup>(3)</sup>	385,592	312,869	366,408	383,219	629,228
Drug and Justice	9,822	11,995	31,349	13,071	32,811
Agriculture and Natural Resources	13,119	7,883	10,378	8,183	10,115
Contributions to Municipalities	59,191	59,191	59,002	56,371	53,744
Other	13,538	25,874	39,879	33,168	40,721
<b>TOTAL</b>	<b>\$3,652,501</b>	<b>\$3,830,459</b>	<b>\$4,067,470</b>	<b>\$4,091,328</b>	<b>\$4,420,125</b>

(1) Estimated.

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

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

Source: Office of Management and Budget

## BUDGET OF THE COMMONWEALTH OF PUERTO RICO

### Office of Management and Budget

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

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



## **Budgetary Process**

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

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

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

## **Financial Control and Adjustment Procedures**

Revenue estimates for budgetary purposes are prepared by the Treasury, except for estimates of federal grants, which are prepared by OMB based on information received from the various departments and other recipients of such grants. Revenue and federal grant estimates are under continuous review and, if necessary, are revised at least quarterly during the fiscal year. Fiscal control over expenditures is exercised by the Governor, through the Director of OMB, and the Secretary of the Treasury. Monthly reviews and expenditure cut-off procedures are followed to prevent 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 Legislative Assembly a detailed report of any adjustment necessary to balance the budget, or make recommendations to the Legislative Assembly for new taxes or authorize borrowings under provisions of existing legislation or take any other necessary action to meet the estimated deficiency. Any such proposed adjustments shall give effect to the “priority norms” established by law for the disbursement of public funds in the following order of priority; first, the payment of the interest on and amortization requirements for public debt (Commonwealth general obligations and guaranteed debt for which the Commonwealth’s guarantee has been exercised); second, the fulfillment of obligations arising out of legally binding contracts, court decisions on eminent domain, and other unavoidable obligations to protect the name, credit and good faith of the Commonwealth; third, current expenditures in the areas of health, protection of persons and property, education, welfare and retirement systems; and fourth, all other purposes.

A Budgetary Fund was created by Act No. 147 of June 18, 1980, as amended (the “Budgetary Fund”), to cover the appropriations approved in any fiscal year in which the revenues available for such fiscal year are insufficient, to secure the payment of public debt, and to provide for unforeseen circumstances in the provision of public service. Currently, an amount equal to one percent of the General Fund net revenues of the preceding fiscal year is deposited annually into the Fund. In addition, other income (not classified as revenues) that is not assigned by law to a specific purpose is also required to be deposited in the Budgetary Fund. The maximum balance of the Budgetary Fund may not exceed 6% of the total appropriations included in the budget for the preceding fiscal year. As of July 1, 2005, the balance in the Budgetary Fund was \$182.6 million. As of June 30, 2006, the Budgetary Fund is projected to have a balance of \$98 million.

An Emergency Fund was created by Act No. 91 of June 21, 1966, as amended (the “Emergency Fund”), to cover unexpected public needs caused by calamities, such as wars, hurricanes, earthquakes, droughts, floods and plagues, and to protect people’s lives and property and the public sector credit. The Emergency Fund is capitalized annually with an amount totaling no less than one percent of the General Fund net revenues of the preceding fiscal year. Act No. 91 was amended on August 28, 2003, to set an upper limit to the Emergency Fund of \$150 million at the beginning of the fiscal year and was further amended in 2005 to authorize the disbursement of funds from the Emergency Fund to cover certain General Fund expenditures and operational costs of the State Emergency Management Agency. The 2005 amendment also authorizes GDB to lend to the Commonwealth up to \$150 million to replenish the Emergency Fund to provide funding for emergency and disaster needs. As of July 1, 2005, prior to the aforementioned 2005 amendment, the balance in the Emergency Fund was \$134.5 million.

## **Appropriations**

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

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

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

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

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

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

In the summaries of the central government budgets presented below, grants to the University of Puerto Rico are included in current expenditures for education and the 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 disbursements 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.

For fiscal year 2005, approximately 56% of the General Fund was committed for payment of the central government payroll. In addition, approximately 27% of the General Fund was committed to the payment of fixed charges such as municipal subsidies, grants to the University of Puerto Rico, funding for the judicial branch, rental payments to the Public Buildings Authority, among others, and debt service on the direct debt of the Commonwealth. For fiscal year 2006, it is proposed that approximately 55% and 7% of the General Fund be committed for payment of the central government payroll and debt service on the direct debt of the Commonwealth, respectively. In the case of the judicial branch, legislation approved in December of 2002 provides that, commencing with fiscal year 2004, the Commonwealth will appropriate annually to the judicial branch an amount initially equal to 3.3% of the average annual revenue from internal sources for each of the two preceding fiscal years. This percentage will increase until it reaches 4% in fiscal year 2008, and may be further increased upon review, with scheduled reviews every five years.

### **Fiscal Year 2005 Budget (Preliminary)**

The consolidated budget for fiscal year 2005 totaled \$24.8 billion. Of this amount, \$14.5 billion is assigned to the central government. This amount included General Fund total resources and appropriations of \$8.9 billion, which represent an increase of \$641 million, or 7.7%, over budgeted amounts for fiscal year 2004. These total resources budgeted included \$8.3 billion of total revenues and \$550 million of additional resources from a GDB loan secured by tax receivables. The budget for fiscal year 2005 was approved July 1, 2004.

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

	<b>General Fund</b>	<b>Bond Fund</b>	<b>Special Funds</b>	<b>Total</b>
Revenues from internal sources:				
Property taxes	\$ 3,910	-	\$ 112,977	\$ 116,887
Personal income taxes	2,919,198	-	-	2,919,198
Retained non-resident income tax	612,006	-	-	612,006
Corporate income taxes	1,871,919	-	-	1,871,919
Partnership income taxes	3,245	-	-	3,245
Tollgate taxes	22,973	-	-	22,973
17% withholding tax on interest	10,490	-	-	10,490
10% withholding tax on dividends	80,398	-	-	80,398
Inheritance and gift taxes	7,129	-	-	7,129
Excise taxes:				
Alcoholic beverages	298,235	-	-	298,235
Motor vehicles and accessories	606,662	-	-	606,662
Cigarettes	146,527	-	-	146,527
Special excise tax on certain petroleum products	-	-	-	-
General 5% excise tax	557,369	-	-	557,369
Other (excise taxes)	175,434	-	47,100	222,534
Licenses	87,416	-	-	87,416
Miscellaneous non-tax revenues:				
Contributions from lottery fund	49,602	-	-	49,602
Electronic lottery	68,011	-	-	68,011
Registration and document certification fees	230,341	-	-	230,341
Other	189,974	-	296,907	486,881
Total revenues from internal sources	7,940,839	-	456,984	8,397,823
Revenues from non-Commonwealth sources:				
Federal excise taxes on off-shore shipments	341,093	-	-	341,093
Federal grants	-	-	4,093,028 <sup>(1)</sup>	4,093,028
Customs	25,037	-	-	25,037
Total revenues from non-Commonwealth sources	366,130	-	4,093,028 <sup>(2)</sup>	4,459,158
Total revenues	8,306,969	-	4,550,012	12,856,981
Other:				
Other Income	550,000	-	-	550,000
Balance from previous year	-	-	497,811	497,811
Bonds authorized	-	550,000	-	550,000
Total other sources	550,000	550,000	497,811	1,597,811
Total resources	8,856,969	550,000	5,047,823	14,454,792
Appropriations:				
Current expenses:				
General government	828,449	-	51,224	879,673
Education	2,839,044	-	1,191,151	4,030,195
Health	1,429,230	-	512,622	1,941,852
Welfare	434,370	-	2,101,620	2,535,990
Economic development	198,925	-	66,478	265,403
Public safety and protection	1,557,482	-	89,497	1,646,979
Transportation and communications	92,636	-	51,342	143,978

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

	<b>General Fund</b>	<b>Bond Fund</b>	<b>Special Funds</b>	<b>Total</b>
Housing	26,539	-	206,341	232,880
Contributions to municipalities	369,829	-	2,031	371,860
Special pension contributions	239,285	-	-	239,285
Debt service	379,856	-	112,977	492,833
Other debt service (appropriations)	457,939	-	25,000	482,939
Total appropriations-current expenses	8,853,584	-	4,410,283	13,263,867
Capital improvements	-	550,000	242,632	792,632
Total appropriations	8,853,584	550,000	4,652,915	14,056,499
Year-end balance	3,385	-	394,908	398,293
<b>Total appropriations and year-end balance</b>	<b>\$8,856,969</b>	<b>\$550,000</b>	<b>\$5,047,823</b>	<b>\$14,454,792</b>

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

(2) Act No. 93 of August 20, 1997 establishes that resources that do not represent revenues become part of the Budgetary Fund.

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

In the fiscal year 2005 budget, revenues and other budgetary funds total \$13.4 billion, excluding balances from the previous fiscal year and authorized general obligation bonds. The net increase in General Fund revenues in the fiscal year 2005 budget, as compared to fiscal year 2004 results, is due to increases in personal income taxes (up \$198 million), corporate income taxes (up \$41 million), various excise taxes (up \$189 million), and decreases in tollgate taxes (down \$19 million), customs (down \$9 million), electronic lottery transfers (down \$18 million), contributions from the lottery fund (down \$16 million), and retained non-resident income taxes (down \$19 million).

Current expenses and capital improvements of all budgetary funds total \$14.1 billion, an increase of \$1 billion from fiscal year 2004. The major changes in General Fund expenditures by program in fiscal year 2005 were: education (up \$287 million), public safety and protection (up \$163 million), special pension contributions (up \$52 million), debt service on Commonwealth's general obligation and guaranteed debt (up \$35.8 million), welfare (up \$30 million), health (up \$25 million), economic development (up \$16 million), transportation and communications (up \$9 million), contributions to municipalities (up \$7 million), housing (up \$2 million), and a decrease in other debt service, consisting principally of Commonwealth appropriation debt (down \$30 million), and general government debt (down \$40 million).

Actual expenditures for fiscal year 2005 are currently estimated at \$9.2 billion, which amount exceeds the General Fund budget by \$354 million and are attributed mainly to increases in the areas of education (\$303 million), public safety and protection (\$23 million), health (\$15 million), welfare (\$10 million), and economic development (\$3 million). This amount also excludes approximately \$80 million of additional expenditures that were not originally budgeted. The government covered this budget imbalance with several financing transactions, among them, (i) the use of a portion of the proceeds of a bond issue by Infrastructure Financing Authority to replace a General Fund budgetary allocation to the University of Puerto Rico (\$317 million); (ii) the use of a portion of the proceeds of a bond issue by Children's Trust to cover other General Fund appropriations (\$100 million); (iii) income generated through debt service deposit (forward delivery) agreements (\$83 million); and (iv) the release of excess funds held by AFICA (\$30 million), all of which totaled \$530 million. The remaining \$98 million of this amount was carried forward to budgetary reserves for future use. The \$354 million amount does not include expenditures for the Health Insurance Administration, the Medical Services Administration, the Police Department, previous fiscal years' debt with vendors, and additional contributions to the Government Employees Retirement System, the latter of which is estimated to be \$20 million. See *Retirement Systems* above.

The general obligation bond authorization for the fiscal year 2005 budget was \$550 million, all of which bonds have been issued.

### Budget for Fiscal Year 2006

The consolidated budget for fiscal year 2006 totals \$24.8 billion. Of this amount, \$14.8 billion is assigned to the central government. This includes General Fund total resources and appropriations of \$8.9 billion, which represents an increase of \$91 million, or 1%, over budgeted amounts for fiscal year 2005. The following table presents a summary of the Commonwealth's current central government budget for the fiscal year ending June 30, 2006.

**Commonwealth of Puerto Rico**  
**Summary of Central Government Annual Budget**  
**Fiscal Year Ending June 30, 2006**  
**(in thousands)**

	General Fund	Bond Fund	Special Funds	Total
Revenues from internal sources:				
Property taxes	\$ -	-	\$113,825	\$113,825
Personal income taxes	3,093,000	-	-	3,093,000
Retained non-resident income tax	628,000	-	-	628,000
Corporate income taxes	2,143,000	-	-	2,143,000
Partnership income taxes	3,000	-	-	3,000
Tollgate taxes	17,000	-	-	17,000
17% withholding tax on interest	11,000	-	-	11,000
10% withholding tax on dividends	74,000	-	-	74,000
Inheritance and gift taxes	2,000	-	-	2,000
Excise taxes:				
Alcoholic beverages	316,000	-	-	316,000
Motor vehicles and accessories	614,000	-	-	614,000
Cigarettes	152,000	-	-	152,000
Special excise tax on certain petroleum products	30,000	-	-	30,000
General 5% excise tax	634,000	-	-	634,000
Other (excise taxes)	134,000	-	47,100	181,100
Licenses	110,000	-	-	110,000
Miscellaneous non-tax revenues:				
Contributions from lottery fund	63,000	-	-	63,000
Electronic lottery	83,000	-	-	83,000
Registration and document certification fees	231,000	-	-	231,000
Other	131,000	-	309,200	440,200
Total revenues from internal sources	8,469,000	-	470,125	8,939,125
Revenues from non-Commonwealth sources:				
Federal excise taxes on off-shore shipments	350,000	-	-	350,000
Federal grants	-	-	4,420,125 <sup>(1)</sup>	4,420,125
Customs	26,000	-	-	26,000
Total revenues from non-Commonwealth sources	376,000	-	4,420,125 <sup>(2)</sup>	4,796,125
Total revenues	8,845,000	-	4,890,250	13,735,250
Other:				
Other Income	100,000	-	-	100,000
Balance from previous year	-	-	394,908	394,908

**Commonwealth of Puerto Rico**  
**Summary of Central Government Annual Budget**  
**Fiscal Year Ending June 30, 2006**  
**(in thousands)**

	<b>General Fund</b>	<b>Bond Fund</b>	<b>Special Funds</b>	<b>Total</b>
Bonds authorized	-	675,000	-	675,000
Total other sources	100,000	675,000	394,908	1,169,908
Total resources	<b>8,945,000</b>	<b>675,000</b>	<b>5,285,158</b>	<b>14,905,158</b>
Appropriations:				
Current expenses:				
General government	\$775,022	-	\$51,844	\$826,866
Education	3,104,967	-	1,315,482	4,420,449
Health	1,460,502	-	508,895	1,969,397
Welfare	441,035	-	2,190,033	2,631,068
Economic development	180,498	-	69,252	249,750
Public safety and protection	1,532,161	-	93,860	1,626,021
Transportation and communications	100,750	-	58,605	159,355
Housing	19,391	-	323,818	343,209
Contributions to municipalities	386,395	-	1,985	388,380
Special pension contributions <sup>(3)</sup>	239,265	-	-	239,265
Debt service	116,812	-	113,825	230,637
Other debt service (appropriations) <sup>(4)</sup>	582,202	-	19,000	601,202
Total appropriations-current expenses	8,939,000	-	4,746,599	13,685,599
Capital improvements	6,000	675,000	487,149	1,168,149
Total appropriations	8,945,000	675,000	5,233,748	14,853,748
Year-end balance	-	-	51,410	51,410
Total appropriations and year-end balance	<b>\$8,945,000</b>	<b>\$675,000</b>	<b>\$5,285,158</b>	<b>\$14,905,158</b>

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

(2) Act No. 93 of August 20, 1997 establishes that resources that do not represent revenues become part of the Budgetary Fund.

(3) Includes \$60 million from the Budgetary Fund.

(4) Includes \$75 million from the Emergency Fund.

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

In the fiscal year 2006 budget, revenues and other resources of all budgetary funds total \$13.8 billion, excluding balances from the previous fiscal year and authorized general obligation bonds. The net increase in General Fund revenues in the fiscal year 2006 budget, as compared to fiscal year 2005 preliminary results, is accounted for mainly by increases in personal income taxes (up \$174 million), retained non-resident income taxes (up \$16 million), corporate income taxes (up \$271 million), various excise taxes (up \$137 million), licenses (up \$23 million), contributions from the lottery fund (up \$13 million), electronic lottery fund (up \$15 million), federal excise taxes on offshore shipments (up \$9 million), and decreases in tollgate taxes and withholding taxes on dividends (down \$6 million each), inheritance and gift taxes (down \$5 million), other excise taxes (down \$41 million) and other miscellaneous non-tax revenues (down \$59 million).

Current expenses and capital improvements of all budgetary funds total \$14.9 billion, an increase of approximately \$797 million from fiscal year 2005. The major changes in General Fund expenditures by program in fiscal year 2006 are mainly due to increases in education (up \$265 million), health (up \$31.3 million), welfare (up \$6 million), transportation and communications (up \$8 million), contributions to municipalities (up \$16 million), other debt service, consisting principally of Commonwealth appropriation debt (up \$124.3 million), decreases in general government (down \$53 million) and economic development (down \$18.4 million), and decreases in housing (down \$7 million), public safety and protection (down \$25 million), and debt service on Commonwealth's general obligation and guaranteed debt (down \$263 million).

The general obligation bond authorization for the fiscal year 2006 budget is \$675 million.

## **2006 Budget Approval Process**

*Executive Order Budget.* On March 16, 2005, the Governor of Puerto Rico, Aníbal Acevedo-Vilá, submitted to the Legislative Assembly of the Commonwealth a proposed balanced budget of revenues and expenditures for fiscal year 2006 providing for General Fund resources and expenditures of \$9.684 billion, representing an increase of \$476 million, or 5.2%, over estimated actual expenditures for fiscal year 2005 (\$9.208 billion). The proposed budget package included several new revenue raising measures sufficient to cover budgeted expenditures, most of which required legislative approval. However, as mentioned below, the Legislative Assembly did not approve the budget proposed by the Governor.

On June 30, 2005, the Legislative Assembly, which is controlled by the principal opposition political party, approved a budget resolution for fiscal year 2006 that provided for General Fund expenditures of \$9.258 billion. Governor Acevedo-Vilá vetoed this budget resolution because the revenue measures contained therein, as estimated by the Secretary of Treasury, were insufficient to cover the budgeted expenditures as required by the Constitution. The Governor did, however, sign into law certain revenue raising measures approved by the Legislative Assembly estimated to generate approximately \$130 million in new revenues. Although the revenue raising measures contained language conditioning their effectiveness on the approval by the Governor of the \$9.258 billion budget resolution, according to the Secretary of Justice, these revenue raising measures are enforceable regardless of such language. Although no legal action has been initiated thus far, no assurance can be given that the effectiveness of such revenue measures will not be challenged.

As a result of the Governor's veto, and in accordance with the Commonwealth's Constitution, the budget for fiscal year 2005 (with certain adjustments) carried over and will continue in effect for fiscal year 2006 unless another budget for fiscal year 2006 is approved by the Legislative Assembly and the Governor. At this time, it is not anticipated that a new budget for fiscal year 2006 will be approved prior to the end of the fiscal year, although it is possible that other appropriations for special purposes may be approved from time to time.

According to an opinion from the Secretary of Justice, the fiscal year 2006 budget that went into effect on July 1, 2005 authorized total spending of \$9.489 billion, consisting of the amounts provided by (i) the fiscal year 2005 budget resolution, (ii) laws that assigned resources according to formulas or over several years, including fiscal year 2006, and (iii) laws approved during fiscal year 2005 with respect to ordinary government operational expenses. This amount was reduced to \$9.284 billion as a result of (i) new appropriations approved after July 1, 2005, (ii) automatic reductions to certain formula-based appropriations pegged to the amount of estimated revenues, and (iii) a special adjustment eliminating the appropriation for \$384 million related to a portion of debt service for general obligation bonds due during fiscal year 2006.

On August 30, 2005, the Governor adopted Executive Order 2005-58 (the "Budget 2006 Executive Order"), in which he made certain additional adjustments to the budget in order to bring the total expenditures in line with the Secretary of Treasury's estimate of total revenues for fiscal year 2006 of \$8.945 billion, as required by Commonwealth law. These adjustments included a \$384 million reduction related to a portion of debt service for general obligation bonds due during fiscal year 2006 (the "Excluded Debt Service") which is being paid from a GDB line of credit already in place and may be paid ultimately from the proceeds of a Commonwealth bond issue.



As a result of the insufficiency of projected revenues for fiscal year 2006 to meet the appropriations made in the fiscal year 2005 budget, and based in part on the opinion by the Secretary of Justice, the Governor made certain modifications to amounts assigned to agencies and instrumentalities under the 2005 budget by reallocating funds to agencies that provide direct services, such as the Department of Education, the Health Department and the police. This reallocation reduced the budget of many other Commonwealth agencies and instrumentalities from the levels provided in the fiscal year 2005 budget. Some of the entities whose budgets were reduced (the House of Representatives, the Senate, the State Elections Commission, the Superintendent of the Capitol, and the Office of the Ombudsman) filed suit challenging, on statutory grounds, the Governor's reduction of their previous year's budget allocations. Two superior court judges have ruled differently on this matter. These decisions are currently pending resolution before the Puerto Rico Supreme Court. See *Litigation* below.

*2006 Budget Imbalance.* Notwithstanding the budget reduction implemented by the Fiscal Reform Executive Order, the Commonwealth estimates that its actual expenditures during fiscal year 2006 payable from General Fund revenues will total \$9.319 billion. Without taking into account any additional revenues, the Additional Expenditures and the Excluded Debt Service, and assuming no other expenditures during fiscal year 2006, the difference between estimated expenditures of \$9.319 billion and estimated revenues of \$8.945 billion is \$374 million. The Fiscal Reform Executive Order requires all central government agencies to operate within their assigned budgets for the remainder of fiscal year 2006. Accordingly, agencies must present a report to OMB outlining plans to avoid additional expenditures and finish the year within budget, no later than 30 days after the effectiveness of the Fiscal Reform Executive Order. This action is designed to reduce such difference of \$374 million and other Additional Expenditures. The reports required by the Fiscal Reform Executive Order must also be presented to the speaker of the House, and the President of the Senate, the House Ways and Means Committee and the House Budget Committee, who may determine, based on such reports, whether any additional revenue measures are warranted. In the event expenditures were still to exceed revenues, the Commonwealth estimates it would have available \$221 million from the Emergency Fund, the Budgetary Fund, and other non-recurring resources. For more details about the Additional Expenditures, see "Summary and Management's Discussion of General Fund Results" under *Puerto Rico Taxes, Other Revenues, and Expenditures*.

As an initial temporary measure, on August 3, 2005, the Governor issued an Executive Order requiring most Executive Branch agencies to establish a voluntary employee hourly reduction program. The purpose of the program is to reduce salary expenditures by the government. The program established two hourly alternatives with different pay incentives: (1) one day per week work reduction with a 15% reduction in salary; and (2) 50% reduction in the regular hourly work week with a 35% reduction in salary (for those employees with 5 years or less before retirement, the second option will only entail a 25% reduction in salary).

It is possible that the Commonwealth may realize additional revenues and incur additional expenditures not included in the above estimated budget imbalance. As previously stated, revenues for the first quarter of fiscal year 2006 have exceeded budgeted amounts by \$56 million. Although the Treasury Department is not in a position to project fiscal year-end revenues before completing the first semester, revenues may exceed the budgeted amount. There is no assurance that such level of revenue collection will continue for the remainder of the fiscal year, or that revenue levels will exceed the budgeted amount of \$8.945 billion.

In addition, it is possible that expenditures may exceed the estimated level of \$9.319 billion. This amount is based on the expenditure projections provided to OMB by certain key central government agencies taking into account their actual expenditures during the first two months of fiscal year 2006, with such projections having been adjusted to reflect certain recently legislated or otherwise expected expenditure increases. This amount, however, does not take into account the Additional Expenditures, some of which are contingent on negotiations and court decisions and include the following items, among others: (i) possible increases (in excess of the amount already budgeted) in health insurance premiums payable by the Commonwealth in fiscal year 2006 under its health reform program, which premiums are currently being negotiated (approximately \$102 million); (ii) increases in the budget of the Legislative Assembly, the State Elections Commission, and the Office of the Ombudsman, whose budget reductions are being challenged in court, were such challenges to be successful (approximately \$30 million); (iii) amounts required to be contributed by the Commonwealth to the Employees Retirement System relating to the costs of providing special benefits to retired employees, which amounts are not included in the fiscal year 2006 budget (approximately \$43 million); (iv) potential additional expenditures in connection with the Medical Services Administration (approximately

\$30 million); (v) other potential additional non-payroll operational expenditures (approximately \$106 million), and (vi) previous years' debts with vendors.

Although the Commonwealth is using its best efforts in order to maximize revenues and reduce expenditures, there is no assurance that revenues will be greater than the budgeted \$8.945 billion or that expenditures will not exceed the estimated level of \$9.319 billion. Moreover, though contrary to current public policy, the Commonwealth and its instrumentalities could obtain further extensions of credit by GDB to fund any remaining imbalance in fiscal year 2006 should other measures be insufficient to cover such imbalance.

### **Differences between Budget and Basic Financial Statements**

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

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

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

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

### **LITIGATION**

The Commonwealth is a defendant in numerous legal proceedings pertaining to matters incidental to the performance of routine governmental operations. Under Act No. 104 of the Legislative Assembly 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 Legislative Assembly 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, 2004, the Commonwealth has included in its financial statements reported liabilities of approximately \$219 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, one in Commonwealth court and one in the United States District Court for the District of Puerto Rico, by an association of primary care health centers seeking to recover from the Commonwealth \$120 million of Medicaid funds retained by the Department of Health since 1997. In June 2004, the Superior Court of the Commonwealth in San Juan determined that the Commonwealth must return those funds. The Commonwealth appealed this decision. As of June 30, 2004, the Commonwealth has accrued \$120 million for this legal contingency. With respect to the federal case, a preliminary injunction was issued by the Court against the Commonwealth requiring it to disburse approximately \$20 million in six payments beginning in October 2005.

The Commonwealth is 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 \$38 million of compulsory motor vehicle 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 also a defendant in various cases, including a class action presented by parents of special education students alleging deficient services to these students in the areas of education and health care before Commonwealth Courts. One court recently decided in favor of the parents' request to include damage claims in the same class action case. This decision is appealable and thus, not final at this time. The Commonwealth does not anticipate any final determination or damages award, in any case, to be granted in this fiscal year.

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

The Governor, the Director of OMB and the Secretary of the Treasury are also defendants in various lawsuits by governmental entities whose budgets for fiscal year 2006 were reduced under the Executive Order of August 30, 2005. These claimants are challenging, on constitutional and statutory grounds, the Governor's reallocation of resources see "2006 Budget Approval Process" under *Budget of the Commonwealth of Puerto Rico*. The Commonwealth believes these challenges will not prevail. If all or any of these challenges prevail, however, further adjustments would have to be made to the fiscal year 2006 budget in the form of cuts to other agencies' budgets in the approximate amount of \$30 million.

## THE MUNICIPALITIES OF SAN JUAN, BAYAMÓN, CAROLINA, AND GUAYNABO

### General

San Juan - The Municipality of San Juan (“San Juan”), founded in 1521, is the capital city of the Commonwealth of Puerto Rico (the “Commonwealth” or “Puerto Rico”) and is the largest of the seventy-eight municipalities of Puerto Rico in terms of population. San Juan’s boundaries encompass an area of approximately 47.8 square miles, and according to the 2000 Census of the U.S. Census Bureau, the population of San Juan was 434,374. San Juan is bounded on the North by the Atlantic Ocean and San Juan Bay, on the South by the Municipalities of Caguas and Trujillo Alto, on the East, by the Municipalities of Carolina and Trujillo Alto, and on the West by the Municipality of Guaynabo.

Bayamón - The Municipality of Bayamón (“Bayamón”), founded in 1772, is the second largest of the seventy-eight municipalities of Puerto Rico in terms of population. Bayamón’s boundaries encompass an area of approximately 44 square miles, and according to the 2000 Census of the U.S. Census Bureau, the population of Bayamón was 224,044. Bayamón is bounded on the North by the municipalities of Toa Baja, Cataño, and Guaynabo, on the South by the municipalities of Comerío and Aguas Buenas, on the East by the municipality of Guaynabo, and on the West by the municipalities of Toa Alta and Naranjito.

Carolina - The Municipality of Carolina (“Carolina”), founded in 1857, is the fourth largest of the seventy-eight municipalities of Puerto Rico in terms of population. Carolina’s boundaries encompass an area of approximately 45.3 square miles and, according to the 2000 Census of the U.S. Census Bureau, the population of Carolina was 186,076. Carolina is bounded on the North by Loíza and the Atlantic Ocean, on the South by Gurabo, on the East by Canóvanas, and on the West by San Juan and Trujillo Alto.

Guaynabo - The Municipality of Guaynabo (“Guaynabo”), founded in 1769, is the sixth largest of the seventy-eight municipalities of Puerto Rico in terms of population and is primarily a residential community, which is part of the San Juan Metropolitan Area. Guaynabo’s boundaries encompass an area of approximately 27 square miles, and according to the 2000 Census of the U.S. Census Bureau, the population of Guaynabo was 100,053. Guaynabo is bounded on the North by the San Juan Bay and the municipalities of Toa Baja, Cataño and San Juan, on the South by the municipality of Aguas Buenas, on the East by the municipality of San Juan, and on the West by the municipality of Bayamón.

### Form of Government and Services Offered

Each Municipality is a political legal entity with full legislative and administrative powers in every area of municipal government, with perpetual existence and legal personality, separate and independent from the central government of Puerto Rico. Each of the municipal governments consists of its Mayor and a sixteen-member Municipal Legislature (seventeen-member in the case of San Juan), all of whom are elected by the residents of the applicable municipality every four years. The Mayor is responsible, among other matters, for: (i) establishing and carrying out the policies and the ordinances of the Municipal Legislature, (ii) overseeing the day-to-day operations of the municipal government, and (iii) appointing the heads of the various municipal departments. The Municipal Legislature is responsible, among other matters, for (i) adopting municipal ordinances and resolutions, (ii) adopting the budget for each fiscal year, and (iii) approving the appointment by the Mayor of the heads of the various municipal departments.

Each municipality provides a full range of services to its residents including health, public works, environmental control, education, public safety, public housing and community development, culture and recreation as well as many other general and administrative services.

## Population, Income and Employment

The table below shows the total population and population percentage changes of each of the four municipalities and of Puerto Rico for the period from 1970 to 2000.

### POPULATION

	<u>1970</u>	<u>1980</u>	<u>1990</u>	<u>2000</u>
San Juan	463,242	434,849	437,745	434,374
% Change	---	(6.1%)	0.7%	(0.8%)
Bayamón	156,192	196,206	220,262	224,044
% Change	---	25.6%	12.3%	1.7%
Carolina	107,643	165,954	177,806	186,076
% Change	---	54.2%	7.1%	4.7%
Guaynabo	67,042	80,742	92,886	100,053
% Change	---	20.4%	15.0%	7.7%
Puerto Rico	2,712,033	3,196,520	3,522,037	3,808,610
% Change	---	17.9%	10.2%	8.1%

Source: U.S. Census Bureau

The table below shows median family income figures and percentage changes for the period from 1970 to 2000 for each of the four municipalities and for Puerto Rico.

### MEDIAN FAMILY INCOME

	<u>1970</u>	<u>1980</u>	<u>1990</u>	<u>2000</u>
San Juan	\$4,418	\$7,668	\$12,332	\$20,640
% Increase	---	73.6%	60.8%	67.4%
Bayamón	\$4,846	\$8,311	\$13,708	\$22,403
% Increase	---	71.5%	64.9%	63.4%
Carolina	\$5,392	\$8,870	\$14,547	\$23,412
% Increase	---	64.5%	64.0%	60.9%
Guaynabo	\$5,299	\$9,615	\$17,066	\$30,209
% Increase	---	81.4%	77.5%	77.0%
Puerto Rico	\$3,063	\$5,923	\$9,988	\$16,543
% Increase	---	93.45%	68.6%	65.6%

Source: U.S. Census Bureau

The tables below provide comparable average employment figures for each of the four municipalities and for Puerto Rico for 2002 through 2005.

<b>SAN JUAN</b>				
<u>Year</u>	<u>Labor Force</u>	<u>Employed</u>	<u>Unemployed</u>	<u>Percentage Unemployment</u>
2002 <sup>1</sup>	172,900	160,100	12,800	7.4%
2003 <sup>1</sup>	177,600	164,600	13,000	7.3
2004 <sup>1</sup>	180,500	167,400	13,000	7.2
2005 <sup>2</sup>	182,600	168,500	14,100	7.7

<b>BAYAMÓN</b>				
<u>Year</u>	<u>Labor Force</u>	<u>Employed</u>	<u>Unemployed</u>	<u>Percentage Unemployment</u>
2002 <sup>1</sup>	89,700	83,100	6,600	7.3%
2003 <sup>1</sup>	92,500	85,700	6,800	7.4
2004 <sup>1</sup>	93,700	87,100	6,600	7.0
2005 <sup>2</sup>	88,300	81,000	7,100	8.1

<b>CAROLINA</b>				
<u>Year</u>	<u>Labor Force</u>	<u>Employed</u>	<u>Unemployed</u>	<u>Percentage Unemployment</u>
2002 <sup>1</sup>	84,100	77,200	7,000	8.3%
2003 <sup>1</sup>	86,900	79,700	7,200	8.3
2004 <sup>1</sup>	88,200	81,100	7,100	8.0
2005 <sup>2</sup>	81,500	74,700	6,700	8.3

<b>GUAYNABO</b>				
<u>Year</u>	<u>Labor Force</u>	<u>Employed</u>	<u>Unemployed</u>	<u>Percentage Unemployment</u>
2002 <sup>1</sup>	42,900	40,900	2,100	4.8%
2003 <sup>1</sup>	44,400	42,300	2,100	4.8
2004 <sup>1</sup>	45,200	43,000	2,200	4.8
2005 <sup>2</sup>	46,500	43,700	2,800	6.1

<b>PUERTO RICO</b>				
<u>Year</u>	<u>Labor Force</u>	<u>Employed</u>	<u>Unemployed</u>	<u>Percentage Unemployment</u>
2002 <sup>1</sup>	1,330,000	1,170,000	160,000	12.0%
2003 <sup>1</sup>	1,378,000	1,211,000	167,000	12.1
2004 <sup>1</sup>	1,392,000	1,234,000	158,000	11.4
2005 <sup>2</sup>	1,384,700	1,237,000	147,100	10.6

1) The data presented are by place of residence, based on the 1990 Census.

2) The data presented are by place of residence, based on the 2000 Census.

Source: Puerto Rico Department of Labor and Human Resources  
 Bureau of Labor Statistics Division  
 Research and Statistics Division  
 Program-Labor Area Unemployment Statistics

## Education

Elementary and secondary education is provided by the public school system of the Commonwealth's Department of Education and various private schools. There are currently 134 public schools in San Juan, 45 public schools in Bayamón, 45 public schools in Carolina and 24 public schools in Guaynabo.

## Protection

Each municipality is served by a Municipal Police Department and by the Police Department of the Commonwealth.

The Fire Department of the Commonwealth provides service through truck and ladder companies located in and around each municipality.

## Health

Each municipality is included in the Commonwealth's Health Reform program. This program provides comprehensive health insurance coverage for qualifying low income residents through a managed care system. Under the program, the Government of Puerto Rico selects, through a bidding system, one private health insurance company in each of several designated regions of Puerto Rico and pays such insurance company the insurance premiums for each eligible beneficiary within such region. The municipalities pay the Government of Puerto Rico an amount mandated by law to cover part of the insurance premium paid by the Government of Puerto Rico for its qualifying residents. In addition, San Juan participates in this program not only as a health provider, through various municipal health facilities, including a 200-bed hospital, but also as an Independent Provider Association (IPA) sharing with insurers the health insurance risk.

## Utilities

Electricity is supplied to businesses and residents by Puerto Rico Electric Power Authority. Water and sewage services are provided to businesses and residents by Puerto Rico Aqueduct and Sewer Authority.

## Cultural

Each municipality develops and promotes a variety of cultural activities and projects that contribute to the development of an appreciation for, among other things, the following: (i) history of each municipality and of Puerto Rico, (ii) the arts, (iii) literature, (iv) cinema, and (v) folklore.

## Environmental Control and Public Works

Each municipality is responsible for coordinating, among other things, garbage collection, cleaning and maintenance of municipal parks, streets, canals, streams, flood pumps and roads and other services relating to the construction, renovation and maintenance of the municipality's infrastructure.

## Sources of Revenue

The principal sources of revenue, as is the case with the other municipalities of Puerto Rico, are ad valorem property taxes, municipal license taxes, service charges and federal grants. The table below sets forth the current Special Additional and Basic Tax rates for each municipality.

	<u>San Juan</u>	<u>Bayamón</u>	<u>Carolina</u>	<u>Guaynabo</u>
Special Additional Tax	2.00%	1.75%	2.00%	2.25%
Basic Tax (Real)	6.00	6.00	6.00	6.00
Basic Tax (Personal)	4.00	4.00	4.00	4.00

Each municipality imposes a volume of business or municipal license tax pursuant to Act No. 113 of July 10, 1974, as amended ("Act No. 113"), on all business entities that operate within the levying municipality and that are not exempt from the tax pursuant to the Commonwealth's tax incentives laws. The municipal license taxes are collected directly by the levying municipality. The municipal license tax is applied to gross revenues, as defined in Act No. 113, computed at the rates set by the levying municipality as described in the table below:

	<u>San Juan</u>	<u>Bayamón</u>	<u>Carolina</u>	<u>Guaynabo</u>
Financial Entities	1.5%	1.5%	1.5%	1.5%
Others	0.5*	0.5	0.5	0.5

\* For others with gross revenues under \$1,000,000 the rate is 0.2%

Each municipality is also the beneficiary of various contributions that are made by the Commonwealth to all of the municipalities. See “SOURCES OF PAYMENT FOR THE BONDS - The Municipal Bonds” for a general description of these Commonwealth contributions.

Federal agency contributions are an important additional source of revenues. Each municipality receives assistance from the federal government in the form of grants or entitlements. The most important federal grants and entitlements received are under programs operated by the U.S. Department of Health and Human Services, U.S. Department of Housing and Urban Development, U.S. Department of Education and U.S. Department of Labor. In addition, each municipality receives payments in lieu of taxes or similar contributions from Puerto Rico Electric Power Authority and Puerto Rico Aqueduct and Sewer Authority.

### **Budgeting Process**

The Mayor of each municipality is responsible for preparing and submitting a draft balanced general budget resolution to the applicable Municipal Legislature no later than May of each year. The draft budget resolution must include a budget message and a financing plan, as required by law. The budget message must include a summary of the principal budget aspects and justification for the principal budget requests. The financial plan must provide, among other things, a summary of municipal expenditures by categories such as salaries, wages, materials, services and permanent works for the upcoming fiscal year, a detailed estimate of resources to cover expenditures, a comparative statement of proposed appropriations and information with respect to each program and its objectives.

The Mayor is obligated to include in the draft general budget resolution, and in order of priority, the following items:

1. interest and amortization payments on public municipal debt;
2. other statutory obligations or expenses;
3. payment of judgments;
4. amounts necessary to cover any prior year deficit;
5. amounts required to be paid by the municipality under established contractual commitments;
6. expenses and obligations required to be included by law; and
7. other operating expenses.

The Municipal Legislature may amend the budget resolution, but it may not eliminate or reduce the items set forth in items 1 through 5 above (among others). The Municipal Legislature is required to approve and submit the budget to the Mayor no later than by mid-June of each year, and the Mayor has six days after receipt to approve it or return it to the Municipal Legislature for amendments.

### **General Obligation Debt and Sources for Debt Service**

The Puerto Rico Legislature has fixed a limitation for the issuance of general obligation municipal bonds and notes for the payment of which the good faith, credit and taxing power of each municipality may be pledged. See “Limitations on Ability of Municipalities to Issue General Obligation Debt - The Municipal Bonds” for a general description of such limitations.

The table below, based on the current total net assessed valuation of real and personal property in each municipality provided by CRIM, shows (in millions) the Legal Margin and Available Legal Margin as calculated by GDB after subtracting from each municipality’s Legal Margin the amount of outstanding general obligation debt as of July 1, 2005, and adding to the Legal Margin the excess amount in its Redemption Fund as of June 30, 2005.



	<b><u>San Juan</u></b>	<b><u>Bayamón</u></b>	<b><u>Carolina</u></b>	<b><u>Guaynabo</u></b>
Legal Margin	\$ 412,243,798	\$149,634,661	\$182,934,898	\$123,257,549
Less: Outstanding G.O. Debt	396,575,000	152,286,000	144,933,390	128,425,000
Plus: Excess Redemption Fund Moneys	<u>37,836,828</u>	<u>18,597,225</u>	<u>42,264,276</u>	<u>17,443,238</u>
Available Legal Margin	<u>\$ 53,505,626</u>	<u>\$ 15,945,886</u>	<u>\$ 80,265,784</u>	<u>\$ 12,275,787</u>

The applicable law also requires that in order for a municipality to be able to issue additional general obligation bonds and notes such municipality must have sufficient “payment capacity.” Act No. 64 provides that a municipality has sufficient “payment capacity” to incur additional general obligation debt if the deposits in such municipality’s Redemption Fund and the annual amounts collected with respect to such municipality’s Special Additional Tax (as defined below), as projected by GDB, will be sufficient to service to maturity the municipality’s outstanding general obligation debt and the additional proposed general obligation debt (“Payment Capacity”).

Each municipality is required under applicable law to levy the Special Additional Tax in such amounts as shall be required for the payment of its general obligation municipal bonds and notes. In addition, principal of and interest on all general obligation municipal bonds and notes and on all notes issued in anticipation of the issuance of general obligation bonds or notes issued by such municipality constitute a first lien on its Basic Tax revenues. Accordingly, each municipality’s Basic Tax revenues would be available to make debt service payments on its general obligation municipal bonds and notes to the extent that its Special Additional Tax, together with moneys on deposit in its Redemption Fund, are not sufficient to cover such debt service. It has never been necessary to apply Basic Taxes to pay debt service on general obligation debt of any of the four municipalities.

## SUMMARY OF THE 2005 INDENTURE

The following is a summary of certain provisions of the 2005 Indenture. References in this summary to Bonds include the 2005 Series A Bonds to which this Official Statement relates and any bonds issued under the 2005 Indenture to refund as described below outstanding bonds previously issued under the 2005 Indenture. This summary does not purport to be complete, and reference is made to the 2005 Indenture for its complete terms.

### Funds and Accounts

A special fund is created under the 2005 Indenture to be held by the 2005 Trustee and designated “Puerto Rico Municipal Finance Agency Series 2005 Bonds Interest and Sinking Fund” (the “2005 Sinking Fund”). The 2005 Sinking Fund is composed of three separate accounts: the 2005 Bond Service Account, the 2005 Redemption Account and the 2005 Reserve Account. The 2005 Trustee is required to deposit moneys received from payments on the 2005 Municipal Bonds in such accounts as described above under “SOURCES OF PAYMENT FOR THE BONDS.”

Moneys in the 2005 Bond Service Account will be applied to the payment of the interest on all the outstanding 2005 Series A Bonds and the principal of all serial 2005 Series A Bonds.

Moneys in the 2005 Redemption Account will be applied to the purchase or redemption of all term 2005 Series A Bonds, including the retirement of term 2005 Series A Bonds to the extent of the Amortization Requirements under the 2005 Indenture.

The Agency will cause to be deposited, from the proceeds of the 2005 Series A Bonds, to the credit of the 2005 Reserve Account, an amount equal to the 2005 Required Debt Service Reserve. Thereafter, the Agency will cause to be deposited to the credit of the 2005 Reserve Account to the extent of any deficiency therein (i) all moneys paid to the Agency pursuant to the Enabling Act for the purpose of restoring the 2005 Reserve Account to the required amount and (ii) any other moneys which may be made available to the Agency for the purposes of the 2005 Reserve Account from any other source. Moneys in the 2005 Reserve Account will be applied first to the payment of interest on the 2005 Series A Bonds and maturing principal of the serial 2005 Series A Bonds whenever and to the extent moneys in the 2005 Bond Service Account are insufficient for such purpose, and then for the purpose of making the required deposits to the 2005 Redemption Account whenever and to the extent moneys received by the 2005 Trustee from the payments of principal of and interest on the 2005 Municipal Bonds are insufficient for such purpose. The Agency may at any time deliver to the 2005 Trustee for deposit to the credit of the 2005 Reserve Account, in lieu of cash or Investment Obligations (as defined below), a qualifying insurance policy or a letter of credit, the issuer of whose policy or letter of credit results in the rating of municipal obligations secured by such policy or letter of credit, at the time of deposit in the 2005 Reserve Account, in any of the three highest rating categories (without regard to any gradations within any such category) by both Moody’s and S&P as provided in the 2005 Indenture.

Another special fund is created under the 2005 Indenture to be held by the 2005 Trustee and designated “Puerto Rico Municipal Finance Agency Series 2005 Bonds Rebate Fund” (the “2005 Rebate Fund”). Moneys in the 2005 Rebate Fund shall be held by the 2005 Trustee in trust and paid from time to time to the United States Treasury to the extent required to satisfy the Agency’s rebate liability in respect of any of its tax exempt bonds (whether or not issued under the 2005 Indenture) and will not be subject to any lien or charge in favor of the holders of the 2005 Series A Bonds. Any balance remaining in the 2005 Rebate Fund after the making of each such payment by the 2005 Trustee shall be transferred by the 2005 Trustee from the 2005 Rebate Fund to the 2005 Operating Fund as promptly as practicable.

An additional special fund is created under the 2005 Indenture to be held by the 2005 Trustee and designated “Puerto Rico Municipal Finance Agency Series 2005 Bonds Operating Fund” (the “2005 Operating Fund”). Moneys held for the credit of the 2005 Operating Fund may be used for the payment of the fees and expenses of the 2005 Trustee, amounts due to the provider of any municipal bond insurance policy for the Bonds, administrative expenses of

the Agency and GDB in relation to its monitoring of the Agency and the 2005 Municipal Bonds, the fees, expenses and other obligations of the Agency in respect of any credit facility held in the 2005 Reserve Account, and financing costs incurred in connection with the issuance of Bonds under the 2005 Indenture and for such other lawful purposes of the Agency as the President of the Agency shall direct.

### **2005 Acquisition Fund**

The proceeds of the 2005 Series A Bonds remaining after the required deposit to the 2005 Reserve Account and after the payment of financing expenses will be deposited in the 2005 Acquisition Fund. The 2005 Trustee shall apply moneys in the 2005 Acquisition Fund to acquire the 2005 Municipal Bonds from GDB only upon proper requisition by the Agency. Moneys in the 2005 Acquisition Fund may also be used to pay maturing principal of and interest on the 2005 Series A Bonds (whether at maturity or by redemption) whenever moneys in the 2005 Sinking Fund are insufficient for such purpose.

### **Release of 2005 Municipal Bonds**

The Agency may direct the 2005 Trustee to release from the lien and charge under the 2005 Indenture all or any of the 2005 Municipal Bonds then held by the 2005 Trustee in trust thereunder provided that the following requirements have been met:

(1) the following shall have been filed with the 2005 Trustee:

(a) a certificate signed by the President of the Agency setting forth (i) the name of each 2005 Municipal Issuer whose 2005 Municipal Bonds are to be released and a brief description of such 2005 Municipal Bonds containing, among other things, the dated date, the aggregate principal amount, the maturity date or dates and the interest rate or rates corresponding thereto; (ii) for each fiscal year after the fiscal year in which such release is to occur the sum of moneys to be received by the 2005 Trustee in such fiscal year from the payments of principal of and interest on the 2005 Municipal Bonds to be held by the 2005 Trustee after said release and any other available moneys under the 2005 Indenture; and (iii) the amount of the principal and interest requirements for each such fiscal year on account of all 2005 Series A Bonds then outstanding under the 2005 Indenture; and

(b) an opinion of bond counsel to the Agency, in form and substance satisfactory to the 2005 Trustee, to the effect that such release will not cause interest on the 2005 Series A Bonds then outstanding under the 2005 Indenture to be includable in the gross income of the recipients thereof for federal income tax purposes to the extent that such interest was not so includable on the respective dates of issuance of said 2005 Series A Bonds; and

(2) in each fiscal year after the fiscal year in which such release is to occur the amount shown in item (iii) of the certificate mentioned in clause (1)(a) above shall not be greater than the amount shown in item (ii) of said certificate.

### **Investment of Funds**

Any moneys in the 2005 Bond Service Account, the 2005 Redemption Account, the 2005 Reserve Account, the 2005 Acquisition Fund, the 2005 Rebate Fund, and the 2005 Operating Fund will as nearly as may be practicable (except as provided in the 2005 Indenture with respect to defeasance and with respect to bonds issued thereunder to refund any outstanding 2005 Series A Bonds), be invested and reinvested by the 2005 Trustee, at the direction of the Agency, in Investment Obligations listed in clauses (i), (ii), (iii), (iv), (ix), and (xi) below or any other Investment Obligations listed below and permitted in writing by Moody's and S&P (the eligible provider of any investment agreement listed in said clause (ix) being limited to those whose unsecured long-term debt obligations are rated in the highest rating category by Moody's and S&P or which investment agreement is collateralized at all times in a manner sufficient to result in such agreement being rated in the highest such rating category by such rating services), which mature, or which are subject to redemption at the option of the holder thereof, not later than the respective dates when the moneys held for the credit of such Funds and Accounts will be required for the purposes intended. Investment Obligations so purchased with moneys in any Account or Fund will be deemed at all times to be part of such Account

or Fund, and the interest accrued thereon and any profit or loss resulting from such investment will be credited to or charged against such Account or Fund.

“Investment Obligations” for purposes of the 2005 Indenture include:

(i) direct obligations of, or obligations the timely payment of principal of and interest on which are unconditionally guaranteed by, the United States Government;

(ii) direct obligations of, or obligations the timely payment of principal of and interest on which are unconditionally guaranteed by, any of the following agencies or instrumentalities of the United States Government: Banks for Cooperatives, Federal Farm Credit Banks, Federal Home Loan Banks, Export-Import Bank of the United States, Federal Financing Bank, Government National Mortgage Association, Federal National Mortgage Association, Farmer’s Home Administration, Federal Home Loan Mortgage Corporation, and Federal Housing Administration;

(iii) obligations issued or unconditionally guaranteed as to the timely payment of principal and interest by any agency or instrumentality controlled or supervised by and acting as an instrumentality of the United States Government pursuant to authority granted by the Congress (the obligations referred to in clauses (i) through (iii) and receipts evidencing the ownership of payments of principal of or interest on any such obligations being called “Government Obligations”);

(iv) time deposits, certificates of deposit or similar arrangements with, or banker’s acceptances issued by, any bank, banking association or trust company, including the 2005 Trustee, which is a member of the Federal Deposit Insurance Corporation having a combined capital and surplus aggregating not less than \$150,000,000 and reported deposits of not less than \$250,000,000;

(v) repurchase agreements with banks mentioned in (iv) above or with primary government dealers having a capital and surplus in excess of \$150,000,000 with respect to any of the securities mentioned in (i), (ii) and (iii) above, provided such securities are on deposit with the 2005 Trustee and such agreements are structured as sale-purchase agreements rather than secured loans;

(vi) obligations issued by the Commonwealth or any state or territory of the United States, which obligations are rated in one of the three highest rating categories (without regard to any gradations within such categories) by both Moody’s and S&P;

(vii) municipal obligations, the payment of the principal of and the interest on which is insured, which are rated in one of the three highest rating categories (without regard to any gradations within such categories) by both Moody’s and S&P;

(viii) commercial paper rated, or backed by a letter of credit or line of credit the provider of which is rated, in the highest rating category (without regard to any gradations within such category) by both Moody’s and S&P;

(ix) an agreement for the investment of moneys entered into by the 2005 Trustee (A) with the Federal National Mortgage Association or any bank, trust company or national banking association or a corporation subject to registration with the Board of Governors of the Federal Reserve System under the Bank Holding Company Act of 1956, as amended, or any government securities dealer, insurance company or other financial institution whose unsecured obligations or uncollateralized long-term debt obligations, or of such institution’s parent or holding company, are rated in one of the three highest rating categories (without regard to any gradations within such categories) by both Moody’s and S&P or which has issued a letter of credit, contract or agreement in support of debt obligations which at all times shall be so rated, or (B) with such other person if the agreement with such person is collateralized at all times by such obligations as are described in clauses (i) through (iii) above, having a market value at least equal to the principal amount of such agreement, as to which collateral the 2005 Trustee has a perfected first priority security interest and which collateral is held by the 2005 Trustee or its agent, free and clear of claims by third parties;

(x) units of beneficial interest in any non-arbitrage investment program pools created by GDB or any of its subsidiaries or affiliates;

(xi) certain highly rated taxable or tax-exempt money-market funds;

(xii) any other obligations permitted under the laws of the Commonwealth which are rated in any of the three highest rating categories (without regard to any gradations within such category) by both Moody's and S&P; and

(xiii) any securities otherwise permitted as eligible collateral under Act No. 69 of the Legislature of Puerto Rico, approved August 14, 1991, as amended.

### **Refunding Bonds**

The Agency may issue bonds under the 2005 Indenture for the purpose of providing funds, together with any other available funds, to pay at or redeem prior to their maturity or maturities all or any part of the 2005 Series A Bonds outstanding under the 2005 Indenture, including the payment of any redemption premium thereon, the interest thereon to the date fixed for their payment or redemption and any expenses incurred in connection with such refunding.

The 2005 Trustee shall not authenticate and deliver such refunding bonds unless it receives evidence that, among other things, the payments to be received by the 2005 Trustee in each fiscal year on the 2005 Municipal Bonds, together with any available moneys specified for such purpose by the Agency, will be at least equal to the principal and interest requirements in such fiscal year for all bonds outstanding under the 2005 Indenture.

### **Enforcement of Municipal Bonds**

The Agency has agreed to take any and all actions available to it under the laws of the Commonwealth to assure that payment of the principal of and interest on the 2005 Municipal Bonds held by the 2005 Trustee will be timely, and that if payment of such principal and interest is not made when the same become due and payable, the Agency has agreed to take any and all actions available to it under the laws of the Commonwealth to enforce such payment.

### **Additional Indebtedness**

The Agency has agreed not to incur any additional indebtedness secured by a lien on the 2005 Municipal Bonds and payments in respect thereof or which indebtedness will be payable from the 2005 Sinking Fund or the 2005 Acquisition Fund; provided, however, that additional series of refunding bonds may be issued from time to time as permitted under "Refunding Bonds" above, on a parity with the 2005 Series A Bonds.

### **Accounting**

The Agency has covenanted that it will keep accurate records and accounts of the moneys collected and of the application of such moneys. Such records and accounts will be open at all reasonable times to the inspection of the holders of the 2005 Series A Bonds and their agents and representatives.

The Agency has further covenanted that promptly after the close of each fiscal year an audit of its books and accounts for such fiscal year will be made by an independent firm of certified public accountants of recognized ability and standing to be chosen by the Agency.

## **Events of Default; Remedies**

The 2005 Indenture provides for each of the following events to be declared as an “event of default” under the 2005 Indenture:

- (a) payment of principal of and redemption premium, if any, or any installment of interest on the 2005 Series A Bonds was not made when the same became due and payable (whether at maturity or upon redemption), or
- (b) there was a failure to retire the 2005 Series A Bonds by purchase or redemption in any fiscal year in a principal amount at least equal to the applicable amortization requirement under the 2005 Indenture for such fiscal year, or
- (c) the amount on deposit to the credit of the 2005 Reserve Account was less than the 2005 Required Debt Service Reserve, and the President of the Agency failed or refused to comply with the provisions of the Enabling Act which require him to certify the amount of such deficiency to the Secretary of the Treasury, or the Commonwealth failed to apportion and pay to the Agency for deposit in the 2005 Reserve Account such amount as certified by the President of the Agency pursuant to such provisions of the Enabling Act, or
- (d) the Agency was, for any reason, rendered incapable of fulfilling its obligations under the 2005 Indenture, or
- (e) the Agency defaulted in the due and punctual performance of any other of its covenants, conditions, agreements and provisions contained in the 2005 Series A Bonds or the 2005 Indenture to be performed and such default continued for thirty (30) days after written notice to the Agency by the holders of not less than 10% in aggregate principal amount of the 2005 Series A Bonds then outstanding.

Upon the happening and the continuance of any event of default under the 2005 Indenture, the 2005 Trustee may, and upon the request of the holders of 25% in aggregate principal amount of the 2005 Series A Bonds then outstanding must, proceed to protect and enforce its rights and the rights of the holders of the 2005 Series A Bonds by such suits, actions or special proceedings in equity or at law, or by proceedings in the office of any board or officer having jurisdiction, either for the specific performance of any covenant or agreement contained in the 2005 Indenture or in aid or execution of any power granted in the 2005 Indenture or for the enforcement of any proper legal or equitable remedy, as the 2005 Trustee deems most effectual to protect and enforce such rights.

No holder of any of the 2005 Series A Bonds has any right to institute any suit, action or proceeding in equity or at law on any 2005 Series A Bond or for the execution of any trust under the 2005 Indenture or for any other remedy under the 2005 Indenture unless such holder has given to the 2005 Trustee written notice of such event of default on account of which suit, action or proceeding is to be instituted, and unless, also, the holders of not less than 25% in aggregate principal amount of the 2005 Series A Bonds then outstanding have made written request of the 2005 Trustee after the right to exercise such power or right of action accrued, and have afforded the 2005 Trustee a reasonable opportunity either to proceed to exercise such powers or to institute such suit, action or proceeding, and unless, also, there has been offered to the 2005 Trustee reasonable security and indemnity against the cost and liabilities to be incurred therein or thereby, and the 2005 Trustee refused or neglected to comply with such request within a reasonable time. The 2005 Indenture provides, however, that notwithstanding any other provision therein, the owner of any 2005 Series A Bond has the absolute and unconditional right to receive payment of the principal of and the premium, if any, and the interest on such 2005 Series A Bond when due and to institute suit for the enforcement of any such payment, and such right may not be impaired without the consent of such owner.

## **Defeasance**

Any outstanding 2005 Series A Bond will be deemed to have been paid within the meaning of the 2005 Indenture when the whole amount of the principal of and interest on such 2005 Series A Bond has been paid or duly

provided for and the conditions set forth in clause (c) below have been satisfied or when, among other things, (a) such 2005 Series A Bond has been duly called for redemption or irrevocable instructions to call such 2005 Series A Bond for redemption have been given to the 2005 Trustee, (b) there have been deposited with the 2005 Trustee either moneys in an amount which will be sufficient, or Government Obligations, which do not contain provisions permitting redemption at the option of the issuer, the principal of and interest on which when due, and without reinvestment, will provide moneys which, together with the moneys, if any, deposited with or held by the 2005 Trustee available therefore, will be sufficient, to pay when due the principal of and premium, if any, and interest due and to become due on such 2005 Series A Bond on or prior to the redemption date thereof, and (c) in the event such 2005 Series A Bond does not mature and is not to be redeemed within the next succeeding 60 days, the Agency has given the 2005 Trustee irrevocable instructions to give, as soon as practicable, a notice to the holder of such 2005 Series A Bond stating that the deposit of moneys or Government Obligations described above has been made with the 2005 Trustee and that such 2005 Series A Bond is deemed to have been paid in accordance with the 2005 Indenture and stating the maturity or redemption date upon which moneys are to be available for the payment of the principal of and premium, if any, and interest on such 2005 Series A Bond.

### **Supplemental Indentures**

The Agency and the 2005 Trustee, without the consent of the holders of the 2005 Series A Bonds, may enter into supplemental indentures to (i) cure any ambiguity, correct or supplement any provision in the 2005 Indenture which may be inconsistent with any other provision in the 2005 Indenture, or to make any other provisions with respect to matters or questions arising under the 2005 Indenture which shall not be inconsistent with the existing provisions of the 2005 Indenture; (ii) grant or confer upon the 2005 Trustee for the benefit of the holders of the 2005 Series A Bonds any additional rights, remedies, powers, authority or security that may lawfully be granted to or conferred upon the holders of the 2005 Series A Bonds or the 2005 Trustee; (iii) add to the conditions, limitations and restrictions on the issuance of 2005 Series A Bonds under the provisions of the 2005 Indenture, other conditions, limitations and restrictions thereafter to be observed; or (iv) add to the covenants and agreements of the Agency in the 2005 Indenture other covenants and agreements thereafter to be observed by the Agency, or to surrender any right or power conferred upon the Agency in the 2005 Indenture.

All other supplemental indentures require the written consent of the holders of not less than a majority in aggregate principal amount of the 2005 Series A Bonds at the time outstanding; provided, however, that no such supplement shall permit (a) an extension of the time for payment of the principal of or interest on any 2005 Series A Bond, or (b) a reduction in the principal amount of any 2005 Series A Bond or the redemption premium or the rate of interest thereon, or (c) the creation of a lien upon or a pledge of funds other than the lien and pledge created by the 2005 Indenture, or (d) a preference or priority of any 2005 Series A Bond or Bonds over any other 2005 Series A Bond or Bonds, or (e) a reduction in the aggregate principal amount of the 2005 Series A Bonds required for consent to such supplement or any waiver under the 2005 Indenture.

## SUMMARY OF 1997 INDENTURE

The following is a summary of certain provisions of the 1997 Indenture. References in this summary to 1997 Bonds include the 2005 Series B Refunding Bonds to which this Official Statement relates and any other outstanding bonds issued under the 1997 Indenture. This summary does not purport to be complete and reference is made to the 1997 Indenture.

### Funds and Accounts

The 1997 Indenture establishes a 1997 Sinking Fund to be held by the 1997 Trustee. The 1997 Sinking Fund is composed of three separate accounts: the 1997 Bond Service Account, the 1997 Redemption Account and the 1997 Reserve Account. The 1997 Trustee is required to deposit moneys received from payments on the 1997 Municipal Bonds in such accounts as described above under “SOURCES OF PAYMENT FOR THE BONDS.”

Moneys in the 1997 Bond Service Account will be applied to the payment of the interest on all the outstanding 1997 Bonds and the principal of all serial 1997 Bonds.

Moneys in the 1997 Redemption Account will be applied to the purchase or redemption of term 1997 Bonds, including the retirement of term 1997 Bonds to the extent of the Amortization Requirements.

The Agency will cause to be deposited, from the proceeds of the 1997 Bonds, to the credit of the 1997 Reserve Account, an amount equal to the 1997 Required Debt Service Reserve. Thereafter, the Agency will cause to be deposited to the credit of the 1997 Reserve Account to the extent of any deficiency therein (i) all moneys paid to the Agency pursuant to the Enabling Act for the purpose of restoring the 1997 Reserve Account to the required amount and (ii) any other moneys which may be made available to the Agency for the purposes of the 1997 Reserve Account from any other source. Moneys in the 1997 Reserve Account will be applied first to the payment of interest on the 1997 Bonds and maturing principal of the serial 1997 Bonds whenever and to the extent moneys in the 1997 Bond Service Account are insufficient for such purpose, and then for the purpose of making the required deposits to the 1997 Redemption Account whenever and to the extent moneys received by the 1997 Trustee from the payments of principal of and interest on the 1997 Municipal Bonds are insufficient for such purpose. The Agency may at any time deliver to the 1997 Trustee for deposit to the credit of the 1997 Reserve Account, with the prior approval of the Insurer (as defined therein (currently, Financial Security Assurance Inc.)), in lieu of cash or Investment Obligations (as defined herein), a qualifying insurance policy or a letter of credit, the issuer of whose policy or letter of credit results in the rating of municipal obligations secured by such policy or letter of credit, at the time of deposit in the 1997 Reserve Account, in any of the three highest rating categories (without regard to any gradations within such category) by both Moody's and S&P or their respective successors as provided in the 1997 Indenture.

A special fund is created under the 1997 Indenture to be held by the 1997 Trustee and designated “Puerto Rico Municipal Finance Agency Series 1997 Operating Fund” (the “1997 Operating Fund”). Moneys held for the credit of the 1997 Operating Fund may be used for the payment of the fees and expenses of the 1997 Trustee, amounts due to the provider of any municipal bond insurance policy for the 1997 Bonds, administrative expenses of the Agency, the fees, expenses and other obligations of the Agency in respect of any credit facility held in the 1997 Reserve Account, and financing costs incurred with respect to the 1997 Bonds and for such other lawful purposes of the Agency as the President of the Agency shall direct.

### 1997 Escrow Fund

The 2005 Series B Refunding Bond proceeds remaining after the payment of financing expenses shall be transferred to and held by the 1997 Trustee in the 1997 Escrow Fund for the sole and exclusive purpose of paying the principal of and redemption premium, if any, and interest on the 1997 Refunded Bonds as described above under “PLAN OF FINANCING”.



## Investment of Funds

Any moneys in the 1997 Bond Service Account and the 1997 Redemption Account will be invested and reinvested by the 1997 Trustee, at the direction of the Agency and with the approval of the Insurer, in Investment Obligations listed in clauses (i), (ii), (iii), (v), (ix) and (x) below or any other Investment Obligations listed below and permitted in writing by Moody's and S&P (the eligible provider of any investment agreement listed in said clause (x) being limited to those whose unsecured long-term debt obligations are rated in the highest rating category by Moody's and S&P or which investment agreement is collateralized at all times in a manner sufficient to result in such agreement being rated in the highest such rating category by such rating services), and any moneys in the 1997 Reserve Account, the 1997 Acquisition Fund, and the 1997 Operating Fund will as nearly as may be practicable (except as provided in the 1997 Indenture with respect to defeasance and with respect to 1997 Bonds issued thereunder to refund any outstanding 1997 Bonds), be invested and reinvested by the 1997 Trustee, at the direction of the Agency and with the approval of the Insurer, in Investment Obligations, listed below, in each case which mature or which are subject to redemption at the option of the holder thereof not later than the respective dates when the moneys held for the credit of such Funds and Accounts will be required for the purposes intended. Investment Obligations so purchased with moneys in any Account or Fund will be deemed at all times to be part of such Account or Fund, and the interest accrued thereon and any profit or loss resulting from such investment will be credited to or charged against such Account or Fund.

"Investment Obligations" for purposes of the 1997 Indenture include:

(i) direct obligations of, or obligations the timely payment of principal of and interest on which are unconditionally guaranteed by, the United States Government and receipts evidencing the ownership of payments of principal of or interest on any of such obligations;

(ii) direct obligations of, or obligations the timely payment of principal of and interest on which are unconditionally guaranteed by, any of the following agencies or instrumentalities of the United States Government: Banks for Cooperatives, Federal Farm Credit Banks, Federal Home Loan Banks, Export-Import Bank of the United States, Federal Financing Bank, Government National Mortgage Association, Federal National Mortgage Association, Farmer's Home Administration, Federal Home Loan Mortgage Corporation, and Federal Housing Administration;

(iii) obligations issued or unconditionally guaranteed as to the timely payment of principal and interest by any agency or instrumentality controlled or supervised by and acting as an instrumentality of the United States Government pursuant to authority granted by the Congress;

(iv) time deposits, certificates of deposit or similar arrangements with, or banker's acceptances issued by, any bank, banking association or trust company, including the 1997 Trustee, which is a member of the Federal Deposit Insurance Corporation having a combined capital and surplus aggregating not less than \$150,000,000 and reported deposits of not less than \$250,000,000;

(v) repurchase agreements with banks mentioned in (iv) above or with primary government dealers having a capital and surplus in excess of \$150,000,000 with respect to any of the securities mentioned in (i), (ii) and (iii) above, provided such securities are on deposit with the 1997 Trustee and such agreements are structured as sale-purchase agreements rather than secured loans;

(vi) obligations issued by the Commonwealth or any state or territory of the United States, which are rated in one of the three highest rating categories (without regard to any gradations within such categories) by both Moody's and S&P;

(vii) municipal obligations, the payment of the principal of and the interest on which is insured, which are rated in one of the three highest rating categories (without regard to any gradations within such categories) by both Moody's and S&P;

(viii) commercial paper rated, or backed by a letter of credit or line of credit, the provider of which is rated in the highest rating category (without regard to any gradations within such category) by both Moody's and S&P;

(ix) receipts evidencing the ownership of payments of principal of or interest on any of the securities described in (ii) and (iii) above;

(x) an agreement for the investment of moneys entered into by the 1997 Trustee with a bank, trust company or national banking association, a corporation subject to registration with the Board of Governors of the Federal Reserve System under the Bank Holding Company Act of 1956, or an insurance company, financial corporation or primary securities dealer (A) having a capital and surplus in excess of \$150,000,000, provided that the equity or unsecured long-term debt obligations of such institution, or of such institution's parent or holding company, are rated in one of the three highest rating categories (without regard to any gradations within such categories) by both Moody's and S&P, or (B) collateralized at all times by such obligations as are described in clauses (i) through (iii) above, having a market value at least equal to the principal amount of such agreement, as to which collateral the 1997 Trustee has a perfected first priority security interest and which collateral is held by the 1997 Trustee or its agent, free and clear of claims by third parties;

(xi) units of beneficial interest in any non-arbitrage investment program pools created by GDB or any of its subsidiaries or affiliates;

(xii) any other obligations permitted under the laws of the Commonwealth which are rated in any of the three highest rating categories (without regard to any gradations within such category) by both Moody's and S&P; and

(xiii) any securities otherwise permitted as eligible collateral under Act No. 69 of the Legislature of Puerto Rico, approved August 14, 1991.

### **Refunding Bonds**

The Agency may issue bonds under the 1997 Indenture for the purpose of providing funds, together with any other available funds, to pay at or redeem prior to their maturity or maturities all or any part of the 1997 Bonds outstanding under the 1997 Indenture, including the payment of any redemption premium thereon, the interest thereon to the date fixed for their payment or redemption and any expenses incurred in connection with such refunding. In the event less than all of the 1997 Bonds are being so refunded, the prior consent of the Insurer shall be required.

The 1997 Trustee shall not authenticate and deliver such refunding bonds unless it receives evidence that, among other things, the payments to be received by the 1997 Trustee in any fiscal year on the 1997 Municipal Bonds together with any available moneys specified for such purpose by the Agency will be at least equal to the principal and interest requirements in such fiscal year for all 1997 Bonds outstanding under the 1997 Indenture.

### **Enforcement of 1997 Municipal Bonds**

The Agency has agreed to take any and all action available to it under the laws of the Commonwealth to assure that payment of the principal of and interest on the 1997 Municipal Bonds held by the 1997 Trustee will be timely, and that if payment of such principal and interest is not made when the same becomes due and payable, the Agency has agreed to take any and all action available to it under the laws of the Commonwealth to enforce such payment.

### **Additional Indebtedness**

The Agency has agreed not to incur any additional indebtedness secured by a lien on the 1997 Municipal Bonds and payments in respect thereof or which indebtedness will be payable from the 1997 Sinking Fund or the 1997 Acquisition Fund; provided, however, that additional series of refunding bonds may be issued from time to time as permitted under "Refunding Bonds," above on a parity with the 1997 Bonds.

## **Accounting**

The Agency has covenanted that it will keep accurate records and accounts of the moneys collected and of the application of such moneys. Such records and accounts will be open at all reasonable times to the inspection of the holders of the 1997 Bonds and their agents and representatives.

The Agency has further covenanted that promptly after the close of each fiscal year an audit of its books and accounts for such fiscal year will be made by an independent firm of certified public accountants of recognized ability and standing to be chosen by the Agency.

## **Events of Default; Remedies**

The 1997 Indenture provides for each of the following events to be declared as an “event of default” under the 1997 Indenture:

(a) payment of principal of and redemption premium, if any, on the 1997 Bonds was not made when the same became due and payable (whether at maturity or upon redemption), or

(b) payment of any installment of interest was not made when the same became due and payable, or

(c) there was a failure to retire 1997 Bonds by purchase or redemption in any fiscal year in a principal amount at least equal to the Amortization Requirement for such fiscal year, or

(d) the amount on deposit to the credit of the 1997 Reserve Account was less than the 1997 Required Debt Service Reserve, and the President of the Agency failed or refused to comply with the provisions of the Enabling Act which require him to certify the amount of such deficiency to the Secretary of the Treasury, or the Commonwealth failed to apportion and pay to the Agency for deposit in the 1997 Reserve Account such amount as certified by the President of the Agency pursuant to such provisions of the Enabling Act, or

(e) the Agency was, for any reason, rendered incapable of fulfilling its obligations under the 1997 Indenture, or

(f) the Agency defaulted in the due and punctual performance of any other of the covenants, conditions, agreements and provisions contained in the 1997 Bonds or the 1997 Indenture on the part of the Agency to be performed and such default continued for 30 days after written notice to the Agency by the holders of not less than 10% in aggregate principal amount of the 1997 Bonds then outstanding.

Upon the happening and continuance of any event of default under the 1997 Indenture, the 1997 Trustee may, and upon the request of the holders of 25% in aggregate principal amount of the 1997 Bonds then outstanding must, proceed to protect and enforce its rights and the rights of the holders of the 1997 Bonds by such suits, actions or special proceedings in equity or at law, or by proceedings in the office of any board or officer having jurisdiction, either for the specific performance of any covenant or agreement contained in the 1997 Indenture or in aid or execution of any power granted in the 1997 Indenture or for the enforcement of any proper legal or equitable remedy, as the 1997 Trustee deems most effectual to protect and enforce such rights.

No holder of any of the 1997 Bonds has any right to institute any suit, action or proceeding in equity or at law on any 1997 Bond or for the execution of any trust under the 1997 Indenture or for any other remedy under the 1997 Indenture unless such holder has given to the 1997 Trustee written notice of such event of default on account of which suit, action or proceeding is to be instituted, and unless, also, the holders of not less than 25% in aggregate principal amount of the 1997 Bonds then outstanding have made written request of the 1997 Trustee after the right to exercise such power or right of action accrued, and have afforded the 1997 Trustee a reasonable opportunity either to proceed to exercise such powers or to institute such suit, action or proceeding, and unless, also, there has been offered to the 1997 Trustee reasonable security and indemnity against the cost and liabilities to be incurred therein or thereby, and the 1997 Trustee refused or neglected to comply with such request within a reasonable time. The 1997 Indenture provides,

however, that notwithstanding any other provision therein, the owner of any 1997 Bond has the absolute and unconditional right to receive payment of the principal of and premium, if any, and interest on such 1997 Bond when due and to institute suit for the enforcement of any such payment, and such right may not be impaired without the consent of such owner.

### **Defeasance**

Any outstanding 1997 Bond will be deemed to have been paid within the meaning of the 1997 Indenture when the whole amount of the principal of and interest on such 1997 Bond has been paid or duly provided for and the conditions set forth in clause (c) below have been satisfied or when, among other things, (a) if such 1997 Bond has been duly called for redemption or irrevocable instructions to call such 1997 Bond for redemption have been given to the 1997 Trustee, (b) there have been deposited with the 1997 Trustee either moneys in an amount which will be sufficient, or Government Obligations, which do not contain provisions permitting redemption at the option of the issuer, the principal of and interest on which when due, and without reinvestment, will provide moneys which, together with the moneys, if any, deposited with or held by the 1997 Trustee available therefor, will be sufficient, to pay when due the principal of and premium, if any, and interest due and to become due on such 1997 Bond on or prior to the redemption date thereof, and (c) in the event such 1997 Bond does not mature and is not to be redeemed within the next succeeding 60 days, the Agency has given the 1997 Trustee irrevocable instructions to give, as soon as practicable, a notice to the holder of such 1997 Bond stating that the deposit of moneys or Government Obligations described above has been made with the 1997 Trustee and that such 1997 Bond is deemed to have been paid in accordance with the 1997 Indenture and stating the maturity or redemption date upon which moneys are to be available for the payment of the principal of and premium, if any, and interest on such 1997 Bond.

### **Supplemental Indentures**

The Agency and the 1997 Trustee, without the consent of the holders of the 1997 Bonds, may enter into supplemental indentures to (i) cure any ambiguity, correct or supplement any provision herein which may be inconsistent with any other provision herein, or to make any other provisions with respect to matters or questions arising under the 1997 Indenture which shall not be inconsistent with the existing provisions of the 1997 Indenture; (ii) grant or to confer upon the 1997 Trustee for the benefit of the holders of the 1997 Bonds any additional rights, remedies, powers, authority, or security that may lawfully be granted to or conferred upon the holders of the 1997 Bonds or the 1997 Trustee; (iii) add to the conditions, limitations and restrictions on the issuance of 1997 Bonds under the provisions of the 1997 Indenture, other conditions, limitations and restrictions thereafter to be observed; or (iv) add to the covenants and agreements of the Agency in the 1997 Indenture other covenants and agreements thereafter to be observed by the Agency, or to surrender any right or power conferred upon the Agency in the 1997 Indenture.

All other supplemental indentures require the consent of the holders of not less than a majority in aggregate principal amount of the 1997 Bonds at the time outstanding; provided, however, that no such supplement shall permit (a) an extension of the time for payment of the principal of or interest on any 1997 Bond, or (b) a reduction in the principal amount of any 1997 Bond or the redemption premium or the rate of interest thereon, or (c) the creation of a lien upon or a pledge of funds other than the lien and pledge created by the 1997 Indenture, or (d) a preference or priority of any 1997 Bond or Bonds over any other 1997 Bond or Bonds, or (e) a reduction in the aggregate principal amount of the 1997 Bonds required for consent to such supplement or any waiver under the 1997 Indenture.

Notwithstanding the foregoing, all amendments or supplements to the 1997 Indenture which adversely affect the Insurer's interest shall not become effective until the Insurer shall have consented thereto.

## SUMMARY OF THE 1999 INDENTURE

The following is a summary of certain provisions of the 1999 Indenture. References in this summary to 1999 Bonds include the 2005 Series C Refunding Bonds to which this Official Statement relates and any other bonds issued under the 1999 Indenture. This summary does not purport to be complete, and reference is made to the 1999 Indenture for its complete terms.

### Funds and Accounts

The 1999 Indenture establishes a 1999 Sinking Fund to be held by the 1999 Trustee. The 1999 Sinking Fund is composed of three separate accounts: the 1999 Bond Service Account, the 1999 Redemption Account and the 1999 Reserve Account. The 1999 Trustee is required to deposit moneys received from payments on the 1999 Municipal Bonds in such accounts as described above under “SOURCES OF PAYMENT FOR THE BONDS.”

Moneys in the 1999 Bond Service Account will be applied to the payment of the interest on all the outstanding 1999 Bonds and the principal of all serial 1999 Bonds.

Moneys in the 1999 Redemption Account will be applied to the purchase or redemption of term 1999 Bonds, including the retirement of term 1999 Bonds to the extent of the Amortization Requirements under the 1999 Indenture. The Agency will cause to be deposited, from the proceeds of the 1999 Bonds, to the credit of the 1999 Reserve Account, an amount equal to the 1999 Required Debt Service Reserve. Thereafter, the Agency will cause to be deposited to the credit of the 1999 Reserve Account to the extent of any deficiency therein (i) all moneys paid to the Agency pursuant to the Enabling Act for the purpose of restoring the 1999 Reserve Account to the required amount and (ii) any other moneys which may be made available to the Agency for the purposes of the 1999 Reserve Account from any other source. Moneys in the 1999 Reserve Account will be applied first to the payment of interest on the 1999 Bonds and maturing principal of the serial 1999 Bonds whenever and to the extent moneys in the 1999 Bond Service Account are insufficient for such purpose, and then for the purpose of making the required deposits to the 1999 Redemption Account whenever and to the extent moneys received by the 1999 Trustee from the payments of principal of and interest on the 1999 Municipal Bonds are insufficient for such purpose. The Agency may at any time deliver to the 1999 Trustee for deposit to the credit of the 1999 Reserve Account, with the prior approval of the Insurer, in lieu of cash or Investment Obligations (as defined below), a qualifying insurance policy or a letter of credit, the issuer of whose policy or letter of credit results in the rating of municipal obligations secured by such policy or letter of credit, at the time of deposit in the 1999 Reserve Account, in any of the three highest rating categories (without regard to any gradations within such category) by both Moody’s and S&P as provided in the 1999 Indenture.

A special fund is created under the 1999 Indenture to be held by the 1999 Trustee and designated “Puerto Rico Municipal Finance Agency Series 1999 Operating Fund” (the “1999 Operating Fund”). Moneys held for the credit of the 1999 Operating Fund may be used for the payment of the fees and expenses of the 1999 Trustee, amounts due to the provider of any municipal bond insurance policy for the 1999 Bonds, administrative expenses of the Agency and GDB in relation to its monitoring of the Agency and the 1999 Municipal Bonds, the fees, expenses and other obligations of the Agency in respect of any credit facility held in the 1999 Reserve Account, and financing costs incurred with respect to the 1999 Bonds and for such other lawful purposes of the Agency as the President of the Agency shall direct.

### Escrow Funds

The 2005 Series C Refunding Bonds proceeds remaining after any required deposit to the 1999 Reserve Account, the payment of financing expenses and the distribution of moneys to certain municipalities derived from the refunding of the 1999 Refunded Bonds will be transferred to and held by the 1999 Trustee in the 1999 Escrow Fund for the sole purpose of paying the principal of and redemption premium, if any, and interest on the 1999 Refunded Bonds as described above under “PLAN OF FINANCING”.

## **Release of 1999 Municipal Bonds**

The Agency may direct the 1999 Trustee to release from the lien and charge under the 1999 Indenture all or any of the 1999 Municipal Bonds then held by the 1999 Trustee in trust thereunder provided that the following requirements have been met:

(1) the following shall have been filed with the 1999 Trustee:

(a) a certificate signed by the President of the Agency setting forth (i) the name of each 1999 Municipal Issuer whose 1999 Municipal Bonds are to be released and a brief description of such 1999 Municipal Bonds containing, among other things, the dated date, the aggregate principal amount, the maturity date or dates and the interest rate or rates corresponding thereto; (ii) for each fiscal year after the fiscal year in which such release is to occur the sum of moneys to be received by the 1999 Trustee in such fiscal year from the payments of principal of and interest on the 1999 Municipal Bonds to be held by the 1999 Trustee after said release and any other available moneys under the 1999 Indenture; and (iii) the amount of the principal and interest requirements for each such fiscal year on account of all 1999 Bonds then outstanding under the 1999 Indenture; and

(b) an opinion of bond counsel to the Agency, in form and substance satisfactory to the 1999 Trustee, to the effect that such release will not cause interest on the 1999 Bonds then outstanding under the 1999 Indenture to be includable in the gross income of the recipients thereof for federal income tax purposes to the extent that such interest was not so includable on the respective dates of issuance of said 1999 Bonds; and

(2) in each fiscal year after the fiscal year in which such release is to occur the amount shown in item (iii) of the certificate mentioned in clause (1)(a) above shall not be greater than the amount shown in item (ii) of said certificate.

## **Investment of Funds**

Any moneys in the 1999 Bond Service Account, the 1999 Redemption Account, the 1999 Reserve Account, the 1999 Acquisition Fund, and the 1999 Operating Fund will as nearly as may be practicable (except as provided in the 1999 Indenture with respect to defeasance and with respect to bonds issued thereunder to refund any outstanding 1999 Bonds), be invested and reinvested by the 1999 Trustee, at the direction of the Agency and with the approval of the Insurer, in Investment Obligations listed in clauses (i), (ii), (iii), (iv), (ix), (x) and (xi) below or any other Investment Obligations listed below and permitted in writing by Moody's and S&P (the eligible provider of any investment agreement listed in said clause (ix) being limited to those whose unsecured long-term debt obligations are rated in the highest rating category by Moody's and S&P or which investment agreement is collateralized at all times in a manner sufficient to result in such agreement being rated in the highest such rating category by such rating services), which mature, or which are subject to redemption at the option of the holder thereof, not later than the respective dates when the moneys held for the credit of such Funds and Accounts will be required for the purposes intended. Investment Obligations so purchased with moneys in any Account or Fund will be deemed at all times to be part of such Account or Fund, and the interest accrued thereon and any profit or loss resulting from such investment will be credited to or charged against such Account or Fund.

"Investment Obligations" for purposes of the 1999 Indenture include:

(i) direct obligations of, or obligations the timely payment of principal of and interest on which are unconditionally guaranteed by, the United States Government;

(ii) direct obligations of, or obligations the timely payment of principal of and interest on which are unconditionally guaranteed by, any of the following agencies or instrumentalities of the United States Government: Banks for Cooperatives, Federal Farm Credit Banks, Federal Home Loan Banks, Export-Import Bank of the United

States, Federal Financing Bank, Government National Mortgage Association, Federal National Mortgage Association, Farmer's Home Administration, Federal Home Loan Mortgage Corporation, and Federal Housing Administration;

(iii) obligations issued or unconditionally guaranteed as to the timely payment of principal and interest by any agency or instrumentality controlled or supervised by and acting as an instrumentality of the United States Government pursuant to authority granted by the Congress (the obligations referred to in clauses (i) through (iii) and receipts evidencing the ownership of payments of principal of or interest on any such obligations being called "Government Obligations");

(iv) time deposits, certificates of deposit or similar arrangements with, or banker's acceptances issued by, any bank, banking association or trust company, including the 1999 Trustee, which is a member of the Federal Deposit Insurance Corporation having a combined capital and surplus aggregating not less than \$150,000,000 and reported deposits of not less than \$250,000,000;

(v) repurchase agreements with banks mentioned in (iv) above or with primary government dealers having a capital and surplus in excess of \$150,000,000 with respect to any of the securities mentioned in (i), (ii) and (iii) above, provided such securities are on deposit with the 1999 Trustee and such agreements are structured as sale-purchase agreements rather than secured loans;

(vi) obligations issued by the Commonwealth or any state or territory of the United States, which are rated in one of the three highest rating categories (without regard to any gradations within such categories) by both Moody's and S&P;

(vii) municipal obligations, the payment of the principal of and the interest on which is insured, which are rated in one of the three highest rating categories (without regard to any gradations within such categories) by both Moody's and S&P;

(viii) commercial paper rated, or backed by a letter of credit or line of credit, the provider of which is rated in the highest rating category (without regard to any gradations within such category) by both Moody's and S&P;

(ix) an agreement for the investment of moneys entered into by the 1999 Trustee with a bank, trust company or national banking association, a corporation subject to registration with the Board of Governors of the Federal Reserve System under the Bank Holding Company Act of 1956, or an insurance company, financial corporation or primary securities dealer (A) having a capital and surplus in excess of \$150,000,000, provided that the equity or unsecured long-term debt obligations of such institution, or of such institution's parent or holding company, are rated in one of the three highest rating categories (without regard to any gradations within such categories) by both Moody's and S&P or (B) collateralized at all times by such obligations as are described in clauses (i) through (iii) above, having a market value at least equal to the principal amount of such agreement, as to which collateral the 1999 Trustee has a perfected first priority security interest and which collateral is held by the 1999 Trustee or its agent, free and clear of claims by third parties;

(x) units of beneficial interest in any non-arbitrage investment program pools created by GDB or any of its subsidiaries or affiliates;

(xi) certain highly rated taxable or tax-exempt money-market funds;

(xii) any other obligations permitted under the laws of the Commonwealth which are rated in any of the three highest rating categories (without regard to any gradations within such category) by both Moody's and S&P; and

(xiii) any securities otherwise permitted as eligible collateral under Act No. 69 of the Legislature of Puerto Rico, approved August 14, 1991, as amended.

## **Refunding Bonds**

The Agency may issue 1999 Bonds under the 1999 Indenture for the purpose of providing funds, together with any other available funds, to pay at or redeem prior to their maturity or maturities all or any part of the 1999 Bonds outstanding under the 1999 Indenture, including the payment of any redemption premium thereon, the interest thereon to the date fixed for their payment or redemption and any expenses incurred in connection with such refunding.

The 1999 Trustee shall not authenticate and deliver such refunding bonds unless it receives evidence that, among other things, the payments to be received by the 1999 Trustee in any fiscal year on the 1999 Municipal Bonds, together with any available moneys specified for such purpose by the Agency, will be at least equal to the principal and interest requirements in such fiscal year for all 1999 Bonds outstanding under the 1999 Indenture.

## **Enforcement of Municipal Bonds**

The Agency has agreed to take any and all actions available to it under the laws of the Commonwealth to assure that payment of the principal of and interest on the 1999 Municipal Bonds held by the 1999 Trustee will be timely, and that if payment of such principal and interest is not made when the same become due and payable, the Agency has agreed to take any and all actions available to it under the laws of the Commonwealth to enforce such payment.

## **Additional Indebtedness**

The Agency has agreed not to incur any additional indebtedness secured by a lien on the 1999 Municipal Bonds and payments in respect thereof or which indebtedness will be payable from the 1999 Sinking Fund or the 1999 Acquisition Fund; provided, however, that additional series of refunding bonds may be issued from time to time, as permitted under "Refunding Bonds" above, on a parity with the 1999 Bonds.

## **Accounting**

The Agency has covenanted that it will keep accurate records and accounts of the moneys collected and of the application of such moneys. Such records and accounts will be open at all reasonable times to the inspection of the holders of the 1999 Bonds and their agents and representatives.

The Agency has further covenanted that promptly after the close of each fiscal year an audit of its books and accounts for such fiscal year will be made by an independent firm of certified public accountants of recognized ability and standing to be chosen by the Agency.

## **Events of Default; Remedies**

The 1999 Indenture provides for each of the following events to be declared as an "event of default" under the 1999 Indenture:

(a) payment of principal of and redemption premium, if any, or any installment of interest on the 1999 Bonds was not made when the same became due and payable (whether at maturity or upon redemption), or

(b) there was a failure to retire 1999 Bonds by purchase or redemption in any fiscal year in a principal amount at least equal to the applicable amortization requirement under the 1999 Indenture for such fiscal year, or

(c) the amount on deposit to the credit of the 1999 Reserve Account was less than the 1999 Required Debt Service Reserve, and the President of the Agency failed or refused to comply with the provisions of the Enabling Act which require him to certify the amount of such deficiency to the Secretary of the Treasury, or



the Commonwealth failed to apportion and pay to the Agency for deposit in the 1999 Reserve Account such amount as certified by the President of the Agency pursuant to such provisions of the Enabling Act, or

(d) the Agency was, for any reason, rendered incapable of fulfilling its obligations under the 1999 Indenture, or

(e) the Agency defaulted in the due and punctual performance of any other of its covenants, conditions, agreements and provisions contained in the 1999 Bonds or the 1999 Indenture to be performed and such default continued for thirty (30) days after written notice to the Agency by the holders of not less than 10% in aggregate principal amount of the 1999 Bonds then outstanding.

Upon the happening and the continuance of any event of default under the 1999 Indenture, the 1999 Trustee may, and upon the request of the holders of 25% in aggregate principal amount of the 1999 Bonds then outstanding must, proceed to protect and enforce its rights and the rights of the holders of the 1999 Bonds by such suits, actions or special proceedings in equity or at law, or by proceedings in the office of any board or officer having jurisdiction, either for the specific performance of any covenant or agreement contained in the 1999 Indenture or in aid or execution of any power granted in the 1999 Indenture or for the enforcement of any proper legal or equitable remedy, as the 1999 Trustee deems most effectual to protect and enforce such rights.

No holder of any of the 1999 Bonds has any right to institute any suit, action or proceeding in equity or at law on any 1999 Bond or for the execution of any trust under the 1999 Indenture or for any other remedy under the 1999 Indenture unless such holder has given to the 1999 Trustee written notice of such event of default on account of which suit, action or proceeding is to be instituted, and unless, also, the holders of not less than 25% in aggregate principal amount of the 1999 Bonds then outstanding have made written request of the 1999 Trustee after the right to exercise such power or right of action accrued, and have afforded the 1999 Trustee a reasonable opportunity either to proceed to exercise such powers or to institute such suit, action or proceeding, and unless, also, there has been offered to the 1999 Trustee reasonable security and indemnity against the cost and liabilities to be incurred therein or thereby, and the 1999 Trustee refused or neglected to comply with such request within a reasonable time. The 1999 Indenture provides, however, that notwithstanding any other provision therein, the owner of any 1999 Bond has the absolute and unconditional right to receive payment of the principal of and the premium, if any, and the interest on such 1999 Bond when due and to institute suit for the enforcement of any such payment, and such right may not be impaired without the consent of such owner.

## **Defeasance**

Any outstanding 1999 Bond will be deemed to have been paid within the meaning of the 1999 Indenture when the whole amount of the principal of and interest on such 1999 Bond has been paid or duly provided for and the conditions set forth in clause (c) below have been satisfied or when, among other things, (a) such 1999 Bond has been duly called for redemption or irrevocable instructions to call such 1999 Bond for redemption have been given to the 1999 Trustee, (b) there have been deposited with the 1999 Trustee either moneys in an amount which will be sufficient, or Government Obligations, which do not contain provisions permitting redemption at the option of the issuer, the principal of and interest on which when due, and without reinvestment, will provide moneys which, together with the moneys, if any, deposited with or held by the 1999 Trustee available therefor, will be sufficient, to pay when due the principal of and premium, if any, and interest due and to become due on such 1999 Bond on or prior to the redemption date thereof, and (c) in the event such 1999 Bond does not mature and is not to be redeemed within the next succeeding 60 days, the Agency has given the 1999 Trustee irrevocable instructions to give, as soon as practicable, a notice to the holder of such 1999 Bond stating that the deposit of moneys or Government Obligations described above has been made with the 1999 Trustee and that such 1999 Bond is deemed to have been paid in accordance with the 1999 Indenture and stating the maturity or redemption date upon which moneys are to be available for the payment of the principal of and premium, if any, and interest on such 1999 Bond.

## **Supplemental Indentures**

The Agency and the 1999 Trustee, without the consent of the holders of the 1999 Bonds, may enter into supplemental indentures to (i) cure any ambiguity, correct or supplement any provision in the 1999 Indenture which may be inconsistent with any other provision in the 1999 Indenture, or to make any other provisions with respect to matters or questions arising under the 1999 Indenture which shall not be inconsistent with the existing provisions of the 1999 Indenture; (ii) grant or to confer upon the 1999 Trustee for the benefit of the holders of the 1999 Bonds any additional rights, remedies, powers, authority or security that may lawfully be granted to or conferred upon the holders of the 1999 Bonds or the 1999 Trustee; (iii) add to the conditions, limitations and restrictions on the issuance of 1999 Bonds under the provisions of the 1999 Indenture, other conditions, limitations and restrictions thereafter to be observed; or (iv) add to the covenants and agreements of the Agency in the 1999 Indenture other covenants and agreements thereafter to be observed by the Agency, or to surrender any right or power conferred upon the Agency in the 1999 Indenture.

All other supplemental indentures require the consent of the holders of not less than a majority in aggregate principal amount of the 1999 Bonds at the time outstanding; provided, however, that no such supplement shall permit (a) an extension of the time for payment of the principal of or interest on any 1999 Bond, or (b) a reduction in the principal amount of any 1999 Bond or the redemption premium or the rate of interest thereon, or (c) the creation of a lien upon or a pledge of funds other than the lien and pledge created by the 1999 Indenture, or (d) a preference or priority of any 1999 Bond or Bonds over any other 1999 Bond or Bonds, or (e) a reduction in the aggregate principal amount of the 1999 Bonds required for consent to such supplement or any waiver under the 1999 Indenture.

Notwithstanding the foregoing, all amendments or supplements to the 1999 Indenture which adversely affect the Insurer's interest shall not become effective until the Insurer shall have consented thereto.

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 TELEPHONE 212 839 5300  
 FACSIMILE 212 839 5599  
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 FOUNDED 1866

\_\_\_\_\_ BEIJING  
 \_\_\_\_\_ GENEVA  
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 \_\_\_\_\_ LONDON  
 \_\_\_\_\_ SHANGHAI  
 \_\_\_\_\_ SINGAPORE  
 \_\_\_\_\_ TOKYO

\_\_\_\_\_, 2005

PUERTO RICO MUNICIPAL FINANCE AGENCY  
 San Juan, Puerto Rico

Gentlemen:

We have examined Act No. 29 of the Legislature of Puerto Rico, approved June 30, 1972, as amended (the “Act”), creating Puerto Rico Municipal Finance Agency (the “Agency”), a body corporate and politic constituting a public corporation and governmental instrumentality of the Commonwealth of Puerto Rico (the “Commonwealth”).

We have also examined certified copies of the proceedings of the Board of Directors of the Agency authorizing the execution and delivery of a Trust Indenture, dated as of December 1, 2005 (the “Trust Indenture”), by and between the Agency and JPMorgan Chase Bank, N.A., trustee (the “Trustee”), and other proofs submitted relative to the authorization, issuance and sale of the following described bonds (the “2005 Bonds”)

**\$413,115,000**

**PUERTO RICO MUNICIPAL FINANCE AGENCY**

**2005 SERIES A BONDS**

**Dated: Date of Delivery.**

Maturing in such principal amounts and subject to redemption, all as set forth in the Trust Indenture, and bearing interest at the rates set forth in the resolution of the Agency awarding the 2005 Bonds.

The proceeds of the 2005 Bonds are to be used to acquire municipal bonds of various municipalities of the Commonwealth and to make a deposit to the Reserve Account established under the Trust Indenture in an amount (with other moneys deposited therein) equal to the Required Debt Service Reserve (as defined in the Trust Indenture).

Pursuant to the Trust Indenture, the Agency is authorized to issue additional series of bonds from time to time upon the terms and conditions set forth therein, and any such bonds will be on a parity with the 2005 Bonds and all other bonds issued under the Trust Indenture (all such additional series of bonds together with the 2005 Bonds being herein collectively called the “Bonds”).

The principal of and the interest on the 2005 Bonds and all other bonds issued by the Agency under the Trust Indenture are payable from payments of principal of and interest on the municipal bonds held by and pledged to the Trustee and other funds of the Agency available therefor, all as provided in the Trust Indenture.

We have also examined one of the 2005 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. As authorized by the Act and by said proceedings, the Trust Indenture has been duly executed and delivered and contains reasonable and sufficient covenants and provisions in accordance with law with respect to the payments of principal of and interest on the municipal bonds acquired by the Trustee, the conservation and application of all funds, the safeguarding of moneys on hand or on deposit and the rights and remedies of the Trustee and the holders of the Bonds.
4. The 2005 Bonds have been duly authorized and issued, among other things, to provide funds for the purchase of municipal bonds and to make a deposit to the Reserve Account.
5. The 2005 Bonds are valid and binding obligations of the Agency, payable from funds of the Agency, including, but without limitation, (i) payments of principal of and interest on municipal bonds acquired and held by the Trustee, (ii) moneys in and investment income on the Reserve Account established under the Trust Indenture held by the Trustee, (iii) the proceeds of the sale of any such municipal bonds and (iv) any moneys appropriated or transferred to the Agency by the Commonwealth pursuant to the Act. The Trust Indenture provides for the creation of a special fund designated "Puerto Rico Municipal Finance Agency Series 2005 Interest and Sinking Fund" (herein called the "Sinking Fund") and for the payment into said special fund of a sufficient amount of the payments of principal of and interest on municipal bonds held by the Trustee on behalf of the Agency and moneys available in the Reserve Account in the Sinking Fund to pay the principal of and interest on all Bonds issued under the Trust Indenture as the same become due and payable, which fund is pledged to and charged with the payment of the principal of and interest on all Bonds issued under the Trust Indenture.
6. The Bonds are additionally secured by a pledge and assignment of all municipal bonds acquired and held by the Trustee pursuant to the Trust Indenture and all payments of principal and interest made in respect of any municipal bonds so held.
7. The Agency in the Trust Indenture has validly covenanted and will be legally obligated diligently to enforce and take all reasonable steps, actions and proceedings for the enforcement of the terms, covenants and conditions of all municipal bonds acquired and held by the Trustee on behalf of the Agency, including the prompt collection, and the giving of notice to the Secretary of the Treasury of the Commonwealth (the "Secretary") of any failure or default of any municipality in the payment, of the principal of and the interest on such municipal bonds.

8. The Agency is authorized and under the Trust Indenture has covenanted to cause to be made by its President and delivered to the Secretary annually, on or before December 1, his certificate as provided for by the Act, stating the sum, if any, required to restore the Reserve Account to an amount equal to the Required Debt Service Reserve. The sum or sums so certified are required to be apportioned and paid to the Agency from any available or uncommitted funds in the General Fund of the Commonwealth during the then current fiscal year of the Commonwealth. Such apportionment does not require legislative action. If there are no such available or uncommitted funds, the Secretary is required to request the amount so certified from the Director of the OMB, who shall include it in the General Budget of the Commonwealth for the next fiscal year. The Legislature of Puerto Rico is authorized but not legally required to appropriate such sum.

9. The Bonds do not constitute a debt of the Commonwealth or of any of its municipalities or other political subdivisions, other than the Agency, and neither the Commonwealth nor any of such municipalities or other political subdivisions, other than the Agency, shall be liable thereon. The good faith, credit and unlimited taxing power of each municipality are, however, pledged to the payment of its municipal bonds which secure the Bonds.

10. Under the provisions of the Acts of Congress now in force and under existing regulations, rulings and court decisions, (i) subject to compliance with the covenant referred to below and requirements of the Internal Revenue Code of 1986, as amended (the "Code"), regarding 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 2005 Bonds is not includable in gross income for federal income tax purposes, and (ii) the 2005 Bonds and the interest thereof are exempt from state, Commonwealth and local income taxation.

Interest on the 2005 Bonds is not an item of tax preference for the purpose of the federal alternative minimum tax imposed on individuals and corporations by the Code. Such interest will, however, be includable in the computation of the alternative minimum tax on corporations 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 the 2005 Bonds or (b) the inclusion in certain computations (including, without limitation, those related to the corporate alternative minimum tax) of interest that is not included in gross income. No opinion is rendered by the undersigned on the effect of any action taken or not taken after the date of this opinion without approval of the undersigned (except for such action or omission to act as otherwise provided for in the documents pertaining to the Bonds) or in reliance upon the advice of counsel other than the undersigned on the exclusion from gross income of the interest on the Bonds for federal income tax purposes.

The Agency and the issuers of the municipal bonds purchased and held by the Trustee have covenanted to comply to the extent permitted by the Constitution and laws of the Commonwealth, with the requirements of the Code, so that interest on the 2005 Bonds will remain exempt from federal income taxes to which it is not subject on the date of issuance of the 2005 Bonds. We are not aware of any provision of the Constitution or laws of the Commonwealth which would prevent the Agency and said issuers from complying with the requirements of the Code.

Respectfully submitted,

[To Be Signed, "Sidley Austin Brown & Wood LLP"]

# SIDLEY AUSTIN BROWN & WOOD LLP

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LOS ANGELES  
SAN FRANCISCO  
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\_\_\_\_\_, 2005

PUERTO RICO MUNICIPAL FINANCE AGENCY  
San Juan, Puerto Rico

Gentlemen:

We have examined Act No. 29 of the Legislature of Puerto Rico, approved June 30, 1972, as amended (the “Act”), creating Puerto Rico Municipal Finance Agency (the “Agency”), a body corporate and politic constituting a public corporation and governmental instrumentality of the Commonwealth of Puerto Rico (the “Commonwealth”). We have also examined certified copies of the proceedings of the Board of Directors of the Agency authorizing the execution and delivery of a Trust Indenture, dated as of April 1, 1997, as amended (the “Trust Indenture”), by and between the Agency and Banco Santander Puerto Rico, trustee (the “Trustee”), and other proofs submitted relative to the authorization, issuance and sale of the following described bonds (the “2005 Bonds”).

**\$59,075,000**

## PUERTO RICO MUNICIPAL FINANCE AGENCY

### 2005 SERIES B REFUNDING BONDS

**Dated: Date of Delivery.**

Maturing in such principal amounts and subject to redemption, all as set forth in the Trust Indenture, and bearing interest at the rates set forth in the resolution of the Agency awarding the 2005 Bonds.

The proceeds of the 2005 Bonds are to be used, with other available moneys, to refund a portion of the Agency's outstanding 1997 Series A Bonds (the “Refunded Bonds”) heretofore issued and now outstanding under the Trust Indenture.

Pursuant to the Trust Indenture, the Agency is authorized to issue additional series of bonds from time to time upon the terms and conditions set forth therein, and any such bonds will be on a parity with the 2005 Bonds and any remaining 1997 Bonds outstanding and all other bonds issued under the Trust Indenture (all such additional series of bonds together with the 2005 Bonds and said remaining 1997 Bonds being herein collectively called the “Bonds”).

The principal of and the interest on the 2005 Bonds and all other bonds issued by the Agency under the Trust Indenture are payable from payments of principal of and interest on the municipal bonds held by and pledged to the Trustee and other funds of the Agency available therefor, all as provided in the Trust Indenture.

We have also examined one of the 2005 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. As authorized by the Act and by said proceedings, the Trust Indenture has been duly executed and delivered and contains reasonable and sufficient covenants and provisions in accordance with law with respect to the payments of principal of and interest on the municipal bonds acquired by the Trustee, the conservation and application of all funds, the safeguarding of moneys on hand or on deposit and the rights and remedies of the Trustee and the holders of the Bonds.

4. The 2005 Bonds have been duly authorized and issued, among other things, to provide funds, with other available moneys, to refund a portion of said 1997 Series A Bonds and to make a deposit to the Reserve Account.

5. The 2005 Bonds are valid and binding obligations of the Agency, payable from funds of the Agency, including, but without limitation, (i) payments of principal of and interest on municipal bonds held by the Trustee, (ii) moneys in and investment income on the Reserve Account established under the Trust Indenture held by the Trustee, (iii) the proceeds of the sale of any such municipal bonds and (iv) any moneys appropriated or transferred to the Agency by the Commonwealth pursuant to the Act. The Trust Indenture provides for the creation of a special fund designated "Puerto Rico Municipal Finance Agency Series 1997 Interest and Sinking Fund" (herein called the "Sinking Fund") and for the payment into said special fund of a sufficient amount of the payments of principal of and interest on municipal bonds held by the Trustee on behalf of the Agency and moneys available in the Reserve Account in the Sinking Fund to pay the principal of and interest on all Bonds issued under the Trust Indenture as the same become due and payable, which fund is pledged to and charged with the payment of the principal of and interest on all Bonds issued under the Trust Indenture.

6. The Bonds are additionally secured by a pledge and assignment of all municipal bonds acquired and held by the Trustee pursuant to the Trust Indenture and all payments of principal and interest made in respect of any municipal bonds so held.

7. The Agency in the Trust Indenture has validly covenanted and will be legally obligated diligently to enforce and take all reasonable steps, actions and proceedings for the enforcement of the terms, covenants and conditions of all municipal bonds acquired and held by the Trustee on behalf of the Agency, including the prompt collection, and the giving of notice to the Secretary of the Treasury of the Commonwealth (the "Secretary") of any failure or default of any municipality in the payment, of the principal of and the interest on such municipal bonds.

8. The Agency is authorized and under the Trust Indenture has covenanted to cause to be made by its President and delivered to the Secretary annually, on or before December 1, his certificate as provided for by the Act, stating the sum, if any, required to restore the Reserve Account to an amount equal to the Required Debt Service Reserve. The sum or sums so certified are required to be apportioned and paid to the Agency from any available or uncommitted funds in the General Fund of the Commonwealth during the then current fiscal year of the Commonwealth. Such apportionment does not require legislative action. If there are no such available or uncommitted funds, the Secretary is required to request the amount so certified from the Director of the OMB, who shall include it in the General Budget of the Commonwealth for the next fiscal year. The Legislature of Puerto Rico is authorized but not legally required to appropriate such sum.

9. The Bonds do not constitute a debt of the Commonwealth or of any of its municipalities or other political subdivisions, other than the Agency, and neither the Commonwealth nor any of such municipalities or other political subdivisions, other than the Agency, shall be liable thereon. The good faith, credit and unlimited taxing power of each municipality are, however, pledged to the payment of its municipal bonds which secure the Bonds.

10. Under the provisions of the Acts of Congress now in force and under existing regulations, rulings and court decisions, (i) subject to compliance with the covenant referred to below and requirements of the Internal Revenue Code of 1986, as amended (the "Code"), regarding 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 2005 Bonds is not includable in gross income for federal income tax purposes, and (ii) the 2005 Bonds and the interest thereof are exempt from state, Commonwealth and local income taxation.

Interest on the 2005 Bonds is not an item of tax preference for the purpose of the federal alternative minimum tax imposed on individuals and corporations by the Code. Such interest will, however, be 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 the 2005 Bonds or (b) the inclusion in certain computations (including, without limitation, those related to the corporate alternative minimum tax) of interest that is not included in gross income. No opinion is rendered by the undersigned on the effect of any action taken or not taken after the date of this opinion without approval of the undersigned (except for such action or omission to act as otherwise provided for in the documents pertaining to the Bonds) or in reliance upon the advice of counsel other than the undersigned on the exclusion from gross income of the interest on the Bonds for federal income tax purposes.

The Agency and the issuers of the municipal bonds purchased and held by the Trustee have covenanted to comply to the extent permitted by the Constitution and laws of the Commonwealth, with the requirements of the Code, so that interest on the 2005 Bonds will remain exempt from federal income taxes to which it is not subject on the date of issuance of the 2005 Bonds. We are not aware of any provision of the Constitution or laws of the Commonwealth which would prevent the Agency and said issuers from complying with the requirements of the Code.

Respectfully submitted,

[To Be Signed, "Sidley Austin Brown & Wood LLP"]



# SIDLEY AUSTIN BROWN & WOOD LLP

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\_\_\_\_\_, 2005

PUERTO RICO MUNICIPAL FINANCE AGENCY  
San Juan, Puerto Rico

Gentlemen:

We have examined Act No. 29 of the Legislature of Puerto Rico, approved June 30, 1972, as amended (the “Act”), creating Puerto Rico Municipal Finance Agency (the “Agency”), a body corporate and politic constituting a public corporation and governmental instrumentality of the Commonwealth of Puerto Rico (the “Commonwealth”). We have also examined certified copies of the proceedings of the Board of Directors of the Agency authorizing the execution and delivery of a Trust Indenture, dated as of December 1, 1999, as amended (the “Trust Indenture”), by and between the Agency and U.S. Bank Trust National Association, successor trustee (the “Trustee”), and other proofs submitted relative to the authorization, issuance and sale of the following described bonds (the “2005 Bonds”).

**\$258,645,000**

## PUERTO RICO MUNICIPAL FINANCE AGENCY

### 2005 SERIES C REFUNDING BONDS

**Dated: Date of Delivery.**

Maturing in such principal amounts and subject to redemption, all as set forth in the Trust Indenture, and bearing interest at the rates set forth in the resolution of the Agency awarding the 2005 Bonds.

The proceeds of the 2005 Bonds are to be used, with other available moneys, to refund a portion of the Agency's outstanding 1999 Series A Bonds and 1999 Series B Refunding Bonds (the “Refunded Bonds”) heretofore issued and now outstanding under the Trust Indenture.

Pursuant to the Trust Indenture, the Agency is authorized to issue additional series of bonds from time to time upon the terms and conditions set forth therein, and any such bonds will be on a parity with the 2005 Bonds and any remaining 1999 Bonds outstanding and all other bonds issued under the Trust Indenture (all such additional series of bonds together with the 2005 Bonds and said remaining 1999 Bonds being herein collectively called the “Bonds”).

The principal of and the interest on the 2005 Bonds and all other bonds issued by the Agency under the Trust Indenture are payable from payments of principal of and interest on the municipal bonds held by and pledged to the Trustee and other funds of the Agency available therefor, all as provided in the Trust Indenture.

We have also examined one of the 2005 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. As authorized by the Act and by said proceedings, the Trust Indenture has been duly executed and delivered and contains reasonable and sufficient covenants and provisions in accordance with law with respect to the payments of principal of and interest on the municipal bonds acquired by the Trustee, the conservation and application of all funds, the safeguarding of moneys on hand or on deposit and the rights and remedies of the Trustee and the holders of the Bonds.

4. The 2005 Bonds have been duly authorized and issued, among other things, to provide funds, with other available moneys, to refund a portion of said 1999 Series A Bonds and 1999 Series B Refunding Bonds.

5. The 2005 Bonds are valid and binding obligations of the Agency, payable from funds of the Agency, including, but without limitation, (i) payments of principal of and interest on municipal bonds held by the Trustee, (ii) moneys in and investment income on the Reserve Account established under the Trust Indenture held by the Trustee, (iii) the proceeds of the sale of any such municipal bonds and (iv) any moneys appropriated or transferred to the Agency by the Commonwealth pursuant to the Act. The Trust Indenture provides for the creation of a special fund designated "Puerto Rico Municipal Finance Agency Series 1999 Interest and Sinking Fund" (herein called the "Sinking Fund") and for the payment into said special fund of a sufficient amount of the payments of principal of and interest on municipal bonds held by the Trustee on behalf of the Agency and moneys available in the Reserve Account in the Sinking Fund to pay the principal of and interest on all Bonds issued under the Trust Indenture as the same become due and payable, which fund is pledged to and charged with the payment of the principal of and interest on all Bonds issued under the Trust Indenture.

6. The Bonds are additionally secured by a pledge and assignment of all municipal bonds acquired and held by the Trustee pursuant to the Trust Indenture and all payments of principal and interest made in respect of any municipal bonds so held.

7. The Agency in the Trust Indenture has validly covenanted and will be legally obligated diligently to enforce and take all reasonable steps, actions and proceedings for the enforcement of the terms, covenants and conditions of all municipal bonds acquired and held by the Trustee on behalf of the Agency, including the prompt collection, and the giving of notice to the Secretary of the Treasury of the Commonwealth (the "Secretary") of any failure or default of any municipality in the payment, of the principal of and the interest on such municipal bonds.

8. The Agency is authorized and under the Trust Indenture has covenanted to cause to be made by its President and delivered to the Secretary annually, on or before December 1, his certificate as provided for by the Act, stating the sum, if any, required to restore the Reserve Account to an amount equal to the Required Debt Service Reserve. The sum or sums so certified are required to be apportioned and paid to the Agency from any available or uncommitted funds in the General Fund of the Commonwealth during the then current fiscal year of the Commonwealth. Such apportionment does not require legislative action. If there are no such available or uncommitted funds, the Secretary is required to request the amount so certified from the Director of the OMB, who shall include it in the General Budget of the Commonwealth for the next fiscal year. The Legislature of Puerto Rico is authorized but not legally required to appropriate such sum.

9. The Bonds do not constitute a debt of the Commonwealth or of any of its municipalities or other political subdivisions, other than the Agency, and neither the Commonwealth nor any of such municipalities or other political subdivisions, other than the Agency, shall be liable thereon. The good faith, credit and unlimited taxing power of each municipality are, however, pledged to the payment of its municipal bonds which secure the Bonds.

10. Under the provisions of the Acts of Congress now in force and under existing regulations, rulings and court decisions, (i) subject to compliance with the covenant referred to below and requirements of the Internal Revenue Code of 1986, as amended (the "Code"), regarding 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 2005 Bonds is not includable in gross income for federal income tax purposes, and (ii) the 2005 Bonds and the interest thereof are exempt from state, Commonwealth and local income taxation.

Interest on the 2005 Bonds is not an item of tax preference for the purpose of the federal alternative minimum tax imposed on individuals and corporations by the Code. Such interest will, however, be 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 the 2005 Bonds or (b) the inclusion in certain computations (including, without limitation, those related to the corporate alternative minimum tax) of interest that is not included in gross income. No opinion is rendered by the undersigned on the effect of any action taken or not taken after the date of this opinion without approval of the undersigned (except for such action or omission to act as otherwise provided for in the documents pertaining to the Bonds) or in reliance upon the advice of counsel other than the undersigned on the exclusion from gross income of the interest on the Bonds for federal income tax purposes.

The Agency and the issuers of the municipal bonds purchased and held by the Trustee have covenanted to comply to the extent permitted by the Constitution and laws of the Commonwealth, with the requirements of the Code, so that interest on the 2005 Bonds will remain exempt from federal income taxes to which it is not subject on the date of issuance of the 2005 Bonds. We are not aware of any provision of the Constitution or laws of the Commonwealth which would prevent the Agency and said issuers 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:

Policy No.: -N

BONDS:

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.  
31 West 52<sup>nd</sup> Street, New York, N.Y. 10019

(212) 826-0100

Form 500NY (5/90)



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

## FINANCIAL GUARANTY INSURANCE POLICY

ISSUER: Policy No.: CIFG NA-#

CUSIP: Effective Date:

OBLIGATIONS:

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

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

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

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

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

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

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

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

CDC IXIS FINANCIAL GUARANTY NORTH AMERICA, INC.

By \_\_\_\_\_  
 Authorized Officer