

\$499,910,000
Puerto Rico Electric Power Authority
\$401,785,000 Power Revenue Refunding Bonds, Series KK
\$98,125,000 Power Revenue Bonds, Series LL

The Power Revenue Refunding Bonds, Series KK and the Power Revenue Bonds, Series LL (collectively, the “Bonds”) are being issued pursuant to a Trust Agreement, dated as of January 1, 1974, as amended, with State Street Bank and Trust Company, N.A., New York, New York, successor trustee (the “1974 Agreement”).

The Bonds, the outstanding bonds of the Puerto Rico Electric Power Authority (the “Authority”) previously issued under the 1974 Agreement and any additional bonds that the Authority may from time to time issue under the 1974 Agreement are payable solely from the net revenues of the Authority’s electric system.

The Bonds will have the following characteristics:

- The Bonds will be dated their date of delivery.
- 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 not subject to redemption.
- Interest on the Bonds will be payable on January 1, 2003 and on each July 1 and January 1 thereafter.
- The inside cover page contains information concerning the maturity schedule, interest rates and yields of the Bonds.
- The scheduled payment of principal and of interest when due on a portion of the Bonds will be guaranteed under insurance policies to be issued concurrently with the delivery of Bonds by Financial Security Assurance Inc., MBIA Insurance Corporation and XL Capital Assurance Inc. as set forth on the inside cover page.
- The issuance of the Bonds and the purchase of the Bonds by the Underwriters are subject to the approval of legality by Sidley Austin Brown & Wood LLP, New York, New York, Bond Counsel, and certain other conditions.
- 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 interest thereon will be exempt from state, Commonwealth and local income taxation. However, see *Tax Exemption*, beginning on page 52 of this Official Statement, for alternative minimum tax consequences with respect to interest on the Bonds, a description of certain rules that the Authority must comply with to preserve the federal tax exemption of interest, and other tax considerations.
- Fiddler González & Rodríguez, LLP, San Juan, Puerto Rico will pass upon certain legal matters for the Underwriters.
- It is expected that settlement for the Bonds will occur on or about July 2, 2002.

The Bonds are not a debt or obligation of the Commonwealth or any of its municipalities or other political subdivisions, other than the Authority, and neither the Commonwealth nor any such municipalities or other subdivisions, other than the Authority, shall be liable for the payment of the principal of or interest on the Bonds.

Goldman, Sachs & Co.

Banc of America Securities LLC

UBS PaineWebber Inc.

ABN Amro Financial Services, Inc.

Bear, Stearns & Co. Inc.

Lehman Brothers

Wachovia Bank, National Association

Merrill Lynch & Co.

Morgan Stanley

Salomon Smith Barney

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\$401,785,000 Power Revenue Refunding Bonds, Series KK

Maturity (July 1)	Principal Amount	Interest Rate	Yield
2005	\$ 7,765,000	4.00%	2.88%
2008	9,050,000	5.00	3.75
2009‡	7,420,000	4.50	3.70
2010	19,000,000	5.00	4.15
2011	17,500,000	5.00	4.26
2011‡	26,200,000	4.00	4.06
2011‡	40,000,000	5.00	4.06
2012†	17,500,000	4.00	4.09
2012†	70,560,000	5.25	4.09
2013†	2,000,000	4.50	4.21
2013†	6,955,000	5.25	4.21
2014†	8,140,000	5.50	4.31
2015†	80,920,000	5.50	4.39
2015±	24,120,000	5.50	4.39
2016±	64,655,000	5.50	4.45

\$98,125,000 Power Revenue Bonds, Series LL

Maturity (July 1)	Principal Amount	Interest Rate	Yield
2016±	\$ 20,220,000	5.50%	4.45%
2017±	71,550,000	5.50	4.50
2018±	3,665,000	5.50	4.58
2019±	2,690,000	5.50	4.66

† Insured by Financial Security Assurance Inc.

± Insured by MBIA Insurance Corporation.

‡ Insured by XL Capital Assurance Inc.

No dealer, broker, sales representative or other person has been authorized by the Authority or the Underwriters to give any information or to make any representations, other than those contained herein, and, if given or made, such other information or representations must not be relied upon as having been authorized by the Authority or any Underwriters. This Official Statement does not constitute an offer to sell, or the solicitation of an offer to buy, nor shall there be any sale of the 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 obtained from the Authority, the Commonwealth, and other official sources that are believed to be reliable, but it is not guaranteed as to accuracy or completeness and is not to be construed as a representation by any Underwriter. The information and expressions of opinion herein are subject to change without notice, and neither the delivery of this Official Statement nor any sale made hereunder shall, under any circumstances, create any implication that there has been no change in the affairs of the Authority or the Commonwealth since the date hereof.

The Underwriters have provided the following sentence, as well as the following 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 THIS OFFERING, THE UNDERWRITERS MAY OVERALLOT OR EFFECT TRANSACTIONS WHICH STABILIZE OR MAINTAIN THE MARKET PRICES OF THE BONDS OFFERED HEREBY AND OF OUTSTANDING POWER REVENUE BONDS AT LEVELS ABOVE THOSE WHICH MIGHT OTHERWISE PREVAIL IN THE OPEN MARKET. SUCH STABILIZING, IF COMMENCED, MAY BE DISCONTINUED AT ANY TIME.

Other than with respect to information concerning Financial Security Assurance Inc. (“FSA”), MBIA Insurance Corporation (“MBIA”) and XL Capital Assurance Inc. (“XLCA”) contained under the caption *Bond Insurance* and in Appendices V, VI and VII herein, none of the information in this Official Statement has been supplied or verified by FSA, MBIA and XLCA, respectively, and FSA, MBIA and XLCA make no representation or warranty, express or implied, as to (i) the accuracy or completeness of such information; (ii) the validity of the Bonds; or (iii) the tax exempt status of the interest on the Bonds.

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INTRODUCTORY STATEMENT

The purpose of this Official Statement of Puerto Rico Electric Power Authority (the “Authority”), which includes the cover page, the Appendices hereto and the information incorporated by reference as set forth below, is to furnish information in connection with the issuance and sale by the Authority of its \$401,785,000 Power Revenue Refunding Bonds, Series KK (the “Series KK Bonds”), and \$98,125,000 Power Revenue Bonds, Series LL (the “Series LL Bonds”); the Series KK Bonds and the Series LL Bonds are herein collectively called the “Bonds”).

The Bonds will be issued under and secured by a Trust Agreement, dated as of January 1, 1974, as amended (the “1974 Agreement”), between the Authority and State Street Bank and Trust Company, N.A., successor trustee (the “1974 Trustee”). The Bonds, the \$4,329,764,000 Puerto Rico Electric Power Authority Power Revenue Bonds to be outstanding after the issuance of the Series KK Bonds and the refunding of the Power Revenue Bonds refunded thereby (see *Plan of Financing*) (including \$58,226,000 of bonds held by the United States Rural Utilities Service, see “Rural Electrification Bonds” under *Debt*) and such additional bonds as may be issued under the 1974 Agreement are herein collectively called the “Power Revenue Bonds.”

The scheduled payment of principal of and interest on the Series KK Bonds maturing on July 1, 2012, 2013, 2014, and the \$80,920,000 principal amount of the Series KK Bonds bearing interest at the rate of 5.50% per annum and maturing on July 1, 2015 will be insured by a municipal bond insurance policy (the “FSA Bond Insurance Policy”) to be issued by Financial Security Assurance Inc. (the “FSA Insured Bonds”) concurrently with the delivery of the Bonds. The scheduled payment of principal of and interest on the Series KK Bonds maturing on 2016, the \$24,120,000 principal amount of the Series KK Bonds bearing interest at the rate of 5.50% and maturing on July 1, 2015, and all of the Series LL Bonds will be insured by separate municipal insurance policies (collectively, the “MBIA Bond Insurance Policy”) to be issued by MBIA Insurance Corporation (the “MBIA Insured Bonds”) concurrently with the delivery of the Bonds. The scheduled payment of principal of and interest on Series KK Bonds maturing on July 1, 2009, the \$26,200,000 principal amount of Series KK Bonds bearing interest at the rate of 5% per annum and maturing on July 1, 2011 and the \$40,000,000 principal amount of Series KK Bonds bearing interest at the rate of 5% per annum and maturing on July 1, 2011 will be insured by a municipal insurance policy (the “XLCA Bond Insurance Policy”) to be issued by XL Capital Assurance Inc. (the “XLCA Insured Bonds”) concurrently with the delivery of the Bonds. The FSA Insured Bonds, the MBIA Insured Bonds and the XLCA Insured Bonds are herein collectively called the “Insured Bonds.”

Terms used in this Official Statement and not defined shall have the meanings given to them in Appendix I, *Definitions of Certain Terms*.

This Official Statement also includes 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, 2001 prepared by the Department of the Treasury (the “Commonwealth's Annual Financial Report”), which includes the general purpose financial statements of the Commonwealth for the fiscal year ended June 30, 2001, together with the independent auditor's report thereon, dated January 21, 2002, of KPMG, LLP, San Juan, Puerto Rico, certified public accountants; and

(2) the Commonwealth of Puerto Rico Financial Information and Operating Data Report, dated May 10, 2002.

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's 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 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.

OVERVIEW

The Authority, which supplies virtually all of the electric power consumed in the Commonwealth, is one of the largest municipal utilities in the United States. The Authority was created in 1941 as a public corporation and governmental instrumentality of the Commonwealth. As of March 31, 2002, it served 1,381,701 clients and had utility plant totaling approximately \$7.2 billion. Also as of that date, production plant in service totaled approximately \$2.2 billion, based on original cost, with a dependable generating capacity of 4,905 megawatts ("MW") (including the cogeneration facility in commercial operation described below). In October 2001, the Authority realized a historical peak load of 3,297 MW.

In order to meet expected growth in demand, diversify its fuel sources to reduce the historic reliance on oil-fired generating units, and continue to improve the reliability of its service, the Authority is in the process of increasing its generating capacity from Authority-owned facilities and has also entered into long-term power purchase agreements with privately owned cogeneration facilities.

The Authority has entered into a long-term contract for the purchase of 507 MW of dependable generating capacity from a natural gas-fired cogeneration plant located in Peñuelas, Puerto Rico, and owned by EcoEléctrica, L.P., organized as a joint venture between subsidiaries of Edison International and Enron Corp. ("EcoEléctrica"). Under this agreement, EcoEléctrica operates the facility and assumes all operational risks related thereto. On March 21, 2000, EcoEléctrica started commercial operation. See "Generating Facilities" under *The System*.

On December 3, 2001, Enron Corp. filed for bankruptcy under Chapter 11 of the U.S. Bankruptcy Code in the United States Bankruptcy Court for the Southern District of New York. EcoEléctrica is a separate entity and is not currently subject to any bankruptcy proceedings. The Authority believes that Enron's bankruptcy proceedings should not materially affect EcoEléctrica's operations, generation capacity and fuel supply. EcoEléctrica's liquefied natural gas requirements are being supplied pursuant to an agreement expiring in 2019 with an entity unrelated to Enron Corp.

The Authority has also executed an agreement with AES Puerto Rico, L.P. ("AES-PR"), an affiliate of The AES Corporation ("AES"), to purchase 454 MW of dependable generating capacity from a coal-fired cogeneration facility currently under construction in Guayama, Puerto Rico. Construction of the AES-PR facility commenced in November 1999. Commercial operation of the AES-PR facility is currently projected for the third quarter of 2002. See "Adequacy of Capacity" under *The System*.

The Authority continues with the licensing process in order to replace two 44 MW steam units in San Juan, Puerto Rico, with new generating units that are projected to provide a total of 464 MW of combined cycle

capacity. The Authority is currently seeking an extension to its Prevention of Significant Deterioration (“PSD”) permit which expired on May 31, 2002 from the Environmental Protection Agency (“EPA”). If the extension is not granted or if its approval is delayed, the scheduled completion of the project may be delayed. This project is expected to be operational during fiscal year 2005. See “Adequacy of Capacity” under *The System*.

The Authority also continues to improve its transmission and distribution system and is in the process of acquiring and installing sophisticated integrated automated systems to enhance the Authority’s operations and improve service to its clients. The Authority is constructing new 230 kV transmission lines to complete the transmission loop on the eastern part of the island. The eastern loop will connect major switching and load centers and boost electric system capacity in Puerto Rico’s eastern region. This project is expected to be operational in fiscal year 2003.

For the twelve months ended April 30, 2002, the average percentage of the Authority’s generating capacity available for service (“equivalent availability”) (calculated by including operations at the EcoEléctrica facility) was 80%, up from 60% for fiscal year 1992. Improved System availability, together with the Authority’s progress in implementing its capacity expansion plan and improving its transmission and distribution system, have led to improvements in the reliability of the Authority’s electrical service to its clients.

See “System Improvements and Additional Capacity,” “Adequacy of Capacity” and “Transmission and Distribution Facilities” under *The System*.

Operating Results

During the period from fiscal year 1997 through fiscal year 2001, the number of clients served by the Authority increased at a compound annual rate of 1.4%, and electric energy sales in kilowatt hours (“kWh”) increased at a compound annual rate of 3.8%. During this period, Revenues and Current Expenses increased at a compound annual rate of 9.2% and 9.5%, respectively. Excluding the cost of fuel oil and purchased power, Revenues and Current Expenses increased at a compound annual rate of 2.3% and 2.2%, respectively, during such period, primarily due to higher energy demand. In addition, during this period, fuel oil costs increased at a compound annual rate of 9.8%. Fuel and purchased power charges are passed on to clients through a separate charge included in electric service rates.

During the first nine months of fiscal year 2002, energy sales in kWh increased 1.6% and Revenues and Current Expenses decreased by 8.6% and 10.7%, respectively, compared to the same period for the prior fiscal year. The decrease in Revenues and Current Expense was mainly due to a decrease of \$7.77 per barrel (or 25.7%) in the price of fuel oil, the cost of which is for the most part passed on to the Authority’s clients. Excluding the cost of fuel oil and purchased power, Revenues and Current Expenses increased by 3.1% and 3.7%, respectively, compared to the same period for the prior fiscal year.

Net Revenues increased at a compound annual rate of 8.4% during the period from fiscal year 1997 to fiscal year 2001. For the first nine months of fiscal year 2002, Net Revenues decreased by 2.9% compared to the same period in fiscal year 2001. See “Management’s Discussion and Analysis of Operating Results” under *Net Revenues and Coverage*.

Demand for energy is related to the level of economic and business activity in the Commonwealth, energy costs and climatological factors. According to the Commonwealth Planning Board statistics, real gross product increased by 1.7% in fiscal year 2001, 2.9% in fiscal year 2000, 4.2% in fiscal year 1999 and 3.2% in fiscal year 1998. The most recent real gross product forecast for fiscal year 2002, made in March 2002 and developed by Econométrica Inc., projects an increase in real gross product of 0.5% over fiscal year 2001. Projections of future peak energy demand for the five fiscal year period ending June 30, 2007 prepared by the Authority show an average annual increase of 3.5%.

The following table summarizes the operating results of the Authority for the five fiscal years ended June 30, 2001 and for the nine-month period ended March 31, 2001 and 2002. This table presents Net Revenues (exclusive of certain investment income) of the Authority under the provisions of the 1974 Agreement. These calculations of Net Revenues differ in several important respects from the Authority's calculations of net income prepared in accordance with generally accepted accounting principles. See Schedule II to the Financial Statements for the fiscal years ended June 30, 2000 and 2001 in Appendix II for a reconciliation of the Authority's net income under generally accepted accounting principles with its Net Revenues under the 1974 Agreement.

	Operating Results (dollars in thousands)					Nine Months Ended	
	Fiscal Years Ended June 30,					March 31,	
	1997	1998	1999	2000	2001	2001	2002
Electric energy sales (in millions of kWh)	16,118	17,457	16,989	18,145	18,723	14,043	14,264
Percentage change from year before.....	1.1	8.3	(2.7)	6.8	3.2	3.6	1.6
Peak load (in MW).....	2,894	3,021	3,057	3,133	3,202	3,202	3,297
Percentage change from year before.....	5.6	4.4	1.2	2.4	2.2	2.2	3.0
Total Revenues.....	\$ 1,670,449	\$ 1,733,675	\$ 1,563,953	\$ 2,025,284	\$ 2,373,077	\$ 1,782,820	\$ 1,630,246
Less: Current Expenses	<u>1,198,901</u>	<u>1,186,157</u>	<u>1,052,761</u>	<u>1,466,823</u>	<u>1,722,689</u>	<u>1,303,303</u>	<u>1,164,409</u>
Net Revenues	<u>\$ 471,548</u>	<u>\$ 547,518</u>	<u>\$ 511,192</u>	<u>\$ 558,461</u>	<u>\$ 650,388</u>	<u>\$ 479,517</u>	<u>\$ 465,837</u>
Principal and Interest Requirements	<u>\$ 291,239</u>	<u>\$ 316,138</u>	<u>\$ 348,963</u>	<u>\$ 346,417</u>	<u>\$ 367,796</u>	--	--
Ratio of Net Revenues to Principal and Interest Requirements	1.62	1.73	1.46	1.61	1.77	--	--

System Improvements and Additional Capacity

To meet the expected growth in demand and enhance reliability of electric service to its clients, the Authority has improved its generating system and increased capacity through expansions and improvements of Authority-owned resources and acquisition of additional capacity pursuant to long-term contracts with operators of two cogeneration facilities.

A substantial portion of the capital expenditures for production plant for the five fiscal years ended June 30, 2001 was spent on the rehabilitation and life extension of generating plants in order to achieve and maintain higher levels of availability, reliability and efficiency. System equivalent availability has increased from 60% in fiscal year 1992 to 80% for fiscal year 2001. For the twelve-month period ended April 30, 2002, the System's equivalent availability remained equal to fiscal year 2001 at 80%.

The Authority has entered into agreements with two cogenerators, EcoEléctrica and AES-PR. Under these agreements, EcoEléctrica and AES-PR have agreed to design, finance, construct, own and operate two cogeneration facilities. These facilities will allow the Authority to reduce its dependency on fuel oil while passing on to the cogenerators the risks of development, construction and operation of such facilities, including the commitment to provide a fixed capacity and higher availability levels than the Authority currently achieves, for the term of the power purchase agreements.

Under the agreement with EcoEléctrica, the Authority is currently purchasing 507 MW of dependable generating capacity from a combined cycle power facility fueled primarily by natural gas, which facility began

commercial operation on March 21, 2000. The EcoEléctrica project includes a terminal to receive and store liquefied natural gas (“LNG”). EcoEléctrica has entered into a twenty-year supply agreement to meet its expected need for LNG. The delivery of LNG commenced on July 11, 2000. See “Generating Facilities” under *The System*. See also *Overview* for a brief discussion of the effect that Enron’s bankruptcy filing has on the project’s operations.

Under the agreement with AES-PR, the Authority expects to purchase 454 MW of dependable generating capacity from a coal-fired cogeneration facility using two identical fluidized bed boilers and two steam turbines. Construction of the facility commenced in November 1999, and it is projected to be in service during the third quarter of 2002. See “Adequacy of Capacity—Additional Generating Facilities” under *The System*.

The Authority continues the licensing process in order to replace two 44 MW steam-generating units of the San Juan Steam Plant (Units 5 and 6), removed from service in fiscal year 1997. The Authority’s PSD permit in connection with this project expired on May 31, 2002. The Authority is negotiating with EPA to extend the expiration of this permit. If the extension is not granted or if its approval is delayed, the scheduled completion of the project may be delayed. The new combined cycle generating units, which will provide 464 MW of dependable generating capacity, are currently projected to be in service in the summer of 2005. See *Litigation* for a discussion of a lawsuit brought by the principal contractor for this project.

The Authority also continues to improve and expand its transmission and distribution system. The Authority is expanding its 230 kilovolt (“kV”) transmission lines, which add to the stability of the electric system, improve reliability of service to clients, and reduce transmission losses. See “Transmission and Distribution Facilities” under *The System*.

Set forth below is a summary of the Authority’s historical total capital improvement program and financing sources for the five fiscal years ended June 30, 2001 and the projected capital improvement program and financing sources for the five fiscal years ending June 30, 2006. See “Historical Capital Improvement and Financing Program” and “Projected Five-Year Capital Improvement and Financing Programs” under *The System*.

**Capital Improvements
(dollars in thousands)**

Capital Improvements	Fiscal Years			
	1997-2001 Total	% of Total	2002-2006 Total	% of Total
Production Plant	\$ 800,966	40.7%	\$ 637,388	30.8%
Transmission facilities	298,401	15.2	500,697	24.2
Distribution facilities	529,416	26.9	511,097	24.7
Other.....	339,228	17.2	419,896	20.3
	<u>\$ 1,968,011</u>	<u>100.0%</u>	<u>\$2,069,078</u>	<u>100.0%</u>
Financing Sources				
Internally generated funds.....	\$ 414,033	21.0%	\$ 482,741	23.3%
Borrowed funds	1,553,978	79.0	1,586,337	76.7
	<u>\$ 1,968,011</u>	<u>100.0%</u>	<u>\$2,069,078</u>	<u>100.0%</u>

PLAN OF FINANCING

Power Revenue Refunding Bonds, Series KK

The Authority is issuing the Series KK Bonds pursuant to Section 210 of the 1974 Agreement to refund the following Power Revenue and Power Revenue Refunding Bonds (collectively, the “Refunded Power Revenue Bonds”) on the redemption dates and at the redemption prices set forth below plus accrued interest to the dates fixed for redemption:

<u>Refunded Power Revenue Bonds</u>	<u>Maturity Date</u>	<u>Principal Amount to be Refunded</u>	<u>Interest Rate</u>	<u>Redemption Date</u>	<u>Redemption Price</u>
REA Issue, Series A	7/01/2010	\$ 3,842,000	5.00%	8/02/2002	100%
REA Issue, Series B	7/01/2011	13,120,000	5.00	8/02/2002	100
REA Issue, Series C	7/01/2013	10,582,000	5.00	8/02/2002	100
REA Issue, Series D	1/01/2016	14,910,000	5.00	8/02/2002	100
REA Issue, Series E	1/01/2018	10,523,000	5.00	8/02/2002	100
REA Issue, Series F	7/01/2018	7,525,000	5.00	8/02/2002	100
REA Issue, Series G	7/01/2019	32,101,000	5.00	8/02/2002	100
Series HH	7/01/2003	10,435,000	4.25	N/A	N/A
Series N	7/01/2003	3,999,996 ⁽¹⁾	6.65	N/A	N/A
	7/01/2012	74,205,000	5.00	8/02/2002	100

(1) Capital Appreciation Bond; \$13,488,875.40 initial principal amount currently outstanding. The Authority will pay \$9,900,000 accreted value at maturity on July 1, 2003.

<u>Refunded Power Revenue Bonds</u>	<u>Maturity Date</u>	<u>Principal Amount to be Refunded</u>	<u>Interest Rate</u>	<u>Redemption Date</u>	<u>Redemption Price</u>
Series O	7/01/2012	79,580,000	5.00	8/02/2002	100
Series P	7/01/2003	\$ 4,465,000	6.75%	8/02/2002	101%
	7/01/2004	4,765,000	6.75	8/02/2002	101
Series R	7/01/2003	5,285,000	6.10	8/02/2002	101½
Series T	7/01/2007	9,625,000	6.125	7/01/2004	102
	7/01/2008	10,210,000	6.125	7/01/2004	102
	7/01/2016	96,535,000	6.00	7/01/2004	102
Series X	7/01/2009	8,840,000	5.80	7/01/2005	102
	7/01/2010	9,350,000	5.90	7/01/2005	102

The refunding will permit the Authority to realize savings on its debt service requirements on bonds outstanding under the 1974 Agreement. The Authority will deposit the net proceeds of the Series KK Bonds with the 1974 Trustee, as escrow agent, under the terms of an Escrow Deposit Agreement. The net proceeds will be invested in Government Obligations, the principal of and interest on which when due, will provide moneys sufficient to pay the principal of the redemption price of the Refunded Power Revenue Bonds and the interest coming due on the Refunded Power Revenue Bonds through their respective dates of maturity or redemption.

Upon the deposit with the 1974 Trustee referred to above, the Refunded Power Revenue Bonds will, in the opinion of Bond Counsel, no longer be outstanding under the provisions of the 1974 Agreement and the Refunded Power Revenue Bonds will thereupon be defeased.

Power Revenue Bonds, Series LL

The Authority is issuing the Series LL Bonds pursuant to Section 208 of the 1974 Agreement to finance a portion of the cost of various projects under its capital improvement program.

Estimated Sources and Uses of Funds

Sources:

Principal amount of the Series KK Bonds	\$ 401,785,000.00
Principal amount of the Series LL Bonds	98,125,000.00
Net original issue premium.....	43,119,586.45
Total Sources	<u>\$ 543,029,586.45</u>

Uses:

Deposit to Escrow Fund for Refunded Power Revenue Bonds	\$ 425,881,025.00
Deposit to 1974 Construction Fund.....	106,000,000.00
Underwriting discount, municipal bond insurance premiums and estimated legal, printing and other financing expenses	11,148,561.45
Total Uses	<u>\$ 543,029,586.45</u>

SECURITY

The Bonds are not a debt or obligation of the Commonwealth or any of its municipalities or other political subdivisions, other than the Authority, and neither the Commonwealth nor any such municipalities or other political subdivisions, other than the Authority, are liable thereon, nor shall the Bonds be payable out of any funds other than those of the Authority as further described herein.

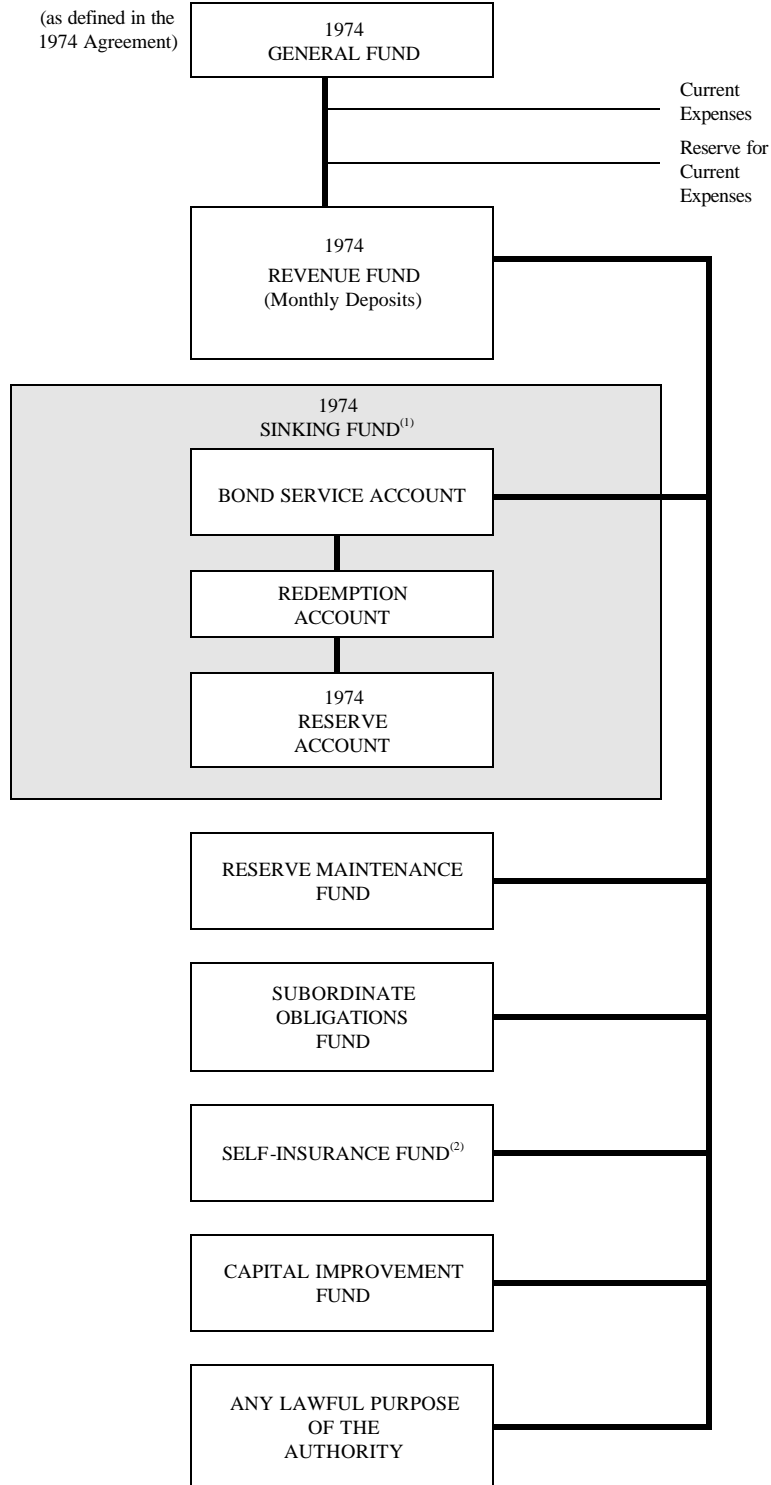
Source of Payment

The Power Revenue Bonds will be payable solely from the Revenues (as defined under the 1974 Agreement) of the System after payment of the Current Expenses (as defined under the 1974 Agreement) of the Authority and any reserve therefor, and the Authority has covenanted to deposit in the 1974 Sinking Fund a sufficient amount of such Revenues after such payment to pay the principal of and the interest on all of the Power Revenue Bonds and to provide a reserve therefor. See Appendix I, *Summary of Certain Provisions of the 1974 Agreement Excluding Proposed Supplemental Agreement*, which should be read in conjunction herewith.

Flow of Funds Under 1974 Agreement

The following schematic representation is provided only to guide readers and does not purport to be complete. Reference is hereby made to Appendix I, *Summary of Certain Provisions of the 1974 Agreement Excluding Proposed Supplemental Agreement*, which should be read in conjunction herewith.

REVENUES



(1) Monthly deposits to the Bond Service Account and the Redemption Account for all Power Revenue Bonds are capped at 1/6 of the interest due on the next interest payment date and 1/12 of the principal due on the next principal payment date and 1/12 of Amortization Requirements for the current fiscal year.

(2) Subject to replenishment at the option of the Authority.

Rate Covenant

The Authority has covenanted in the 1974 Agreement to fix, charge and collect rates so that Revenues of the System will be sufficient to pay Current Expenses and to provide 120% of the aggregate Principal and Interest Requirements for the next fiscal year on account of all outstanding Power Revenue Bonds, reduced by any capitalized interest thereon for such fiscal year. For purposes of calculating Principal and Interest Requirements under the rate covenant and the additional bonds tests set forth below, the Accreted Value of any capital appreciation bonds of the Authority on their maturity dates shall be included as principal due and payable on said maturity dates. The Accreted Value at any date of a capital appreciation bond currently outstanding equals the original principal amount of such capital appreciation bond plus the interest accrued from its date of issuance to such date, based upon the interest rate used to calculate the yields thereof, compounded in the manner provided in the 1974 Agreement, and for future issues of capital appreciation bonds will be determined as provided in the respective resolutions of the Authority authorizing such issues. See "Rate Covenant" in Appendix I, *Summary of Certain Provisions of the 1974 Agreement Excluding Proposed Supplemental Agreement*.

Reserve Account

The Authority has covenanted in the 1974 Agreement to accumulate in the 1974 Reserve Account an amount equal to the interest payable on all outstanding Power Revenue Bonds within the next 12 months, provided that for Power Revenue Bonds issued for other than refunding purposes, the amount to be so deposited in any month, as set forth in "Disposition of Revenues" in Appendix I, *Summary of Certain Provisions of the 1974 Agreement Excluding Proposed Supplemental Agreement*, need not exceed one-sixtieth of the amount of the increase in the interest payable within the next 12 months resulting from the issuance of such Power Revenue Bonds. In connection with the capital appreciation bonds of the Authority, the amount required to be on deposit in the 1974 Reserve Account with respect to the interest accrued thereon is to be derived from the interest rate used to calculate the yields for such bonds times the Accreted Value of such Power Revenue Bonds determined in the manner provided in the 1974 Agreement on the valuation date therefore occurring on or after the first day of the twelfth month succeeding the date of calculation.

The amount required to be accumulated in the 1974 Reserve Account will be approximately \$249.9 million, after the refunding of the Refunded Power Revenue Bonds. As of March 31, 2002, approximately \$255.8 million was on deposit to the credit of the 1974 Reserve Account, which amount is in excess of the amount required to be on deposit therein. The Authority will transfer the excess amount to the 1974 Bond Service Account.

Reserve Maintenance Fund, Self-insurance Fund and Capital Improvement Fund

The 1974 Agreement establishes the Reserve Maintenance Fund, the Self-insurance Fund and the Capital Improvement Fund. Revenues are deposited monthly into each of such Funds after the required deposits into the 1974 Sinking Fund as set forth in the schematic representation above for purposes of (a) paying the cost of unusual or extraordinary maintenance or repairs, maintenance or repairs not recurring annually and renewals and replacements, in the case of the Reserve Maintenance Fund, (b) paying the cost of repairing, replacing or reconstructing any property damaged or destroyed from, or extraordinary expenses incurred as a result of, a cause which is not covered by insurance required by the 1974 Agreement, in the case of the Self-insurance Fund, and (c) paying the cost of anticipated extensions and improvements which cost has not otherwise been provided for from the proceeds of the Power Revenue Bonds, in the case of the Capital Improvement Fund. Each of these Funds serves as an additional reserve for the payment of principal of and interest on Power Revenue Bonds and meeting the Amortization Requirements to the extent that moneys in the 1974 Sinking Fund (including the 1974 Reserve Account) are insufficient for such purpose. See "Disposition of Revenues" in Appendix I, *Summary of Certain Provisions of the 1974 Agreement Excluding Proposed Supplemental Agreement*.

Additional Bonds

Additional Power Revenue Bonds may be issued under the 1974 Agreement for the purpose of paying all or any part of the cost of any improvements to the System or for any other proper corporate purpose of the Authority; provided that, among other requirements, Net Revenues (as defined in the 1974 Agreement) of the Authority for 12 consecutive months out of the preceding 18 months, adjusted to reflect rates in effect on the date of issuance of such bonds, shall be not less than 120% of maximum aggregate annual Principal and Interest Requirements for all Power Revenue Bonds then outstanding, and that the average annual Net Revenues for the five fiscal years succeeding the issuance of such bonds, adjusted to reflect any rate schedule the Authority has covenanted to put in effect during such five fiscal years, as estimated by the Authority and approved by its Consulting Engineers, shall be not less than 120% of the maximum aggregate annual Principal and Interest Requirements for all Power Revenue Bonds then outstanding and the Power Revenue Bonds then to be issued.

Power Revenue Refunding Bonds may also be issued under the 1974 Agreement for the purpose of refunding all or any part of the outstanding Power Revenue Bonds of any series, subject to certain conditions as described herein in “Issuance of Power Revenue Bonds—Sections 208, 209 and 210 of the 1974 Agreement” under Appendix I, *Summary of Certain Provisions of the 1974 Agreement Excluding Proposed Supplemental Agreement*.

Under the earnings coverage tests of the 1974 Agreement, Net Revenues for the twelve months ended March 31, 2002 of \$636.7 million were 153% of the maximum aggregate annual Principal and Interest Requirements of \$415.6 million on all outstanding Power Revenue Bonds. Average annual Net Revenues for the five fiscal years ending June 30, 2008 of \$778.6 million are estimated to be 187% of the maximum aggregate annual Principal and Interest Requirements of \$415.9 million on all outstanding Power Revenue Bonds (including the Bonds, but excluding the Refunded Power Revenue Bonds and certain other Power Revenue Bonds being defeased with other available moneys of the Authority; see *Debt* below).

Subordinate Obligations

The Authority may incur or issue obligations for any proper corporate purpose secured by a pledge of moneys in the Subordinate Obligations Fund. If the Authority incurs any such obligations, Net Revenues of the Authority must be deposited monthly to the credit of the Subordinate Obligations Fund (after the required deposits have been made to the 1974 Sinking Fund and the Reserve Maintenance Fund) in amounts sufficient to pay such obligations as they become due.

The Authority may, in connection with the incurrence of any such obligations, limit the deposit to the Reserve Maintenance Fund referred to in the preceding paragraph to not more than \$400,000 per month, notwithstanding any higher amounts recommended by the Authority’s Consulting Engineers. If such deposit is so limited, the Authority will be required, immediately after each monthly deposit to the Subordinate Obligations Fund, to deposit to the Reserve Maintenance Fund (and prior to any deposits to the Self-insurance Fund and the Capital Improvement Fund) the amount of any such deficiency.

Unless a particular project financed with any such obligations is specified by the Authority as being part of the System, any revenues attributable to such project will not be pledged to the payment of Power Revenue Bonds and any expenses associated with such project will not be payable from Revenues as Current Expenses of the System. See “Disposition of Revenues” in Appendix I, *Summary of Certain Provisions of the 1974 Agreement Excluding Proposed Supplemental Agreement*.

BOND INSURANCE

The FSA Bond Insurance Policy

The following information has been furnished by Financial Security Assurance Inc. (“FSA”) for use in this Official Statement. No representation is made by the Authority as to the accuracy or completeness of the information. Reference is made to Appendix V for a specimen of the FSA Bond Insurance Policy.

Bond Insurance Policy. Concurrently with the issuance of the Bonds, FSA will issue its Municipal Bond Insurance Policy for the FSA Insured Bonds (the “FSA Bond Insurance Policy”). The FSA Bond 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 Bond Insurance Policy.

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

FSA. FSA is a New York domiciled 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. Dexia, S.A., through its bank subsidiaries, is primarily engaged in the business of public finance in France, Belgium and other European countries. No shareholder of Holdings or FSA is liable for the obligations of FSA.

At March 31, 2002, FSA’s total policyholders’ surplus and contingency reserves were approximately \$1,644,743,000 and its total unearned premium reserve was approximately \$841,749,000 in accordance with statutory accounting principles. At March 31, 2002, FSA’s total shareholders’ equity was approximately \$1,746,106,000 and its total net unearned premium reserve was approximately \$693,860,000 in accordance with generally accepted accounting principles.

The financial statements included as exhibits to the annual and quarterly reports filed by Holdings with the 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 FSA: 350 Park Avenue, New York, New York 10022, Attention: Communications Department (telephone (212) 826-0100).

The FSA Bond Insurance Policy does not protect investors against changes in market value of the FSA Insured Bonds, which market value may be impaired as a result of changes in prevailing interest rates, changes in applicable ratings or other causes. FSA makes no representation regarding the 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 Authority the information presented under this caption and a specimen of the FSA Bond Insurance Policy for inclusion in this Official Statement.

The MBIA Bond Insurance Policy

The following information has been furnished by MBIA Insurance Corporation (“MBIA”) for use in this Official Statement. No representation is made by the Authority as to the accuracy or completeness of the information. Reference is made to Appendix VI for a specimen of the MBIA Bond Insurance Policy.

Bond Insurance Policy. The MBIA Bond Insurance Policy unconditionally and irrevocably guarantees the full and complete payment required to be made by or on behalf of the Authority to the 1974 Trustee or its successor of an amount equal to (i) the principal of (either at the stated maturity or by an advancement of maturity pursuant to a mandatory sinking fund payment) and interest on, the MBIA Insured Bonds as such

payments shall become due but shall not be so paid (except that in the event of any acceleration of the due date of such principal by reason of mandatory or optional redemption or acceleration resulting from default or otherwise, other than any advancement of maturity pursuant to a mandatory sinking fund payment, the payments guaranteed by the MBIA Bond Insurance Policy shall be made in such amounts and at such times as such payments of principal would have been due had there not been any such acceleration); and (ii) the reimbursement of any such payment which is subsequently recovered from any owner of the MBIA Insured Bonds pursuant to a final judgment by a court of competent jurisdiction that such payment constitutes an avoidable preference to such owner within the meaning of any applicable bankruptcy law (a "Preference").

The MBIA Bond Insurance Policy does not insure against loss of any prepayment premium which may at any time be payable with respect to any MBIA Insured Bond. The MBIA Bond Insurance Policy does not, under any circumstance, insure against loss relating to: (i) optional or mandatory redemptions (other than mandatory sinking fund redemptions); (ii) any payments to be made on an accelerated basis; (iii) payments of the purchase price of MBIA Insured Bonds upon tender by an owner thereof; or (iv) any Preference relating to (i) through (iii) above. The MBIA Bond Insurance Policy also does not insure against nonpayment of principal of or interest on the MBIA Insured Bonds resulting from the insolvency, negligence or any other act or omission of the 1974 Trustee or any other paying agent for the MBIA Insured Bonds.

Upon receipt of telephonic or telegraphic notice, such notice subsequently confirmed in writing by registered or certified mail, or upon receipt of written notice by registered or certified mail, by MBIA from the 1974 Trustee or any owner of a MBIA Insured Bond the payment of an insured amount for which is then due, that such required payment has not been made, MBIA on the due date of such payment or within one business day after receipt of notice of such nonpayment, whichever is later, will make a deposit of funds, in an account with State Street Bank and Trust Company, N.A., in New York, New York, or its successor, sufficient for the payment of any such insured amounts which are then due. Upon presentment and surrender of such MBIA Insured Bonds or presentment of such other proof of ownership of the MBIA Insured Bonds, together with any appropriate instruments to evidence the assignment of the insured amounts due on the MBIA Insured Bonds as are paid by MBIA, and appropriate instruments to effect the appointment of MBIA as agent for such owners of the MBIA Insured Bonds in any legal proceeding related to payment of insured amounts on the MBIA Insured Bonds, such instruments being in a form satisfactory to State Street Bank and Trust Company, N.A., State Street Bank and Trust Company, N.A. shall disburse to such owners or the 1974 Trustee payment of the insured amounts due on such MBIA Insured Bonds, less any amount held by the 1974 Trustee for the payment of such insured amounts and legally available therefor.

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

MBIA does not accept any responsibility for the accuracy or completeness of this Official Statement or any information or disclosure contained herein, or omitted herefrom, other than with respect to the accuracy of

the information regarding the MBIA Bond Insurance Policy and MBIA set forth under the heading “The MBIA Bond Insurance Policy” under *Bond Insurance*. Additionally, MBIA makes no representations regarding the Bonds or the advisability of investing in the Bonds.

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

MBIA Information. The Company files annual, quarterly and special reports, information statements and other information with the Securities and Exchange Commission (the “SEC”) under File No. 1-9583. Copies of the SEC filings (including (1) the Company’s Annual Report on Form 10-K for the year ended December 31, 2001, and (2) the Company’s Quarterly Report on Form 10-Q for the quarter ended March 31, 2002), are incorporated herein by reference and are available (i) over the Internet at the SEC’s web site at <http://www.sec.com> at the SEC’s public reference room in Washington D.C.; (iii) over the Internet at the Company’s web site at <http://www.mbia.com>; and (iv) at no cost, upon request to MBIA Insurance Corporation, 113 King Street, Armonk, New York 10504. The telephone number of MBIA is (914) 273-4545.

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

As of December 31, 2001, MBIA had admitted assets of \$8.5 billion (audited), total liabilities of \$5.6 billion (audited), and total capital and surplus of \$2.9 billion (audited) determined in accordance with statutory accounting practices prescribed or permitted by insurance regulatory authorities. As of March 31, 2002, MBIA had admitted assets of \$8.6 billion (unaudited), total liabilities of \$5.7 billion (unaudited), and total capital and surplus of \$2.9 billion (unaudited) determined in accordance with statutory accounting practices prescribed or permitted by insurance regulatory authorities.

Financial Strength Ratings of MBIA. Moody’s Investors Service (“Moody’s”) rates the financial strength of MBIA “Aaa.”

Standard & Poor’s Ratings Services, a division of The McGraw-Hill Companies, Inc. (“S&P”) rates the financial strength of MBIA “AAA.”

Fitch, Inc. (“Fitch”) rates the financial strength of MBIA “AAA.”

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

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

The XLCA Bond Insurance Policy

The following information has been furnished by XL Capital Assurance Inc. (“XLCA”) for inclusion in this Official Statement. No representation is made by the Authority as to the accuracy or completeness of the information. Reference is made to Appendix VII for a specimen of the XLCA Bond Insurance Policy.

XLCA accepts no responsibility for the accuracy or completeness of this Official Statement or any other information or disclosure contained herein, or omitted herefrom, other than with respect to the accuracy of the information regarding XLCA and its affiliates set forth under this heading. In addition, XLCA makes no representation regarding the XLCA Insured Bonds or the advisability of investing in the XLCA Insured Bonds.

General. XLCA is a monoline financial guaranty insurance company incorporated under the laws of the State of New York. XLCA is currently licensed to do insurance business in, and is subject to the insurance regulation and supervision by, the State of New York, forty-four other states, the District of Columbia, Puerto Rico and the Republic of Singapore. XLCA has license applications pending, or intends to file an application, in each of those states in which it is not currently licensed.

XLCA is an indirect, wholly-owned subsidiary of XL Capital Ltd, a Cayman Islands corporation (“XL Capital Ltd”). Through its subsidiaries, XL Capital Ltd is a leading provider of insurance and reinsurance coverages and financial products to industrial, commercial and professional service firms, insurance companies and other enterprises on a worldwide basis. The common stock of XL Capital Ltd is publicly traded in the United States and listed on the New York Stock Exchange (NYSE: XL). **XL Capital Ltd is not obligated to pay the debts of or claims against XLCA.**

XLCA was formerly known as The London Assurance of America Inc. (“London”), which was incorporated on July 25, 1991 under the laws of the State of New York. On February 22, 2001, XL Reinsurance America Inc. (“XL Re”) acquired 100% of the stock of London. XL Re merged its former financial guaranty subsidiary, known as XL Capital Assurance Inc. (formed September 13, 1999) with and into London, with London as the surviving entity. London immediately changed its name to XL Capital Assurance Inc. All previous business of London was 100% reinsured to Royal Indemnity Company, the previous owner at the time of acquisition.

Reinsurance. XLCA has entered into a facultative quota share reinsurance agreement with XL Financial Assurance Ltd (“XLFA”), an insurance company organized under the laws of Bermuda, and an affiliate of XLCA. Pursuant to this reinsurance agreement, XLCA expects to cede up to 90% of its business to XLFA. XLCA may also cede reinsurance to third parties on a transaction-specific basis, which cessions may be any or a combination of quota share, first loss or excess of loss. Such reinsurance is used by XLCA as a risk management device and to comply with statutory and rating agency requirements and does not alter or limit XLCA’s obligations under any financial guaranty insurance policy. With respect to any transaction insured by XLCA, the percentage of risk ceded to XLFA may be less than 90% depending on certain factors including, without limitation, whether XLCA has obtained third party reinsurance covering the risk. As a result, there can be no assurance as to the percentage reinsured by XLFA of any given financial guaranty insurance policy issued by XLCA, including the XLCA Bond Insurance Policy.

As of December 31, 2001, XLFA had total assets, liabilities, redeemable preferred shares and shareholder’s equity of US\$543,538,559 (audited), US\$244,403,576 (audited), US\$39,000,000 (audited) and US\$260,134,983 (audited) respectively, determined in accordance with GAAP. XLFA’s insurance financial strength is rated “Aaa” by Moody’s and “AAA” by S&P and Fitch. In addition, XLFA has obtained a financial enhancement rating of “AAA” from S&P.

The obligations of XLFA to XLCA under the reinsurance agreement described above are unconditionally guaranteed by XL Insurance (Bermuda) Ltd (“XLI”), a Bermuda company and one of the world’s leading excess commercial insurers. XLI is a wholly owned indirect subsidiary of XL Capital Ltd. In addition to having an “A+” rating from A.M. Best, XLI’s insurance financial strength is rated “Aa2” by Moody’s and “AA” by S&P and Fitch.

Notwithstanding the capital support provided to XLCA described in this section, the bondholders will have direct recourse against XLCA only, and neither XLFA nor XLI will be directly liable to the bondholders.

Financial Strength and Financial Enhancement Ratings. XLCA’s financial strength is rated “Aaa” by Moody’s and “AAA” by S&P and Fitch. In addition, XLCA has obtained a financial enhancement rating of “AAA” from S&P. These ratings reflect Moody’s, S&P’s and Fitch’s current assessment of XLCA’s creditworthiness and claims-paying ability as well as the reinsurance arrangement with XLFA described under “Reinsurance” above.

The above ratings are not recommendations to buy, sell or hold securities, including the XLCA Insured Bonds and are subject to revision or withdrawal at any time by Moody’s, S&P and Fitch. Any downward revision or withdrawal of these ratings may have an adverse effect on the market prices of the XLCA Insured Bonds. XLCA does not guaranty the market price of the XLCA Insured Bonds nor does it guaranty that the ratings on the XLCA Insured Bonds will not be revised or withdrawn.

Capitalization of XLCA. As of December 31, 2000, XLCA had total admitted assets of \$86,959,000 (audited), total liabilities of \$5,275,000 (audited) and total capital and surplus of \$81,684,000 (audited) determined in accordance with statutory accounting practices prescribed or permitted by insurance regulatory authorities (“SAP”). As of December 31, 2001, XLCA had total admitted assets of \$158,442,157 (audited), total liabilities of \$48,899,461 (audited) and total capital and surplus of \$109,542,696 (audited) determined in accordance with SAP.

For further information concerning XLCA and XLFA, see financial statements of XLCA and XLFA, and the notes thereto, incorporated by reference in this Official Statement. The financial statements of XLCA and XLFA are included as exhibits to the periodic reports filed with the Securities and Exchange Commission (the “SEC”) by XL Capital Ltd and may be reviewed at the EDGAR website maintained by the SEC. All financial statements of XLCA and XLFA included in, or as exhibits to, documents filed by XL Capital Ltd pursuant to Section 13(a), 13(c), 14 or 15(d) of the Securities and Exchange Act of 1934 on or prior to the date of this Official Statement, or after the date of this Official Statement but prior to termination of the offering of the XLCA Insured Bonds, shall be deemed incorporated by reference in this Official Statement. Copies of the statutory quarterly and annual statements filed with the State of New York Insurance Department by XLCA are available upon request to the State of New York Insurance Department.

Regulation of XLCA. XLCA is regulated by the Superintendent of Insurance of the State of New York. In addition, XLCA is subject to regulation by the insurance laws and regulations of the other jurisdictions in which it is licensed. As a financial guaranty insurance company licensed in the State of New York, XLCA is subject to Article 69 of the New York Insurance Law which, among other things, limits the business of each insurer to financial guaranty insurance and related lines, prescribes minimum standards of solvency, including minimum capital requirements, establishes contingency, loss and unearned premium reserve requirements, requires the maintenance of minimum surplus to policyholders and limits the aggregate amount of insurance which may be written and the maximum size of any single risk exposure which may be assumed. XLCA is also required to file detailed annual financial statements with the New York Insurance Department and similar supervisory agencies in each of the other jurisdictions in which it is licensed.

The extent of state insurance regulation and supervision varies by jurisdiction, but New York and most other jurisdictions have laws and regulations prescribing permitted investments, and governing the payment of dividends, transactions with affiliates, mergers, consolidations, acquisitions or sales of assets and incurrence of liabilities for borrowings.

THE FINANCIAL GUARANTY INSURANCE POLICIES ISSUED BY XLCA, INCLUDING THE XLCA BOND INSURANCE POLICY, ARE NOT COVERED BY THE PROPERTY/CASUALTY INSURANCE SECURITY FUND SPECIFIED IN ARTICLE 76 OF THE NEW YORK INSURANCE LAW.

The principal executive offices of XLCA are located at 250 Park Avenue, 19th Floor, New York, New York 10177 and its telephone number at this address is (646) 658-5900.

Concerning the Policies

As provided in the insurance agreements to be entered into by the Authority with each of FSA, MBIA and XLCA concurrently with the delivery of their respective municipal bond insurance policies, as long as FSA, MBIA and XLCA shall not be in default on their respective obligations under the municipal bond insurance policies, FSA, MBIA and XLCA shall be deemed to be the owner of the Insured Bonds insured by each of them for purposes of, among other things, (1) taking remedial actions under the 1974 Agreement and (2) the giving of consents to the execution of any supplemental agreement to the 1974 Agreement.

PROPOSED SUPPLEMENTAL AGREEMENT

The Authority has proposed to execute a supplemental agreement (the “Supplemental Agreement”) to the 1974 Agreement. Purchasers of the Bonds will have consented by their purchase to the terms of the Supplemental Agreement.

The Supplemental Agreement will permit the Authority to secure its obligations to providers of credit or liquidity facilities securing Power Revenue Bonds by granting liens on Revenues on a parity with Power Revenue Bonds. The Supplemental Agreement will be executed when owners of 100% of the outstanding Power Revenue Bonds consent thereto. Upon the issuance of the Bonds (and the refunding of the Refunded Power Revenue Bonds and the defeasance of certain other bonds and the concurrent defeasance of certain other Power Revenue Bonds as described in *Debt* below), the owners of approximately 98.79% of the outstanding Power Revenue Bonds will have consented to the execution of the Supplemental Agreement. See Appendix I, *Summary of Certain Provisions of Proposed Supplemental Agreement*, for additional information respecting the provisions of the Supplemental Agreement.

Copies of the proposed Supplemental Agreement are on file for inspection with the 1974 Trustee.

DESCRIPTION OF THE BONDS

General

The Bonds will bear interest at such rates and will mature on the dates and in the principal amounts set forth on the inside cover page of this Official Statement. The Bonds will be dated their date of delivery. Interest on the Bonds will be payable on each January 1 and July 1, commencing January 1, 2003. Principal of

and premium, if any, and interest on the Bonds will be payable in the manner described below under “Book-Entry Only System.” The Bonds are being issued in fully registered form and, when issued, are to be registered in the name of Cede & Co., as nominee of The Depository Trust Company, New York, New York (“DTC”). DTC is to

act as securities depository for the Bonds. Individual purchases of interests in the Bonds will be made in book-entry form only, in denominations of \$5,000 or any multiple thereof. Purchasers of such interests will not receive definitive Bonds. Principal, redemption premium, if any, and interest are payable directly to DTC by the 1974 Trustee. Upon receipt of such payments, DTC is in turn to remit such principal and interest to the DTC Participants (as such term is hereinafter defined) for subsequent disbursement to the purchasers of interests in the Bonds. See “Book-Entry Only System” below. The Bonds are not subject to redemption.

Book-Entry Only System

The following information in this section concerning DTC and DTC’s book-entry system has been obtained from sources (including DTC) that the Authority believes to be reliable, but none of the Authority, the 1974 Trustee, and the Underwriters takes any responsibility for the accuracy of such information.

DTC will act as securities depository for the Bonds. The Bonds will be issued as fully registered bonds registered in the name of Cede & Co. (DTC’s partnership nominee) or such other nominee as may be requested by an authorized representative of DTC. One fully registered Bond will be issued for each series and maturity of the Bonds, each in the aggregate principal amount of such maturity of the Bonds and will be deposited with DTC. So long as the nominee of DTC is the registered owner of the Bonds, such nominee will, subject to the limitations set forth under “Potential Bond Insurance” in *Security* above, be considered the sole owner or holder of the Bonds for all purposes under the 1974 Agreement and any applicable laws. Except as otherwise provided below, a Beneficial Owner (as hereinafter defined) of interests in the Bonds will not be entitled to have the Bonds registered in such owner’s name, will not be entitled to receive definitive Bonds and will not be considered an owner or holder of the Bonds under the 1974 Agreement.

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

Purchases of 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 (a “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 the transaction, as well as periodic statements of

their holdings, from the Direct or Indirect Participant through which the Beneficial Owner entered into the transaction. Transfers of ownership interests in the Bonds 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.

To facilitate subsequent transfers, all Bonds deposited by Direct Participants with DTC are registered in the name of DTC's partnership nominee, Cede & Co. or such other nominee as may be requested by an authorized representative of DTC. The deposit of Bonds with DTC and their registration in the name of Cede & Co. or such other DTC 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 Beneficial Owners. The Direct and Indirect Participants will remain responsible for keeping account of their holdings on behalf of their customers.

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

Redemption notices shall be sent to Cede & Co. If less than all of the Bonds within a maturity are being redeemed, DTC's practice is to determine by lot the amount of the interest of each Direct Participant in such maturity to be redeemed. Neither DTC nor Cede & Co. will consent or vote with respect to the Bonds unless authorized by a Direct Participant in accordance with DTC procedures. Under its usual procedures, DTC mails an Omnibus Proxy to the Authority as soon as possible after the record date. The Omnibus Proxy assigns Cede & Co.'s consenting or voting rights to those Direct Participants to whose accounts the Bonds are credited on the record date (identified in a listing attached to the Omnibus Proxy).

Principal of and premium, if any, and interest payments on the Bonds will be made to Cede & Co., or such other nominee as may be requested by an authorized representative of DTC. DTC's practice is to credit Direct Participants' accounts upon DTC's receipt of funds and corresponding detail information from the Authority or the 1974 Trustee, on the payment 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 (or its nominee), the 1974 Trustee or the Authority, subject to any statutory or regulatory requirements as may be in effect from time to time. Payment of principal, premium and interest with respect to the Bonds to Cede & Co. (or such other nominee as may be requested by an authorized representative of DTC) is the responsibility of the Authority or the 1974 Trustee, disbursement of such payments to Direct Participants shall be the responsibility of DTC, and disbursement of such payments to Beneficial Owners shall be the responsibility of Direct and Indirect Participants.

DTC may discontinue providing its services as securities depository with respect to the Bonds at any time by giving reasonable notice to the Authority or the 1974 Trustee, or DTC's services with respect to the Bonds may be discontinued or terminated at any time by the Authority, in its sole discretion, and without the consent of any other person. In the event that DTC's services are so discontinued or terminated and no substitute securities depository willing to undertake the functions of DTC under the 1974 Agreement can be found which, in the opinion of the Authority, is willing and able to undertake such functions upon reasonable and customary terms, or in the event it is so determined that continuation of the system of book-entry transfers is not in the best interests of the Beneficial Owners, the Authority is obligated to deliver definitive Bonds to or for the account of such Owners.

The Authority, the 1974 Trustee and the Underwriters will have no responsibility or obligation to DTC, Direct Participants, Indirect Participants or the Beneficial Owners of the Bonds with respect to (i) the accuracy of any records maintained by DTC, any Direct Participant or any Indirect Participant; (ii) the payment by DTC to any Direct Participant or any Indirect Participant of any amount due to any Beneficial Owner in respect of the principal of, or premium, if any, or interest on, any Bonds; (iii) the delivery of any notice by DTC, any Direct Participant or any Indirect Participant; (iv) the selection of Beneficial Owners to receive payment in the event of any partial redemption of the Bonds; or (v) any other action taken or omitted to be taken by DTC or any Direct Participant or Indirect Participant. The current “rules” applicable to DTC are on file with the SEC and current “procedures” of DTC to be followed in dealing with its Participants are on file with DTC.

Discontinuance of the Book-Entry Only System

In the event that such book-entry only system is discontinued, the following provisions will apply: principal and the redemption premium, if any, on the Bonds will be payable in lawful money of the United States of America at the corporate trust office of the 1974 Trustee in New York, New York. Interest on the Bonds will be payable on each January 1 and July 1 by check mailed to the respective addresses of the registered owners thereof as shown on the registration books of the Authority maintained by the 1974 Trustee as of the close of business on the record date therefore (June 15 and December 15) as set forth in the 1974 Agreement. The Bonds will be issued only as registered bonds without coupons in authorized denominations. The transfer of the Bonds will be registerable and the Bonds may be exchanged at the corporate trust office of the 1974 Trustee in New York, New York upon the payment of any taxes or other governmental charges required to be paid with respect to such transfer or exchange.

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

Redemption Provisions

The Bonds are not subject to redemption.

THE AUTHORITY

The Authority was created a body corporate and politic constituting a public corporation and governmental instrumentality of the Commonwealth by the “Puerto Rico Electric Power Authority Act”, Act No. 83 of the Legislature of Puerto Rico, approved May 2, 1941, as amended, re-enacted and supplemented (the “Act”). The Authority was formerly known as Puerto Rico Water Resources Authority.

The Authority was created for the purpose of conserving, developing and utilizing the water and power resources of the Commonwealth in order to promote the general welfare of the Commonwealth. It produces, transmits and distributes electricity in Puerto Rico and is one of the largest municipal utilities in the United States.

The executive offices of the Authority are located at 1110 Ponce de León Avenue, San Juan, Puerto Rico 00907, telephone number (787) 289-4666.

Powers

The Authority has broad powers under the Act, including, among others: to make contracts; to acquire properties by eminent domain or otherwise; to borrow money and to issue bonds for any of its corporate purposes; to secure the payment of its bonds and all other obligations by pledge of its revenues; to determine, fix, alter, charge and collect reasonable rates, fees, rentals and other charges for use of its facilities; and to have complete control and supervision of its properties and activities.

Management

The Act provides that the Governing Board of the Authority (the “Board”) shall be composed of nine members. The Secretary of Transportation and Public Works of the Commonwealth of Puerto Rico serves *ex officio* as a member of the Board, and six other members are appointed by the Governor with the advice and consent of the Senate of Puerto Rico. The remaining two members are client representatives elected directly by the Authority’s clients. Members of the Board serve for a term of four years and members who are not *ex officio* can be reappointed or reelected. There is currently one vacancy on the Board. The members of the Board are set forth below.

<u>Name</u>	<u>Principal Occupation</u>	<u>Term Ends</u>
José A. Del Valle-Vázquez, Chairman	Certified Public Accountant	July 2005
José M. Izquierdo-Encarnación	Secretary of Transportation and Public Works	<i>Ex Officio</i>
José A. Bechara-Bravo	Lawyer and Businessman	February 2003
José A. Fernández-Polo, P.E.	Civil Engineer and General Contractor	February 2003
José Luis Rodríguez-Homs, P.E.	Engineer	February 2006
Roberto Fuertes-Thillet	Lawyer and Consultant	Holding Over**
Modesto Iriarte, Jr.	Consultant	February 2003
Zoilo López-Nieves*	Doctor of Medicine	September 2003

* Consumer representative

** Mr. Fuertes-Thillet will continue to serve as a member of the Board until his successor is appointed.

The Board appoints an Executive Director and a Vice Executive Director who are the principal operating officers of the Authority and are responsible for the general operation of the Authority.

Héctor R. Rosario was appointed Executive Director effective January 21, 2001. Mr. Rosario is a Certified Public Accountant and holds a Master’s Degree in Business Administration. During his 31 years of service with the Authority, he has occupied various supervisory level positions, such as Supervisor-Customer Service; Supervisor-Bank Reconciliations Unit; Supervisor-Disbursements Section; Assistant Treasurer; and Treasurer.

Luis E. Cruz, Vice Executive Director, is a licensed Professional Electrical Engineer and Professional Planner and holds a Master’s Degree in Engineering. He has 30 years of service with the Authority and among the positions he has occupied are: Supervisor-Statistical Section; Supervisor-Forecasting and Rates Studies; Supervisor-Engineering System Development Department; and Head-Planning and Research Division.

Other principal officers of the Authority include the following:

Jorge Leavitt, Director of Electric System, is a licensed Professional Electrical Engineer with 29 years of service at the Authority. He has occupied the positions of Electrical Engineer Supervisor I; Electrical Engineer Supervisor II; Advisor in Engineering; District Engineer; Electric Project Department Administrator; and Assistant Director-Distribution.

Valeriano Otero, Director of Transmission and Distribution, is a licensed Professional Electrical Engineer with 22 years of service with the Authority. He has occupied the positions of Line Supervisor III and District Engineer.

Lourdes Alfonso, Director of Customer Service, holds a Juris Doctor and a Bachelor’s Degree in Business Administration, and has approximately 32 years of service with the Authority. Among the positions she has held

are: Assistant Supervisor-Special Legal Services Department; Attorney at the Litigation Division; Head- Customer Service Division; and Attorney III at the Legal Directorate. She is also a Member of the Employees Retirement System's Board of Trustees.

Luis Figueroa, Director of Finance, is a Certified Public Accountant with 13 years of service at the Authority. During his tenure he has occupied positions of Technical Advisor to the Director of Finance; Assistant Comptroller-General Accounting; and Assistant Comptroller-Payroll and Budget.

Héctor M. Alejandro, Director of Planning and Environmental Protection, holds a Juris Doctor and is a licensed Professional Chemical Engineer. He has approximately 29 years of service with the Authority. Among the positions he has held are: Supervisor-Environmental Program Department; Assistant Head-Environmental Protection and Quality Assurance Division; Head-Environmental Protection and Quality Assurance Division; and Technical Advisor in Environmental Protection.

Wilfredo Pantojas, Director of Administrative Services, holds a Juris Doctor and a Master's Degree in Public Administration and has approximately 16 years of service with the Authority. Among the positions he has held are: Office Supervisor I-Electric System Directorate; Local Orders Manager; Office Supervisor II; and Assistant Head-Material Management Division.

Edwin Rivera, Director of Engineering, is a Licensed Professional Electrical Engineer with approximately 25 years of service at the Authority. During that time he has occupied various positions, including Superintendent-Electric System; Assistant Head-Electric Conservation Division; and Administrator at the Project Administration Office in the Engineering Directorate.

Ana T. Blanes, Director of Human Resources, holds a Juris Doctor and a Bachelor's Degree in Business Administration, with a concentration in Accounting, and has approximately 23 years of service with the Authority. During that time she has occupied positions of District Manager; Legal Officer; Assistance and Productivity Programs Administrator; and Labor Relations Officer.

María M. Méndez, General Counsel, holds a Juris Doctor and a Bachelor's Degree in Business Administration, with a concentration in Marketing, and has approximately 14 years of service with the Authority. She has occupied the positions of: Attorney at the Opinion-Legislation and Contract Division; Acting Assistant General Counsel; and Acting General Counsel.

The Authority retains the firm of Washington Group International, Inc., successor to Raytheon Engineers & Constructors, Inc., operating through its affiliated company Washington Engineers P.S.C., as Consulting Engineers (the "Consulting Engineers") to perform certain responsibilities under the 1974

Agreement. The Consulting Engineers' responsibilities include submitting an annual report to the 1974 Trustee setting forth their recommendations: (a) as to any necessary or advisable revisions of the Authority's rates and charges, (b) as to the amount that should be deposited monthly by the Authority during the ensuing fiscal year to the credit of various funds established under the 1974 Agreement for the purposes specified in the 1974 Agreement, and (c) as to any advice and recommendations as they deem advisable.

Ernst & Young LLP currently acts as the Authority's independent accountants responsible for auditing the Authority's financial statements for fiscal 2002.

THE SYSTEM

The Authority is the supplier of virtually all of the electric power consumed in the Commonwealth. As of March 31, 2002, the System served 1,381,701 clients.

Generating Facilities

As of March 31, 2002, investment in Authority-owned production plant in service totaled approximately \$2.2 billion based on original cost, the total nameplate rating of the Authority-owned generating facilities of the System was 4,421 MW and their total dependable generating capacity was 4,398 MW. In addition, the Authority recently commenced purchasing power under a long-term power purchase agreement from a cogeneration facility operated by EcoEléctrica, with a net dependable generating capacity of 507 MW. The Authority has dispatch control over the EcoEléctrica facility, and its output is fully integrated into the System.

Existing Generating Facilities (in MW)

Generating Plants	Nameplate Rating (77 Units)	Dependable Generating Capacity					
		Total (80 Units)	Steam (16 Units)	Three Cycle Power Blocks (13 Units)	Combustion Turbine (25 Units)	Hydro (21 Units)	Other ⁽¹⁾ (5 Units)
Aguirre.....	1,554	1,534	900 ⁽²⁾	592 ⁽³⁾	42 ⁽⁴⁾	—	—
Costa Sur.....	1,118	1,132	1,090	—	42 ⁽⁴⁾	—	—
Palo Seco.....	731	728	602	—	126 ⁽⁵⁾	—	—
San Juan.....	400	400	400	—	—	—	—
Mayagüez.....	90	84	—	—	84 ⁽⁶⁾	—	—
Arecibo.....	249	249	—	—	249 ⁽⁷⁾	—	—
Other Locations.....	279	271	—	—	168 ⁽⁸⁾	100	3
Subtotal	<u>4,421</u>	<u>4,398</u>	<u>2,992</u>	<u>592</u>	<u>711</u>	<u>100</u>	<u>3</u>
Peñuelas – EcoEléctrica	—	507	—	507 ⁽⁹⁾	—	—	—
Total	<u>4,421</u>	<u>4,905</u>	<u>2,992</u>	<u>1,099</u>	<u>711</u>	<u>100</u>	<u>3</u>

- (1) Consists of four diesel units in the Municipality of Culebra and one in the Municipality of Vieques with an aggregate dependable capacity of approximately 3 MW held on standby reserve.
- (2) Consists of the Authority's two largest units, Aguirre Units 1 and 2, each with a dependable generating capacity of 450 MW.
- (3) Consists of two combined-cycle power blocks, each made up of four 50 MW combustion turbine units and one 96 MW steam-turbine unit.
- (4) Consists of two 21 MW units.
- (5) Consists of six 21 MW units.
- (6) Consists of four 21 MW units.
- (7) Consists of three 83 MW units.
- (8) Consists of eight 21 MW units.
- (9) Consists of one combined-cycle power block owned by EcoEléctrica, made up of two 165 MW combustion turbine units and a 177 MW steam turbine unit.

The EcoEléctrica plant is a cogeneration facility installed by EcoEléctrica in the Municipality of Peñuelas. The facility includes a combined cycle power block, consisting of two combustion turbine units and one steam turbine unit, and a liquefied natural gas terminal. The Authority began purchasing power from EcoEléctrica in September 1999 during the testing and start-up phase of the facility. Commercial operation began on March 21, 2000. The Authority has entered into an agreement with EcoEléctrica to purchase all of the power produced by the facility for a term of 22 years, which commenced on March 21, 2000. The agreement requires EcoEléctrica to provide 507 MW of dependable generating capacity to the Authority. The Authority may purchase any energy produced by the facility in excess of 507 MW, if made available, by paying an energy charge only. No capacity charge would be imposed on the Authority for this "excess" power. EcoEléctrica has entered into a long-term supply agreement to meet its expected needs for natural gas at the facility. Deliveries of natural gas to the facility commenced on July 11, 2000.

The power purchase agreement with EcoEléctrica includes monthly capacity and energy charges to be paid by the Authority for the 507 MW of capacity, which EcoEléctrica is committed to provide. The capacity charge is subject to reduction, progressively to zero, if the facility does not achieve certain availability guarantees determined on a 12-month rolling average basis. The energy charges for power purchases are based on a number

of factors including a natural gas related charge on a per kWh of energy basis and inflation indices. The EcoEléctrica purchased power costs incorporate a minimum monthly power or fuel purchase requirement based on an average capacity utilization factor on the part of the Authority. The Authority only pays for energy actually received (including energy in excess of the 507 MW guaranteed by EcoEléctrica). This element of the agreement, when combined with the possible reduction in the capacity charge described above, effectively transfers substantially all of the economic risk of operating the facility to EcoEléctrica.

See also *Overview* for a brief discussion of the effect that Enron's bankruptcy has on the operations of the project.

In the past, approximately 99% of the Authority's energy was produced by oil-fired units. Based on the Authority's ability to efficiently dispatch the EcoEléctrica facility and the AES-PR facility (described below under "Adequacy of Capacity") as part of its System, the Authority currently projects that approximately 15% of its energy sales will be produced by non-oil-fired units in fiscal year 2002 and close to 33% in fiscal year 2003.

Among other benefits, the integration of the EcoEléctrica and AES-PR cogeneration facilities into the Authority's System will reduce the impact of changes in energy costs to the Authority's clients resulting from short-term changes in fuel costs due to the manner of calculation of the energy charges under the respective agreements. While the agreements provide that energy charges will change based on different formulas relating to the prior year, each agreement fixes the energy price for each year of the contract at the beginning of such year. Fixing the energy component of the price for the whole year reduces the impact of seasonal or short duration variations in the market price of electricity. Because the energy price is fixed and known for the entire year, the Authority is able to achieve better economic dispatching and scheduling of maintenance outages of all of its generating units. In addition, the year delay in the effect of energy price changes for these two facilities on the Authority's energy costs reduces variations of the fuel and purchased power components in the price of electricity sold by the Authority by postponing the impact of the price changes and bringing these changes out of step with energy price changes in the above components produced by other fuels in the Authority's fuel mix.

All of the Authority's purchased power costs under the EcoEléctrica power purchase agreement are accounted for as operating expenses on the Authority's financial statements, are treated as a Current Expense under the 1974 Agreement, and are being recovered by the Authority pursuant to the purchased power charge under its current rate structure. Since the power purchase agreement with AES-PR contains substantially

similar relevant terms and conditions, the Authority anticipates that purchased power costs under the AES-PR agreement will be treated similarly.

Transmission and Distribution Facilities

The System includes an integrated electric transmission system, which permits each generating unit to provide electric power to the grid. Transmission plant in service as of March 31, 2002 totaled \$981.0 million based on original cost. As of March 31, 2002, there were 2,306 circuit miles of transmission lines and 68 transmission switchyards. Transmission lines include 331 circuit miles of 230 kV lines, 676 circuit miles of 115 kV lines and 1,299 circuit miles of 38 kV lines. Transmission substations and 20 plant substations have a total transformer capacity of 9,653,966/16,325,250 kilovolt amperes ("kVA"), without fans and with fans, respectively.

During the period from fiscal year 1997 to fiscal year 2001, the Authority invested \$827.8 million (or 42.1% of its capital improvement program) in its transmission and distribution system. The capital improvement program for the five fiscal years ending June 30, 2006 includes \$1,011.8 million (or 48.9% of such program) for transmission and distribution facilities.

The Authority's 230 kV system interconnects its power plants with major switching centers and load centers throughout the island in order to allow the transmission of bulk power to and between these locations. The Authority recently finished construction of new 230 kV transmission lines that completed the transmission loops on the western part of the island. The western loop connects the new 249 MW combustion turbine plant in the Municipality of Arecibo with the Authority's Mayagüez switchyard, thereby improving the reliability of service to the northwestern part of the island, which is experiencing significant load growth.

The Authority is constructing new 230 kV transmission lines to complete the transmission loop on the eastern part of the island. The eastern loop will connect major switching and load centers on the eastern part of the island and boost electric system capacity in Puerto Rico's eastern region. The eastern loop is expected to be operating during fiscal year 2003.

Investment in distribution plant in service as of March 31, 2002 totaled \$2.0 billion based on original cost. The capital improvement program for the five fiscal years ending June 30, 2006 totals \$511.1 million for extensions and improvements to existing distribution lines to serve new clients and substations for accommodating new load growth areas. As of March 31, 2002, the electric distribution system included approximately 29,724 circuit miles of distribution lines and 995 distribution substations (684 are client-owned) with a total installed transformer capacity of 4,713,010/6,494,170 kVA, without fans and with fans, respectively.

The Authority has a continuing program to digitize all the transmission and distribution facilities into a Geographic Information System ("GIS"). This will allow the Authority to create a common database for all its transmission and distribution facilities. Over 38% of the distribution facilities and all of the transmission facilities have been digitized. The program is scheduled to be completed in fiscal year 2004.

The Authority's field operations are being computerized at the district level through the implementation of a Work Management System that has been in operation since December 1999. The Authority has completed communications facilities to link all the regions and district offices. Integration between the GIS and Work Management System has been completed. This integration enables the Authority to track all work from initiation to completion through the same system, while keeping all geographic information (such as maps) updated with necessary additions and modifications. The Authority has also upgraded its computer technology relating to this integration, achieving greater service reliability for its clients.

With the implementation of these systems, real time data of transmission and distribution activities are now available. This has produced further automation of the reporting and analysis pertaining to the operations of these systems, and has helped improve productivity and reduce costs.

The Authority regularly reviews and upgrades its operating and maintenance practices, with an emphasis on improving the reliability of its transmission and distribution system. In order to improve the productivity of its transmission and distribution employees, the Authority has instituted programs to assist them in both technical and supervisory training.

The Authority is currently improving its transmission system by constructing an underground 115 kV transmission circuit line around the San Juan metropolitan area, in order to reduce the incidents of loss of power in the aftermath of hurricanes and other major storms which strike the Island from time to time. The estimated cost for this project is \$100 million. The Federal Emergency Management Agency has committed to provide grants to the Authority to defray a substantial part of this cost.

The Authority has entered into a long-term agreement for its optical fiber cable requirements with Puerto Rico Information Networks, Inc., a private not-for-profit corporation ("PRIN"). Under this agreement PRIN is required to design, build and transfer to the Authority title to all fiber optic cables installed on the Authority's rights-of-way (mainly its transmission lines). The agreement also provides for the long-term lease to PRIN of any surplus capacity of the cables installed. PRIN has installed 679 kilometers of the approximately 700 kilometers for

the initial backbone network on the Authority's transmission lines. The network of fiber optic cable will allow the Authority to modernize its internal communication systems, which provide operations, load management, system protection and security, and other controls. The project is expected to be completed in the fall of 2002.

The Consulting Engineers are of the opinion that the Authority's production plant and transmission and distribution system are in good repair and sound operating condition. See Appendix III, *Letter of the Consulting Engineers*.

Adequacy of Capacity

General

Electric utilities provide reliable service by establishing a level of dependable generating capacity, which is at least equal to their load plus a reserve sufficient to allow for scheduled maintenance, unscheduled outages (described below), reductions in generating capacity due to partial outages, and other unforeseen events. Unlike most United States electric utilities, which are able to purchase power from neighboring systems in the event of unscheduled outages of generating units or temporary surges in demand, the Authority, as an island utility, is not currently able to do so. In addition, the absence of significant seasonal variations in demand results in a relatively high load factor (78.0% in fiscal year 2000 and 78.9% in fiscal year 2001), which affords the Authority less flexibility to schedule maintenance. Therefore, the Authority must have greater total reserve capacity than other United States utilities to cover instances of generating unit outages (scheduled and unscheduled, partial or total).

For planning purposes, the Authority determines adequacy of capacity using probabilistic analytic methods widely used throughout the electric utility industry. The use of these methods takes into account the unique operational aspects of the Authority.

Improvements to the Authority's generating units since the early 1990's have extended their life and increased their availability, thereby substantially improving the System's equivalent availability. This has enabled the Authority to improve the quality of service to its clients. When coupled with the additional generating capacity included in the capacity expansion plan described below, maintaining the level of equivalent availability at current levels should also allow the Authority to maintain better quality of service to its clients and meet forecasted increases in demand, with lower required reserve margins.

The Authority's program to extend the life and increase the availability of its generating units is composed of two parts. The first is a comprehensive preventive maintenance program pursuant to which the Authority continuously trains its maintenance employees and adheres to a schedule designed to ensure proper operating levels of all major generating units by removing units from service at regular intervals for necessary maintenance ("scheduled outages"). The second part of this program is a design modification program which includes a commitment by the Authority to improve the operation of generating units and the ability of units to operate at design capability and to reduce the risk of units being forced out of service or being forced to operate at partial output ("forced or unscheduled outages"). A portion of the \$801.0 million in capital expenditures for the five fiscal years ended June 30, 2001 for production plant was spent for such design modification program.

The table below shows annualized equivalent availability and the equivalent forced outage rate (the average percentage of total dependable generating capacity which is unavailable throughout the year due to forced outages or partial generating capacity outages) for fiscal years 1997 through 2001 and for the twelve months ended March 31, 2002.

Electric Generation Equivalent Availability and Reliability

	Years Ended June 30,					Twelve Months Ended March 31,
	<u>1997</u>	<u>1998</u>	<u>1999</u>	<u>2000</u>	<u>2001</u>	<u>2002</u>
Equivalent availability	79%	80%	79%	78%	80%	80%
Equivalent forced outage rate	11%	11%	8%	9%	8%	8%

By more effectively utilizing scheduled outages, and by implementing major design modifications, the Authority has reduced the need for extended maintenance downtime and increased the overall reliability of all of its generating facilities. As a result, total production plant availability increased from an average of 60% in fiscal year 1992, to an average of 80% for the twelve months ended March 31, 2002. The Authority calculates that each percentage point increase of System availability is equivalent to adding approximately 60 MW of available capacity to the System.

By including the EcoEléctrica and AES-PR facilities in the Authority’s equivalent availability statistics, the Authority’s total system equivalent availability should improve even further. Assuming EcoEléctrica and AES-PR meet their guaranteed availability of 93% and 90%, respectively, the Authority’s total system availability should increase another 2%. The additional reserve capacity represented by these two cogeneration facilities should also afford the Authority the opportunity to extend maintenance periods on its own generation facilities and also favorably affect the System’s equivalent availability.

Projected Load Growth

Projections of future load growth are a key component in the Authority’s capacity planning. In its financial and capacity planning, the Authority receives three sources of information relating to economic activity. One is prepared by Econométrica Inc. using a macroeconomic model of the Commonwealth economy tied to Data Resources, Inc., one by Inter-American University using a macroeconomic model developed in conjunction primarily with DRI-WEFA, and one by the Commonwealth Planning Board. The Authority’s forecasts of electric energy sales and income are based in part on the correlations between the consumption of electricity and various economic and financial activities in the Commonwealth as represented in the above-

mentioned models. The Authority continuously monitors actual performance relative to its forecasts and prepares new forecasts at least once a year.

The Authority incorporates the highest of the three forecasts as its base case for planning the additional generating capacity required by the System. Recognizing the inherent uncertainty of forecasting growth, the Authority ordinarily uses the lowest of the three forecasts in preparing its base case revenue forecast.

The Consulting Engineers have reviewed the Authority’s projections of future load growth and estimates of peak load and have found them to provide a reasonable basis for planning purposes. See Appendix III, *Letter of the Consulting Engineers*.

Additional Generating Facilities

Based upon the Authority’s improvement of its System equivalent availability and current peak load projections, the Authority and the Consulting Engineers believe that the additional generating units included in the Authority’s capacity expansion plan, together with capacity currently available under the EcoEléctrica contract and projected to be available under the AES-PR contract, will meet projected energy demands and provide an improved quality of service through fiscal year 2009.

Construction of the AES-PR project, a cogeneration facility in the Municipality of Guayama, whose power will be purchased by the Authority, commenced in November 1999 and is currently projected to be completed during the third quarter of 2002. This clean burning coal technology facility will consist of two identical fluidized bed boilers and two steam turbines with 454 MW of dependable generating capacity. The Authority has entered into an agreement with AES-PR to purchase all of the power to be produced by this facility for a term of 25 years from the date of commercial operation. This project, along with the EcoEléctric a plant, will contribute to the Authority's efforts towards fuel diversification and improved reliability of service.

The contract with AES-PR is substantially similar to the EcoEléctrica contract described above in "Generating Facilities" under *The System*. The Authority will also have dispatch control over the cogeneration facility so that its output will be fully integrated into the System. Additionally, the Authority is only obligated to purchase energy actually produced by the facility.

The Authority continues the licensing process in order to replace two 44 MW steam-generating units of the San Juan Steam Plant (Units 5 and 6), removed from service in fiscal year 1997. The Authority's PSD permit in connection with this project expired on May 31, 2002. The Authority is negotiating with EPA to extend the expiration of this permit. If the extension is not granted, or if its approval is delayed, the scheduled completion of the project may be delayed. The new combined cycle generating units, which will provide 464 MW of dependable generating capacity, are currently projected to be in service in the summer of 2005. See *Litigation* for a discussion of a lawsuit brought by the principal contractor for this project.

The following table sets forth the Authority's additional generating capacity plan and the fiscal years in which the additional capacity is expected to be in service.

<u>Capacity Expansion Projects</u>	<u>Additional Capacity (MW)</u>	<u>Expected In-Service Fiscal Year</u>
AES Cogeneration Project.....	454	2003
Replacement San Juan 5 & 6	<u>464</u>	2005
Total.....	<u>918</u>	

Based on the Authority's current projections of peak load and improvement of the equivalent availability of its generating units, the Authority and the Consulting Engineers believe that completion of the aforementioned projects will provide the additional generating capacity needed to continue to provide reliable service to its clients through fiscal year 2009. The Authority believes that the aforesaid schedule of capacity additions can be achieved; however, there is no assurance that permitting or construction delays may not have a material adverse effect on such schedule. Based on its projections of peak load, the System's capacity and the maintenance by the Authority of the System's equivalent availability at its current level, the Authority believes that a delay in the completion of any one of these projects will not materially affect its ability to furnish reliable service.

The following table summarizes the Authority's projected peak load, dependable capacity, reserve margin and dependable reserve margin through fiscal year 2007 under the peak load projections shown below and incorporating the assumptions for additional capacity, including the AES-PR facility and the repowering of San Juan Steam Plant units 5 and 6, described above. Projections of future peak load (for capacity planning purposes) from fiscal year 2003 to fiscal year 2007 prepared by the Authority show an average annual increase of 3.5%.

Fiscal Years Ending June 30,	Peak Load	Dependable Capacity	Reserve Margin	Dependable Reserve Margin (%)
(in MW, except percentages)				
2003	3,401	5,359	1,958	58
2004	3,521	5,309	1,788	51
2005	3,647	5,723	2,076	57
2006	3,776	5,638	1,862	49
2007	3,910	5,553	1,643	42

The Consulting Engineers have examined in detail the Authority's proposed long-term capacity expansion plan (and the methodologies and assumptions upon which it is based) and have found its development to be reasonable and generally consistent with utility industry practice and appropriate for the Authority.

Statistical Information

The following table sets forth certain statistical information regarding the System for the five fiscal years ended June 30, 2001 and for the nine-month periods ended March 31, 2001 and 2002. For the fiscal years ended June 30, 2000, 2001 and thereafter, the information below reflects the inclusion of 507 MW of capacity provided pursuant to the EcoEléctrica contract.

Statistical Information

	Years Ended June 30,					Nine Months Ended March 31,	
	1997	1998	1999	2000	2001	2001	2002
	Nameplate rating at end of period (in MW).....	4,172	4,421	4,421	4,421	4,421	4,421
Dependable generating capacity at end of period (in MW)	4,149	4,398	4,398	4,905 ⁽¹⁾	4,905 ⁽¹⁾	4,905 ⁽¹⁾	4,905 ⁽¹⁾
Peak load, 60-minute (in MW)	2,894	3,021	3,057	3,133	3,202	3,202	3,297
Reserve Margin (%).....	43.4	45.6	43.9	56.6	53.2	53.2	48.8
Average load (in MW)	2,185	2,366	2,299	2,443	2,526	2,517	2,554
Load factor (%).....	75.5	78.3	75.2	78.0	78.9	78.6	77.5
Energy generated, purchased and sold (in millions of kWh):							
Electric energy generated and purchased	19,143	20,725	20,141	20,306	22,132	16,549	16,795
Auxiliary equipment use.....	<u>(1,115)</u>	<u>(1,167)</u>	<u>(1,122)</u>	<u>(1,064)</u>	<u>(1,124)</u>	<u>(849)</u>	<u>(807)</u>
Net electric energy generated and purchased	18,028	19,558	19,019	19,242	21,008	15,700	15,988
Losses and unaccounted for...	<u>(1,910)</u>	<u>(2,101)</u>	<u>(2,030)</u>	<u>(1,097)</u>	<u>(2,285)</u>	<u>(1,657)</u>	<u>(1,724)</u>
Electric Energy Sold.....	<u>16,118</u>	<u>17,457</u>	<u>16,989</u>	<u>18,145</u>	<u>18,723</u>	<u>14,043</u>	<u>14,264</u>
Electric Energy Sales:							
Residential	5,480	6,068	5,939	6,385	6,631	4,968	5,184
Commercial.....	6,330	6,822	6,721	7,206	7,583	5,660	5,853
Industrial.....	3,855	4,089	3,881	4,091	4,019	3,040	2,881
Other.....	<u>453</u>	<u>478</u>	<u>448</u>	<u>463</u>	<u>490</u>	<u>375</u>	<u>346</u>
	<u>16,118</u>	<u>17,457</u>	<u>16,989</u>	<u>18,145</u>	<u>18,723</u>	<u>14,043</u>	<u>14,264</u>
Electric Energy Revenues (in thousands):							
Residential	\$ 491,316	\$ 524,128	\$ 471,070	\$ 633,151	\$ 779,682	\$ 586,798	\$ 541,472
Commercial.....	725,146	745,228	688,526	878,697	1,026,219	768,694	717,973
Industrial.....	346,185	350,292	299,295	391,906	436,313	329,199	282,886
Other.....	<u>73,185</u>	<u>74,338</u>	<u>68,944</u>	<u>80,473</u>	<u>86,889</u>	<u>62,915</u>	<u>62,177</u>
	<u>\$1,635,832</u>	<u>\$1,693,986</u>	<u>\$1,527,835</u>	<u>\$1,984,227</u>	<u>\$2,329,103</u>	<u>\$1,747,606</u>	<u>\$1,604,508</u>
Average revenue per kWh (in cents):							
Residential	8.97	8.64	7.93	9.92	11.76	11.81	10.44
Commercial.....	11.46	10.92	10.24	12.19	13.53	13.58	12.27
Industrial.....	8.98	8.57	7.71	9.58	10.86	10.83	9.82
Other.....	16.16	15.55	15.38	17.39	17.74	16.80	17.96
All Classes	10.15	9.70	8.99	10.94	12.44	12.44	11.25
Average number of clients:							
Residential	1,168,447	1,185,246	1,200,061	1,217,584	1,237,053	1,234,970	1,251,949
Commercial.....	117,436	119,421	120,825	122,243	123,380	123,182	124,657
Industrial.....	2,147	2,094	2,040	1,986	1,929	1,936	1,884
Other.....	<u>3,603</u>	<u>3,193</u>	<u>3,129</u>	<u>3,094</u>	<u>3,306</u>	<u>3,332</u>	<u>3,211</u>
	<u>1,291,633</u>	<u>1,309,954</u>	<u>1,326,055</u>	<u>1,344,907</u>	<u>1,365,668</u>	<u>1,363,420</u>	<u>1,381,701</u>
Monthly average revenue per client:							
Residential	\$ 35.04	\$ 36.85	\$ 32.71	\$ 43.33	\$ 52.52	\$ 52.79	\$ 48.06
Commercial.....	514.57	520.03	474.88	599.01	693.13	693.37	639.95
Industrial.....	13,436.77	13,940.31	12,226.10	16,444.53	18,848.84	18,893.42	16,683.53

Other.....	1,692.69	1,940.13	1,836.16	2,167.45	2,190.18	2,098.01	2,151.53
All classes	\$ 105.54	\$ 107.76	\$ 96.01	\$ 122.95	\$ 142.12	\$ 142.42	\$ 129.03

(1) Includes power purchased from the EcoEléctrica cogeneration facility.

Historical Capital Improvement and Financing Program

Capital improvements and their financing are made pursuant to a program established by the Authority and reviewed annually by the Consulting Engineers. The program for the five fiscal years ended June 30, 2001 and for the nine-month period ended March 31, 2001 and 2002 is shown in the following table.

	Years Ended June 30,					Total ⁽¹⁾	Nine Months Ended March 31	
	1997	1998	1999	2000	2001		2001	2002
Capital Improvements	(in thousands)							
Production plant	\$ 175,507	\$ 175,158	\$ 154,407	\$ 179,119	\$ 116,775	\$ 800,966	\$ 69,571	\$ 89,688
Transmission facilities	49,766	65,252	53,816	48,826	80,741	298,401	55,862	60,866
Distribution facilities	71,630	107,952	133,847	86,848	129,139	529,416	100,131	103,452
Other ⁽²⁾	67,531	51,019	67,694	85,591	67,393	339,228	54,743	39,399
	<u>\$ 364,434</u>	<u>\$ 399,381</u>	<u>\$ 409,764</u>	<u>\$ 400,384</u>	<u>\$ 394,048</u>	<u>\$ 1,968,011</u>	<u>\$ 280,307</u>	<u>\$ 293,405</u>
Financing								
Internally generated funds.....	\$ 70,153	\$ 106,157	\$ 62,958	\$ 74,265	\$ 100,500	\$ 414,033	\$ 75,012	\$ 60,640
Borrowed funds ⁽³⁾	294,281	293,224	346,806	326,119	293,548	1,553,978	205,295	232,765
	<u>\$ 364,434</u>	<u>\$ 399,381</u>	<u>\$ 409,764</u>	<u>\$ 400,384</u>	<u>\$ 394,048</u>	<u>\$ 1,968,011</u>	<u>\$ 280,307</u>	<u>\$ 293,405</u>
Allowance for funds used during construction	\$ 8,266	\$ 10,300	\$ 11,677	\$ 12,138	\$ 22,966	\$ 65,347	\$ 15,298	\$ 10,761

- (1) Includes allowance for funds used during construction of \$65.3 million for the five fiscal years ended June 30, 2001, and \$15.3 million and \$10.8 million for the nine-month period ended March 31, 2001 and March 31, 2002, respectively. The inclusion of such funds increases the carrying value of improvements by the amount of interest on borrowed construction funds used to finance plant additions during the period. See Note 2 to the Financial Statements under Utility Plant included in Appendix II hereto.
- (2) Includes general land and buildings, general equipment, preliminary surveys and investigations.
- (3) Includes interim financing for capital improvements and bond proceeds applied directly to construction.

Projected Five-Year Capital Improvement and Financing Program

Following a public hearing and approval by the Consulting Engineers, the Board must adopt the Authority's capital budget on or before the first day of the ensuing fiscal year. If revisions are required, the Board may amend the capital budget at any time during the fiscal year with the approval of the Consulting Engineers. The capital budget for fiscal year 2002 was adopted on June 13, 2001.

The projected capital improvement program for the five fiscal years ending June 30, 2002 through 2006 aggregates approximately \$2.1 billion. It is currently estimated that \$482.7 million, or approximately 23.3%, of the projected five-year capital improvement program will be financed by internally generated funds. Estimated capital costs reflect, among other factors, construction contingency allowances and annual cost escalations.

The five-year capital improvement program includes \$637.4 million for production plant. A substantial part of this amount represents investment in the improvement of generating units to continue to improve their reliability and efficiency and increase the generating capacity of the System. The projected capital improvement program is consistent with the Authority's base case capacity expansion plan described under "Adequacy of Capacity" above.

In connection with its measures to provide for additional generating capacity, the Authority projects the cost of improving the generating plants to be approximately \$522.6 million. All of the above projected expenditures have been included in the five-year capital improvement program for the five fiscal years ending June 30, 2006. In addition to the Authority's projected capital improvement program for fiscal years 2002 through

2006, the Authority has entered into agreements to purchase power from two cogeneration facilities with a combined dependable generating capacity of 961 MW consisting of 507 MW from the EcoEléctrica plant, which is already in operation, and 454 MW from the AES-PR project, which is expected to become available during the third quarter of 2002. For a detailed discussion of each of the above capacity expansion projects, see “Generating Facilities” and “Adequacy of Capacity—Additional Generating Facilities” above.

The reduction, from \$801.0 million to \$637.4 million, in the amounts budgeted for production plant in the projected five-year capital improvement program compared to the historical five-year capital improvement program reflects (i) the completion of major capital expenditures and (ii) the purchase of additional generating capacity from cogeneration facilities during the five-year period, which purchase will be accounted for as operating expenses of the Authority. The projected capital improvement program also shows that the Authority will concentrate its efforts in improving and expanding its transmission facilities, particularly through the construction of new 230 kV lines.

The Consulting Engineers have examined the projected capital improvement program and found it to be reasonable. The capital improvement program is subject to periodic review and adjustment because of changes in expected demand, environmental requirements, design, equipment delivery schedules, costs of labor, equipment and materials, interest rates and other factors. The following table presents a summary of the projected capital improvement program for the five fiscal years ending June 30, 2006 and its projected financing.

Projected Capital Improvement Program
(in thousands)

	Years Ending June 30,					Total ⁽¹⁾
	2002	2003	2004	2005	2006	
Capital Improvements						
Production plant.....	\$ 144,743	\$ 118,638	\$ 131,389	\$ 132,182	\$ 110,436	\$ 637,388
Transmission facilities.....	85,037	95,485	107,042	98,827	114,306	500,697
Distribution facilities.....	94,325	106,619	105,189	101,567	103,397	511,097
Other ⁽²⁾	92,373	109,411	85,325	77,595	55,192	419,896
	<u>\$ 416,478</u>	<u>\$ 430,153</u>	<u>\$ 428,945</u>	<u>\$ 410,171</u>	<u>\$ 383,331</u>	<u>\$ 2,069,078</u>
Financing Sources						
Internally generated funds.....	\$ 82,158	\$ 125,687	\$ 105,344	\$ 77,540	\$ 92,012	\$ 482,741
Borrowed funds ⁽³⁾	334,320	304,466	323,601	332,631	291,319	1,586,337
	<u>\$ 416,478</u>	<u>\$ 430,153</u>	<u>\$ 428,945</u>	<u>\$ 410,171</u>	<u>\$ 383,331</u>	<u>\$ 2,069,078</u>
Allowance for funds used during construction.....	<u>\$ 15,993</u>	<u>\$ 11,780</u>	<u>\$ 8,564</u>	<u>\$ 14,951</u>	<u>\$ 14,170</u>	<u>\$ 65,450</u>

(1) Includes allowance for funds used during construction of \$65.5 million for the five-year period ending June 30, 2006 (see footnote (1) to the table under “Historical Capital Improvement and Financing Program” above).

(2) Includes general land and buildings, general equipment, preliminary surveys and investigations.

(3) For the purpose of this table, it is assumed that of the total \$1.7 billion Power Revenue Bonds expected to be issued in the five-year period ending June 30, 2006, \$425.0 million is expected to be used to repay lines of credit with the Government Development Bank anticipated to be drawn during this period.

Rates

The Authority has the power to determine, alter, establish and collect reasonable rates for electric service, which shall produce sufficient revenues to cover the operating costs of the Authority, the payment of the principal of and the interest on its bonds, and other contractual obligations. Public hearings are required before the setting of permanent rates, with the final approval vested solely within the Authority. Act No. 21 of the Legislature of Puerto Rico, approved May 31, 1985 (“Act No. 21”), provides uniform procedures for public hearings and review of the actions of certain public corporations, including the Authority, in connection with changes in the rates set by such public corporations. Act No. 21 also authorizes the Legislature by resolution to review rates of certain public corporations, including the Authority. At the request of another

public corporation covered by Act No. 21, the Secretary of Justice has rendered an opinion to the effect that Act No. 21 does not grant a veto power to the Legislature over rates adopted properly by such public corporation.

Until October 1999, electric service rates consisted primarily of (i) basic charges, made up of demand, client and energy related charges, which included a base fuel price of \$2.00 per barrel; and (ii) fuel adjustment charges to recover the costs to the Authority of fuel oil above a base price of \$2.00 per barrel. Effective November 1999, on a temporary basis, fuel adjustment charges were revised to recover also the cost of purchasing power. On March 28, 2000, following a public hearing, a permanent revision of the rate structure was approved to incorporate a purchased power charge to the electric service rates to recover the cost to the Authority of purchasing power. In addition, the \$2.00 per barrel of fuel cost included in the basic charges was transferred to the fuel charges, effective on June 5, 2000. Consequently, revenues will reflect changes in the fuel charge and the purchased power charge caused by fluctuations in the price of fuel oil or purchased power. Basic charges averaged 6.1¢ per kilowatt-hour prior to the March 2000 revisions. The Authority has not increased basic charges since 1989. The following table presents the electric sales revenues derived from basic charges and fuel adjustment charges for the five fiscal years ended June 30, 2001 and the nine-month period ended March 31, 2001 and 2002 and purchased power charges for the fiscal years 2000 and 2001 and for the nine-month period ended March 31, 2001 and 2002.

**Electric Sales Revenues
(in thousands)**

	Years Ended June 30,					Nine Months Ended March 31,	
	1997	1998	1999	2000	2001	2001	2002
Basic charges.....	\$ 983,602	\$1,054,041	\$1,035,471	\$1,086,783	\$1,070,693	\$ 797,476	\$ 821,959
Fuel adjustment charges	652,230	639,945	492,364	825,924	1,059,108	809,011	599,634
Purchased power charges	—	—	—	71,520	199,302	141,119	182,915
	<u>\$1,635,832</u>	<u>\$1,693,986</u>	<u>\$1,527,835</u>	<u>\$1,984,227</u>	<u>\$2,329,103</u>	<u>\$1,747,606</u>	<u>\$1,604,508</u>

The fuel charges imposed in any month are based upon the average of (i) the actual average fuel oil costs for the second preceding month and (ii) the estimated average fuel oil costs for the current month. Purchased power charges are based on estimated purchased power costs for the current month. To the extent that such charges do not fully recover actual fuel or purchase power costs (or recover more than such costs), charges are adjusted in the second succeeding month.

Under the Act, certain residential clients receive a subsidy for the fuel adjustment charge. Residential clients who qualify for the subsidy are billed the full applicable basic charges and fuel adjustment charges, with the applicable subsidy taking the form of a credit against the bill. In addition, under legislation approved in July 1985, certain tourism facilities, such as hotels certified by the Tourism Company, receive subsidies from the Commonwealth. See “Subsidies, Contributions in Lieu of Taxes and Set Aside-Subsidies” below for a more detailed description of these subsidies.

The Consulting Engineers have reviewed the Authority’s rate schedules and believe that the Authority will receive sufficient Revenues to cover Current Expenses and to make the required deposits in the 1974 Sinking Fund, the 1974 Reserve Maintenance Fund, the Capital Improvement Fund and, if any are required, the Self-insurance Fund.

Major Clients

The public sector, which consists of the Commonwealth government and its public corporations and the municipalities (included primarily in the commercial category), accounted for 14.4% of kWh sales and 17.4% of revenues from electric energy sales for the twelve-month period ended April 30, 2002.

The ten largest industrial clients accounted for 4.7% of kWh sales and 3.6% of revenues from electric energy sales for the twelve months ended April 30, 2002. No single client accounted for more than 0.8% of electric energy sales or more than 0.6% of revenues from electric energy sales.

In September 1997, the Authority established a new reduced rate for large industrial clients connected at an 115kV voltage level and meeting certain criteria such as a minimum demand and a high load factor and power factor. This new rate is designed to induce such large clients to whom it may be economical to produce their own electricity to buy more electricity from the Authority and discourage their independent power production. As of April 30, 2002, three of the Authority's industrial clients were using such rate.

Fuel

For the fiscal year ended June 30, 2001, fuel oil expenses amounted to \$944.8 million, or 54.8% of total Current Expenses (\$801.4 million and 54.6% for the preceding fiscal year). For the nine months ended March 31, 2002, fuel oil expenses amounted to \$535.2 million, or 46.0% of total Current Expenses. For the five fiscal years ended June 30, 2001, fuel oil expense was a fairly stable component of total Current Expenses, averaging 53.1% of total Current Expenses. See "Management's Discussion and Analysis of Operating Results" under *Net Revenues and Coverage*.

The Authority's thermal generating units, which produced 87% of the net electric energy generated by the System in fiscal year 2001, are fueled by No. 6 residual fuel oil, except for the smaller combustion-turbine units, the two Aguirre combined-cycle units and the 249 MW combustion turbine plant in Arecibo, which burn No. 2 distillate fuel oil. These combustion turbine units, the two combined cycle units and the 249 MW combustion turbine plant at Arecibo represent 29.7% of the System's aggregate dependable generating capacity.

Since the Authority is not interconnected with other utilities, it maintains some generating units operating as a reserve in anticipation of unscheduled outages or other unforeseen events ("spinning reserve"). Historically, the Authority has maintained 450 MW of spinning reserve. Based on its experience, however, the Authority has determined that it can provide reliable service to its clients while reducing spinning reserve by 200 MW. This reduction was first implemented during the current fiscal year and is estimated that it will result in fuel cost savings ranging between \$20 million and \$30 million annually.

As of March 31, 2002, 100% of the Authority's fuel requirements for its generation facilities were covered by one-year contracts, which expire at various times. The Authority's contracted fuel oil prices consist of an escalation factor plus a fixed price differential. The escalation factor reflects the fuel oil price at the New York market at the time of purchase. The fixed price differential compensates for the fact that the fuel oil is delivered in the Commonwealth and not New York. It also takes into account other aspects of the delivery such as maximum cargo volume and draft restrictions. The Authority does not expect any difficulty in renewing its contracts at price differentials similar to those currently in effect.

Since the Authority's dependence on fuel oil has decreased with the coming on line of the EcoEléctrica plant, the Authority's customary inventory of fuel oil will cover 35 days of ordinary operations, up from 25 days in the past. Although sources of fuel oil are continually changing as a result of variations in relative price, availability and quality, the Authority has never been forced to curtail service to its clients because of fuel oil

shortages. The Authority's total inventory capacity for fuel oil is 3.4 million barrels. As of March 31, 2002, the Authority had an inventory of 2.6 million barrels of fuel oil.

Average fuel oil costs and related costs of production for the five fiscal years ended June 30, 2001 and for the nine months ended March 31, 2001 and 2002 are shown in the following table.

	Fuel Costs					Nine Months Ended	
	Years Ended June 30,					March 31,	
	1997	1998	1999	2000	2001	2001	2002
Average fuel oil cost per barrel (net of handling costs).....	\$ 20.28	\$ 18.38	\$ 14.56	\$ 23.54	\$ 29.33	\$ 30.19	\$ 22.43
Number of barrels used (in millions).....	32.0	34.4	34.4	34.0	32.2	24.1	23.9
Fuel oil cost (in millions).....	\$648.9	\$632.3	\$500.9	\$801.4	\$944.8	\$728.4	\$535.2
Net kWh generated (including purchased power in 2000 and 2001)(in millions)....	17,888.5	19,493.4	18,876.8	19,065.1	18,159.2	13,566.6	13,758.3
Average net kWh per barrel	559.0	566.7	548.7	560.7	564.0	562.9	575.7
Average fuel oil cost per net kWh generated (in cents).....	3.63	3.24	2.65	4.20	5.20	5.37	3.89

With the addition of the output of the EcoEléctrica facility to the Authority's System, the Authority's traditional dependence on oil-fired generation has decreased and is expected to decrease significantly more when the AES-PR facility becomes operational. By fiscal year 2003, when the AES-PR facility is currently projected to become commercially operational, the Authority projects that approximately 33% of its annual energy requirements will be provided by non-oil-fired generating facilities.

Earlier this fiscal year, the Authority entered into a series of contracts that will provide it with protection against increases in the price of fuel oil. Under these contracts, which cover 4 million barrels or about 13% of the Authority's projected 2002 fuel oil consumption requirements, the Authority will receive in cash the difference between the monthly average market price of No. 6 fuel oil above a fixed price per barrel (ranging between \$21 and \$22 per barrel depending on the contract). In addition, the Authority used payments it received from its two cogenerators in return for the granting by the Authority of certain waivers under their power purchase agreements, to capitalize a special fund to provide billing credits to certain of the Authority's clients to protect them against increases in the price of fuel oil. This fund will serve to smooth the effects of the fuel adjustment to certain clients, and is currently capitalized at approximately \$50.7 million.

Subsidies, Contributions in Lieu of Taxes and Set Aside

Subsidies

Under the Act, a subsidy is provided for a portion of fuel charges to qualifying residential clients who use up to 425 kWh monthly or 850 kWh bi-monthly. This subsidy takes the form of a credit against their electric bills.

The Act limits this subsidy to a maximum of \$100 million per year and limits the cost of fuel oil used in calculating the amount of such subsidy to a maximum of \$30 per barrel. The residential clients must pay any fuel adjustment charge resulting from a price of fuel oil in excess of \$30 per barrel.

Through fiscal year 1991, the subsidy was paid to the Authority by the Commonwealth each year and was recorded as a receivable on the Authority's financial statements. As of June 30, 1991, the amount owed by the Commonwealth to the Authority on account of this fuel oil subsidy program was \$94.9 million. In October 1991, the Authority and the Commonwealth entered into a non-interest bearing fifteen-year payment plan, starting in fiscal year 1993, for the payment of this amount. As of March 31, 2002, the amount owed by the Commonwealth was approximately \$31.6 million. The Commonwealth has made all payments due under this plan

through fiscal year ended June 30, 2002. Also in 1991, the Authority revised its subsidy implementing regulations to reduce the number of qualifying clients. Under these regulations, the subsidy has amounted to approximately \$11.3 million per year for the five fiscal years ended June 30, 2001. All subsidy amounts arising since June 30, 1991 have been set-off against the electric energy sales set aside as discussed in *Contributions in Lieu of Taxes and Set Aside* below.

Hotels receive a subsidy in an amount equal to 11% of their monthly billing. In order to receive this subsidy, hotels must maintain their electric service accounts on a current basis. This subsidy takes the form of a credit against their electric bills.

All subsidy amounts are also set off against the electric energy sales set aside as discussed in *Contributions In Lieu of Taxes and Set Aside* below. All of such amounts have been paid in full through fiscal year ended June 30, 2001.

Contributions In Lieu of Taxes and Set Aside

Under the Act, the Authority is required to pay to the Secretary of the Treasury (for distribution to the municipalities) from its Net Revenues, after certain defined expenditures and subject to compliance with its obligations under the 1974 Agreement, contributions in lieu of taxes in the amount of 6% of its gross electric energy sales computed on the basis of an annual average fuel oil price of up to \$30 per barrel. Under certain circumstances, the Authority is empowered to raise the ceiling (if the price exceeds \$30 per barrel) to provide the municipalities, through contributions in lieu of taxes, with sufficient income to offset their billings for consumption plus the necessary amounts to fulfill their obligations to the Authority. Contributions in lieu of taxes to municipalities can be used to offset accounts receivable balances owed to the Authority, as permitted by law. For fiscal year 2001, contributions in lieu of taxes to municipalities amounted to \$121.9 million, of which \$6.4 million was reimbursed to the municipalities and \$115.5 million was used to offset or reduce outstanding accounts receivable balances. In addition, for the nine-month period ended March 31, 2002, contributions in lieu of taxes to municipalities amounted to \$78.5 million.

The Act also requires the Authority to set aside annually from its Net Revenues an additional amount equal to 5% of the Authority's annual gross electric energy sales (based on kWh) (the "electric energy sales set aside"). One-fifth of the electric energy sales set aside are to be applied to cover the costs of the fuel oil subsidy program arising after June 30, 1991 (with any balance remaining being used to reduce the amounts owed by the Commonwealth to the Authority on account of such subsidy as of June 30, 1991). Another one-fifth of the electric energy sales set aside must be paid to the Secretary of the Treasury for distribution among the municipalities (in addition to the contributions in lieu of taxes described above). The balance of the electric energy sales set aside must be used to fund certain of the Authority's capital improvements and other purposes. The Authority's obligation to make available the electric energy sales set aside is also subject to the Authority's obligations under the 1974 Agreement.

If the Authority's Net Revenues, as defined in the Act, in any year are not sufficient to cover the contributions in lieu of taxes and the electric energy sales set aside, said contributions and set aside are reduced to the amount available, and the excess does not carry forward as a liability for future years. During the five fiscal years ended June 30, 2001, the Net Revenues of the Authority were not sufficient to permit the payment to the municipalities of the full contributions in lieu of taxes and provide for the full electric energy sales set aside due to the priority payments of certain obligations which are required by the 1974 Agreement including all deposits into the 1974 Sinking Fund.

In May 1998, the Municipality of Ponce filed a complaint against the Authority in the Court of First Instance, Superior Section San Juan Part requesting the payment by the Authority of the full contributions in lieu

of taxes and electric energy sales set aside for prior fiscal years, as established in the Authority's enabling act. The complaint challenges the Authority's disposition of Net Revenues in order to make deposits to certain funds under the 1974 Agreement and a previous indenture for the purposes of paying costs of capital improvements and seeks a payment by the Authority in the amount by which the amount available to pay the contributions in lieu of taxes and electric energy sales set aside to the Municipality of Ponce has been reduced as a result of such disposition. The Authority believes that because the Act provides that the contributions in lieu of taxes and electric energy sales set aside are only payable after complying with the Authority's deposit obligations under the 1974 Agreement and such previous indenture, and shortfalls do not carry forward as future liabilities of the Authority as described above, it is legally entitled to make such deposits even if the effect is to reduce such contributions and set aside available to municipalities. See *Litigation*.

DEBT

The following table sets forth the bonds and notes of the Authority outstanding as of March 31, 2002 and as adjusted for the issuance of the Bonds and the refunding of the Refunded Power Revenue Bonds. In addition, the column labeled "As Adjusted" excludes the principal due at maturity of the Authority's Power Revenue and Revenue Refunding Bonds, Series N and O, maturing July 1, 2017 (the "Defeased N and O Power Revenue Bonds") which bonds are being defeased concurrently with the issuance of the Bonds from available moneys of the Authority.

	Outstanding as of March 31, 2002	As Adjusted
(in thousands)		
Power Revenue Bonds		
Publicly offered	\$ 4,683,903 ⁽¹⁾	\$ 4,771,448 ⁽³⁾
Rural Electrification Bonds	150,829	58,226
Subordinate Obligations ⁽²⁾	43,689	43,689
	<u>\$ 4,878,421</u>	<u>\$ 4,873,363</u>
Notes		
General Obligation Notes	<u>130,000</u>	<u>130,000</u>
	<u>\$5,008,421</u>	<u>\$ 5,003,363</u>

- (1) Includes \$123.4 million of accretion on Capital Appreciation Bonds for the nine-months ended March 31, 2002.
- (2) In connection with the installation of the Authority's fiber optic telecommunication system, see "Transmission and Distribution Facilities" under *The System* above, the Authority entered into an installment purchase agreement with PRIN under which the Authority will be obligated to make purchase price payments to PRIN to acquire the system. The Authority's obligation to make these payments will be satisfied from moneys in the Subordinate Obligations Fund under the 1974 Agreement. See "Flow of Funds Under 1974 Agreement" and "Subordinate Obligations" under *Security* above. The obligation of the Authority to make these installment purchase payments is subordinate to its obligation to pay the outstanding Power Revenue Bonds. The Authority has determined that the aforementioned telecommunication system will not be part of the System and as such, any rentals received by the Authority from the long-term lease of surplus fiber optic cable capacity to PRIN will not be pledged to the payment of the Power Revenue Bonds.
- (3) Includes \$65.8 million of accretion on Capital Appreciation Bonds for the nine-months ended March 31, 2002.

Rural Electrification Bonds

The Rural Utilities Service (formerly the Rural Electrification Administration) (“RUS”) has purchased Power Revenue Bonds issued by the Authority to provide funds for the construction of distribution facilities to service RUS qualified areas. As of March 31, 2002, the Authority had issued to RUS a total of \$301 million of its Power Revenue Bonds, \$150.8 million of which were outstanding, at interest rates of 2% and 5%.

General Obligation Notes

The Authority has issued \$125 million of its general obligation notes to certain commercial banks to finance the purchase of fuel oil. The notes are due on July 2, 2004. In December 1997, the Authority issued a \$5 million note to EcoEléctrica to finance part of the Authority's cogeneration expenses in connection with EcoEléctrica's cogeneration plant in the Municipality of Peñuelas. The note is due October 30, 2004.

Principal and Interest Requirements

Principal and Interest Requirements, as used herein and as defined in the 1974 Agreement, means for any fiscal year the sum of all principal of, including Amortization Requirements for, and interest on, outstanding Power Revenue Bonds which is payable on January 1 in such fiscal year and on July 1 in the following fiscal year. The following table shows the annual Principal and Interest Requirements for the outstanding Power Revenue Bonds after giving effect to the issuance of the Bonds and the refunding of the Refunded Power Revenue Bonds. In addition, the information in the following table excludes debt service on the Defeased N and O Power Revenue Bonds. The Amortization Requirements are subject to adjustment as provided in the definition thereof. See Appendix I, *Summary of Certain Provisions in the 1974 Agreement Excluding Proposed Supplemental Agreement*.

Debt Service Requirements

Years Ending June 30,	Outstanding Principal and Interest Requirements ⁽¹⁾	The Bonds			Total Debt Service Requirements
		Maturity and Amortization Requirements	Interest	Total	
2003.....	\$356,583,667.55		\$25,935,094.90	\$25,935,094.90	\$382,518,762.45
2004.....	383,939,805.05		26,007,337.50	26,007,337.50	409,947,142.55
2005.....	379,902,790.05	\$7,765,000.00	26,007,337.50	33,772,337.50	413,675,127.55
2006.....	390,226,702.55		25,696,737.50	25,696,737.50	415,923,440.05
2007.....	380,979,395.05		25,696,737.50	25,696,737.50	406,676,132.55
2008.....	341,426,297.55	9,050,000.00	25,696,737.50	34,746,737.50	376,173,035.05
2009.....	344,617,523.80	7,420,000.00	25,244,237.50	32,664,237.50	377,281,761.30
2010.....	303,620,058.80	19,000,000.00	24,910,337.50	43,910,337.50	347,530,396.30
2011.....	235,364,971.30	83,700,000.00	23,960,337.50	107,660,337.50	343,025,308.80
2012.....	238,227,261.30	88,060,000.00	20,037,337.50	108,097,337.50	346,324,598.80
2013.....	327,162,911.30	8,955,000.00	15,632,937.50	24,587,937.50	351,750,848.80
2014.....	325,853,672.54	8,140,000.00	15,177,800.00	23,317,800.00	349,171,472.54
2015.....	213,659,373.78	105,040,000.00	14,730,100.00	119,770,100.00	333,429,473.78
2016.....	232,659,423.78	84,875,000.00	8,952,900.00	93,827,900.00	326,487,323.78
2017.....	249,426,701.26	71,550,000.00	4,284,775.00	75,834,775.00	325,261,476.26
2018.....	249,975,582.50	3,665,000.00	349,525.00	4,014,525.00	253,990,107.60
2019.....	250,176,988.76	2,690,000.00	147,950.00	2,837,950.00	253,014,938.76
2020.....	250,646,588.76				250,646,688.76
2021.....	250,236,731.26				250,236,731.26
2022.....	228,502,087.52				228,502,087.52
2023.....	228,206,206.26				228,206,206.26
2024.....	208,062,293.76				208,062,293.76
2025.....	181,664,125.02				181,664,125.02
2026.....	158,207,256.26				158,207,256.26
2027.....	158,206,162.50				158,206,162.50
2028.....	125,860,300.00				125,860,300.00
2029.....	90,780,212.50				90,780,212.50
2030.....	90,779,387.50				90,779,387.50
2031.....	<u>48,283,437.50</u>				<u>48,283,437.50</u>
Total.....	<u>\$7,223,237,915.76</u>	<u>\$499,910,000.00</u>	<u>\$308,468,219.90</u>	<u>\$808,378,219.90</u>	<u>\$8,031,616,135.66</u>

(1) Debt service requirements on all Power Revenue Bonds outstanding on March 31, 2002, excluding debt service on the Refunded Power Revenue Bonds and on the Defeased N and O Power Revenue Bonds.

NET REVENUES AND COVERAGE

The following table presents the Net Revenues (exclusive of certain investment income) of the Authority under the provisions of the 1974 Agreement for the five fiscal years ended June 30, 1997 through 2001 and for the nine-month period ended March 31, 2001 and 2002 and the ratio of such Net Revenues to Principal and Interest Requirements on the Power Revenue Bonds. These calculations of Net Revenues differ in several important respects from the Authority's calculations of net income prepared in conformity with generally accepted accounting principles. For example, they do not include depreciation as a current expense and do not reflect interest expense as a deduction from Net Revenues.

Historical Net Revenues and Coverage

	Years Ended June 30,					Nine Months Ended March 31,	
	1997	1998	1999	2000	2001	2001	2002
Average number of clients.....		1,309,954	1,326,055	1,344,907	1,365,668	1,363,420	1,381,701
Electric energy sales (in millions of kWh).....	1,291,633	17,457	16,989	18,145	18,723	14,043	14,264
	16,118						
Source of Net Revenues (dollars in thousands)							
Revenues:							
Sales of electrical energy:							
Residential ⁽¹⁾	\$ 491,316	\$ 524,128	\$ 471,070	\$ 633,151	\$ 779,682	\$ 586,798	\$ 541,472
Commercial	725,146	745,228	688,526	878,697	1,026,219	768,694	717,973
Industrial	346,185	350,292	299,295	391,906	436,313	329,199	282,886
Other	73,185	74,338	68,944	80,473	86,889	62,915	62,177
	1,635,832	1,693,986	1,527,835	1,984,227	2,329,103	1,747,606	1,604,508
Revenues from Commonwealth for rural electrification.....	1,068	1,007	941	881	705	522	558
Other operating revenues.....	8,662	11,841	8,827	10,240	8,210	6,541	6,452
Other (principally interest earned).....	24,887	26,841	26,350	29,936	35,059	28,151	18,728
	1,670,449	1,733,675	1,563,953	2,025,284	2,373,077	1,782,820	1,630,246
Current Expenses:							
Operations:							
Fuel.....	648,899	625,346	500,920	801,433	944,760	728,422	535,232
Purchased power	--	--	--	64,517	177,330	125,390	163,203
Other production.....	37,378	43,658	42,818	55,690	56,301	41,925	43,131
Transmission and Distribution	76,735	86,901	83,385	94,793	105,034	74,922	84,724
Customer accounting and Collection.....	68,138	73,647	67,517	76,598	83,453	62,814	62,143
Administrative and General	148,376	139,986	142,866	151,069	139,117	103,977	112,658
Maintenance ⁽²⁾	217,455	215,118	212,530	219,812	213,666	163,568	160,870
Other	1,920	1,501	2,725	2,911	3,028	2,285	2,448
	1,198,901	1,186,157	1,052,761	1,466,823	1,722,689	1,303,303	1,164,409
Net Revenues	\$ 471,548	\$ 547,518	\$ 511,192	\$ 558,461	\$ 650,388	\$ 479,517	\$ 465,837
Coverage							
Principal and Interest Requirements	\$ 291,239	\$ 316,138	\$ 348,963	\$ 346,417	\$ 367,796	--	--
Ratio of Net Revenues to Principal and Interest Requirements.....	1.62	1.73	1.46	1.61	1.77	--	--

(1) Includes residential subsidy. See "Subsidies, Contributions in Lieu of Taxes and Set Aside" under *The System*.

(2) Includes, for maintenance of generating facilities, \$125.5 million, \$116.9 million, \$126.1 million, \$115.6 million and \$113.0 million for fiscal years ended June 30, 1997, 1998, 1999, 2000 and 2001, respectively. For the nine-months ended March 31, 2001 and 2002 the maintenance expense of generating facilities was \$90.9 million and \$86.7 million, respectively.

Management's Discussion and Analysis of Operating Results

The following represents the Authority's analysis of its operations for the nine month period ended March 31, 2001 and 2002, and for the five fiscal years ended June 30, 2001.

For the nine months ended March 31, 2002 as compared to the nine months ended March 31, 2001, Revenues and Current Expenses decreased by \$152.6 and \$138.9 million, respectively, resulting in a decrease in Net Revenues of \$13.7 million. The decrease in Revenues and Current Expenses was mainly due to a decrease of \$7.77 per barrel (or 25.7%) in the price of fuel oil. Accounts receivable of the Authority decreased \$16.2 million from \$410.7 million on June 30, 2001 to \$394.5 million on March 31, 2002. In addition, accounts receivable from the governmental sector increased slightly from \$93.1 million on June 30, 2001 to \$95.4 million in March 31, 2002.

For the fiscal year ended June 30, 2001 as compared to June 30, 2000, Revenues increased by \$347.8 million and Current Expenses increased by \$255.9 million, resulting in an increase in Net Revenues of \$91.9 million. The increase was mainly due to an increase in electric energy sales (in kWh) by 3.2% and an increase of \$5.79 per barrel (or 24.6%) in the price of fuel oil. Accounts receivable of the Authority increased from \$385.2 million on June 30, 2000 to \$410.7 million on June 30, 2001. In addition, accounts receivable from the governmental sector decreased from \$113.6 million on June 30, 2000 to \$93.1 million on June 30, 2001. This decrease was mainly due to the increase in the amount paid by the Authority in contributions of lieu of taxes from \$82.0 million in fiscal 2000 to \$115.5 million in fiscal 2001, which is used to offset the accounts receivable balance owed by the municipalities.

For the fiscal year ended June 30, 2000 as compared to June 30, 1999, Revenues increased by \$461.3 million and Current Expenses increased by \$414.1 million, resulting in an increase in Net Revenues of \$47.2 million. The increases are mainly due to the damage caused by Hurricane Georges in September 1998, which affected the results for the preceding fiscal year and to an increase of \$8.98 (or 61.7%) in the price per barrel of fuel oil. As a result, the accounts receivable of the Authority increased from \$305.9 million on June 30, 1999 to \$385.2 million on June 30, 2000. The increase on Accounts Receivable is related to the increase in Revenues and the proportion of accounts receivable to revenues is consistent with the preceding fiscal year. In addition, accounts receivable from governmental sector increased from \$83.0 million on June 30, 1999 to \$113.6 million on June 30, 2000 for the same reason.

For the fiscal year ended June 30, 1999, as compared to the fiscal year ended June 30, 1998, Revenues decreased by \$169.7 million and Current Expenses decreased by \$133.4 million, resulting in a decrease in Net Revenues of \$36.3 million. The decrease in Revenues and Current Expenses was mainly due to a decrease of \$3.83 per barrel (or 20.8%) in the price of fuel oil as well as the impact of the Hurricane Georges. Accounts receivable of the Authority decreased from \$379.7 million on June 30, 1998 to \$305.9 million on June 30, 1999. Accounts receivable from the governmental sector decreased from \$164.9 million on June 30, 1998 to \$83.0 million on June 30, 1999 mainly due to collections from Puerto Rico Aqueduct and Sewer Authority and other government agencies.

For the fiscal year ended June 30, 1998 as compared to June 30, 1997, Revenues increased by \$63.2 million and Current Expenses decreased by \$12.7 million resulting in an increase in Net Revenues of \$76.0 million. The growth in Revenues was mainly due to an increase of 8.3% in energy sales with energy consumption increases in all categories of clients. On June 30, 1998, accounts receivables of the Authority were \$379.7 million compared to \$351.6 million on June 30, 1997. Accounts receivable from the governmental sector increased from \$155.6 million on June 30, 1997 to \$164.9 million on June 30, 1998.

For the fiscal year ended June 30, 1997 as compared to June 30, 1996, Revenues increased by \$78.7 million and Current Expenses increased by \$53.8 million, resulting in an increase of \$24.9 million in Net Revenues.

The growth in Revenues was mainly due to an increase of \$68.1 million in fuel adjustment clause revenues as a result of higher fuel oil prices. Energy demand reflected a slight increase of 1.1% during this period. Current Expenses increased mainly due to a \$1.59 per barrel increase in the average cost of fuel oil. Accounts receivable of the Authority decreased from \$356.2 million on June 30, 1996 to \$351.6 million on June 30, 1997. Accounts receivable from the governmental sector decreased from \$159.4 million on June 30, 1996 to \$155.6 million on June 30, 1997.

The following table presents the disposition of Net Revenues, in the order of priority of payment, for the five fiscal years ended June 30, 2001 and for the nine-months ended March 31, 2001 and 2002, in accordance with the provisions of the 1974 Agreement. As discussed above, the Net Revenues shown below and in “Projected Net Revenues” under *Net Revenues and Coverage* are calculated in a manner that differs in several important respects from the Authority’s calculation of net income prepared in accordance with generally accepted accounting principles.

	Historical Disposition of Net Revenues					Nine Months Ended	
	(in thousands)					March 31,	
	Years Ended June 30,					2001	
	1997	1998	1999	2000	2001	2001	2002
Disposition of Net Revenues							
1974 Revenue Fund:							
1974 Sinking Fund:							
Interest	\$ 196,552	\$ 216,384	\$ 224,935	\$ 224,758	\$ 240,459	\$ 179,607	\$ 183,292
Principal	110,045	116,199	139,704	145,058	146,989	110,196	118,765
1974 Reserve Account.....	(7,000)	(8,881)	-	-	-	-	-
Reserve Maintenance Fund.....	3,960	5,004	6,000	7,000	7,000	5,247	5,247
Selfinsurance Fund.....	-	-	-	-	-	-	-
Capital Improvement Fund.....	70,153	106,157	62,958	74,265	100,500	75,012	60,640
General Obligation Notes:							
Interest	1,025	718	410	103	-	-	-
Contributions in lieu of taxes and other ⁽¹⁾	<u>96,813</u>	<u>111,937</u>	<u>77,185</u>	<u>107,277</u>	<u>155,440</u>	<u>109,455</u>	<u>97,893</u>
Net Revenues.....	<u>\$ 471,548</u>	<u>\$ 547,518</u>	<u>\$ 511,192</u>	<u>\$ 558,461</u>	<u>\$ 650,388</u>	<u>\$ 479,517</u>	<u>\$ 465,837</u>

(1) Including the following amounts retained by the Authority to offset certain Commonwealth obligations to the Authority, the residential subsidy and other subsidies granted to the hotel industry: \$17.9 million, \$20.0 million, \$18.1 million, \$23.5 million and \$33.6 million for fiscal years ended June 30, 1997, 1998, 1999, 2000 and 2001, respectively. For the nine months ended March 31, 2001 and 2002, those subsidies amounted to \$25.3 million and \$19.4 million, respectively. See “Subsidies, Contributions in Lieu of Taxes and Set Aside” under *The System*.

Factors Affecting the Utility Industry

The electric utility industry generally has faced and is facing certain adverse factors. These include (1) the cost of construction and operation of utility facilities, (2) the uncertain cost of capital, (3) regulations, licensing procedures, litigation and other factors which may delay the construction and increase the cost of new facilities or limit the use of, or necessitate costly modifications to, existing facilities, and (4) the substantially increased capital outlays and longer construction periods required for new facilities. The Authority is unable to predict the future effect of these or other factors upon its operations and financial condition.

The electric utility industry in the United States mainland is changing from a regulated monopoly business to a deregulated competitive industry. The Federal Energy Regulatory Commission (“FERC”) has mandated

wholesale wheeling and open access for transmission facilities owned by utilities that engage in interstate commerce. Many states have enacted or proposed laws and regulations which are designed to (i) insure open access to transmission facilities to promote wholesale power supply competition and (ii) phase in retail competition.

The Authority's competitive situation is different from that of most United States mainland utilities. There are no wholesale clients in the Commonwealth. The application of FERC's requirements to the Authority is limited because the Authority is not interconnected with any other utility. The Authority is not currently subject to FERC's regulations regarding wholesale wheeling.

The absence of mandated open access to the Authority's transmission and distribution system limits competition to on-site power for large industrial customers with little prospect of excess power sales. Additionally, the commercial availability of electric generating units depends heavily on economies of scale and tends not to be economic in small sizes, less than 60 MW, which size is significantly larger than the peak demand of the Authority's largest industrial customers.

The Authority continues to improve its competitive position by (i) improving its quality of service, (ii) rehabilitating its generating, transmission and distribution facilities to improve reliability and efficiency, (iii) diversifying its fuel sources, and (iv) adopting a capacity expansion plan which will meet its load requirements at the lowest System cost.

Projected Net Revenues

The main assumptions used by the Authority in preparing the estimates of Net Revenues are the following:

Revenues..... Projected Revenues from sales of electric energy are based upon economic growth projections for the Commonwealth. The Revenue projections assume annual sales growth of 3.2%.

Fuel..... Projected fuel prices are based upon an analysis prepared by the Authority. The following table sets forth projected average per barrel fuel prices:

Projected Fuel Prices

Years Ending June 30,	Average Price Per Barrel ⁽¹⁾
2002.....	\$21.82
2003.....	\$21.35
2004.....	\$22.38
2005.....	\$23.59
2006.....	\$25.41

(1) This is a blended price of No. 2 and No. 6 fuel oil prices. The prices exclude handling charges.

The following table presents the Authority's estimates of Net Revenues for the five fiscal years ending June 30, 2006, in accordance with the provisions of the 1974 Agreement, and the ratio of Net Revenues to Principal and Interest Requirements for Power Revenue Bonds.

Beginning in fiscal year 2000, a portion of the Authority's electric sales is derived from energy purchased from cogenerators. See "Adequacy of Capacity" under *The System*. For purposes of the following table and the 1974 Agreement, all payments by the Authority for the purchase of such energy are treated as a Current Expense and will be passed through to its clients in the same manner as its fuel costs are passed through. Payments to be made by the Authority for the purchase of power will fluctuate based on plant availability, price changes and other factors. See "Generating Facilities" under *The System* for a description of the benefits to the Authority of the integration of the EcoEléctrica and AES-PR cogeneration facilities into the Authority's System.

Projected Net Revenues and Coverage

	Years Ending June 30,				
	2002 ⁽¹⁾	2003	2004	2005	2006
Average number of clients.....	1,384,206	1,403,844	1,424,481	1,444,121	1,464,762
Electric energy sales (in millions of kWh).....	19,051.3	19,756.2	20,352.2	20,823.7	21,655.4
Authority generation (gross)(in millions of KWh).....	19,576.6	17,157.5	17,622.1	18,393.2	19,512.4
Purchased generation (gross)(in millions of KWh).....	2,986.0	6,195.0	6,435.0	6,221.0	6,085.0

<u>Sources of Net Revenues</u>	(dollars in thousands)				
Revenues:					
Sales of electrical energy:					
Residential.....	\$ 717,119	\$ 766,354	\$ 782,243	\$ 809,770	\$ 851,101
Commercial.....	958,533	1,037,601	1,101,832	1,154,489	1,235,627
Industrial.....	377,723	411,788	430,525	454,049	481,285
Other.....	85,055	90,734	91,909	92,548	93,665
	<u>2,138,430</u>	<u>2,306,477</u>	<u>2,406,509</u>	<u>2,510,856</u>	<u>2,661,678</u>
Revenues from Commonwealth for					
Rural Electrification.....	739	704	591	161	116
Other (principally, interests earned).....	33,573	37,115	39,115	41,115	43,115
	<u>2,172,742</u>	<u>2,344,296</u>	<u>2,446,215</u>	<u>2,552,132</u>	<u>2,704,909</u>
Current Expenses ⁽²⁾ :					
Operations.....					
Fuel.....	696,408	594,334	638,146	699,579	786,835
Purchased Power.....	229,265	438,830	450,989	458,351	461,651
Other Production.....	44,707	35,533	36,268	37,019	37,785
Transmission and Distribution.....	85,672	83,400	85,126	86,888	88,686
Customer Accounting and Collections.....	82,614	79,707	81,356	83,040	84,759
Administration and general.....	171,986	181,624	185,382	189,219	193,138
Maintenance.....	233,057	249,901	255,071	260,352	265,741
Other – Interest Charges.....	3,263	2,027	2,078	2,130	2,183
	<u>1,546,972</u>	<u>1,665,356</u>	<u>1,734,416</u>	<u>1,816,578</u>	<u>1,920,778</u>
Net Revenues.....	<u>\$ 625,770</u>	<u>\$ 678,940</u>	<u>\$ 711,799</u>	<u>\$ 735,554</u>	<u>\$ 784,131</u>

Coverage

Principal and Interest Requirements ⁽³⁾	\$ 392,043	\$ 382,519	\$ 430,888	\$ 477,554	\$ 500,056
Ratio of Net Revenues to Principal and Interest Requirements.....	1.60	1.77	1.65	1.54	1.57

(1) Based on actual results through March 31, 2002 and estimates for the remainder of the fiscal year.

(2) The Current Expenses (excluding fuel oil and purchased power) projections assume an annual growth of 2.0%.

- (3) Includes debt service requirements for (i) the outstanding Power Revenue Bonds (including the Bonds, but excluding the Refunded Power Revenue Bonds and the Defeased N and O Power Revenue Bonds), and (ii) expected Power Revenue Bond issues, all at an assumed interest rate of 6.25% (\$644.3 million in fiscal year 2004 and \$463.9 million in fiscal year 2005) (no repayments of principal of these issues are assumed until after fiscal year 2004).

The Authority's estimates of Net Revenues, which were made as part of the adoption of its operating budget for fiscal year 2002, have been reviewed and analyzed by the Consulting Engineers. The Consulting Engineers have concluded that (i) the methodology used by the Authority in preparing its revenue and capacity projections generally follows accepted utility practice and is appropriate for the Authority, (ii) the Authority's estimates of future growth form a reasonable basis for its projected operating results, and (iii) the Authority's rates should generate sufficient revenues to pay its Current Expenses and debt service and to finance that portion of its capital improvement program that is currently anticipated to be financed with current operating revenues. See Appendix III, *Letter of Consulting Engineers*.

Although the Authority and the Consulting Engineers believe that the assumptions upon which the estimates of Net Revenues are based are reasonable, actual results may differ from the estimates as circumstances change. In addition, such projections were not intended to comply with the guidelines established by the American Institute of Certified Public Accountants for preparation and presentation of financial projections. The projections have been prepared on the basis of Net Revenues as defined in the 1974 Trust Agreement which differs in several important respects from the Authority's net income prepared in conformity with generally accepted accounting principles in that they do not include, for example, depreciation as a current expense and do not reflect interest expense as a deduction from Net Revenues.

The following table presents the projected disposition of Net Revenues, in the order of priority of payment, for the five fiscal years ending June 30, 2006, in accordance with the provisions of the 1974 Agreement.

**Projected Disposition of Net Revenues
(in thousands)**

Disposition of Net Revenues	Years Ending June 30,				
	2002	2003	2004	2005	2006
1974 Revenue Fund:					
1974 Sinking Fund:					
Interest	\$247,982	\$249,878	\$255,621	\$288,626	\$292,492
Principal	158,357	137,937	178,402	188,928	207,564
Reserve	-	-	-	-	-
Reserve Maintenance Fund	7,000	7,000	7,000	7,000	7,000
Self-insurance Fund	-	-	-	-	-
Capital Improvement Fund	82,158	125,687	105,344	77,540	92,012
Contributions in lieu of taxes and other ⁽¹⁾	<u>130,273</u>	<u>158,438</u>	<u>165,432</u>	<u>173,460</u>	<u>185,063</u>
Total Net Revenues	<u>\$625,770</u>	<u>\$678,940</u>	<u>\$711,799</u>	<u>\$735,554</u>	<u>\$784,131</u>

(1) Include amounts to be retained by the Authority and used to pay interest on its General Obligation Notes and to offset certain Commonwealth obligations to the Authority, the residential subsidy and the subsidy granted to the hotel industry: \$24.6 million, \$20.0 million, \$21.0 million, \$22.8 million and \$25.4 million for fiscal years ending June 30, 2002, 2003, 2004, 2005 and 2006, respectively. See "Subsidies Contributions in Lieu of Taxes and Set Aside" under *The System*.

ENVIRONMENTAL MATTERS

The Authority's Planning and Environmental Protection Directorate (the "Directorate") is responsible for ensuring the Authority's compliance with all applicable federal and Commonwealth environmental laws and regulations. The Directorate is in charge of developing and implementing a comprehensive program to improve the Authority's performance in all applicable environmental media, taking into account new regulatory requirements as well as alleged instances of noncompliance cited by the Environmental Protection Agency ("EPA") and any other environmental agencies.

Environmental Litigation

In February 1992, EPA conducted a multimedia inspection of the Authority's four thermoelectric plants as well as the Monacillos Transmission Center. EPA released a report of its findings in December 1992. In its findings, EPA identified several alleged instances of non-compliance related to the Authority's air, water and oil spill prevention control and countermeasures compliance programs.

The Authority and EPA undertook negotiations to resolve the issues regarding the deficiencies observed during the inspection and to ensure future compliance with all applicable laws and regulations. As a result of the negotiations, the Authority and EPA reached an agreement that resulted in a Consent Decree approved by the United States District Court for the District of Puerto Rico on March 19, 1999. In the Consent Decree, the Authority agreed to pay a civil penalty of \$1.5 million and to implement additional compliance projects amounting to \$4.5 million. The Authority made the payment for the final installment corresponding to the civil penalty and has updated deposits to the installments required by the Consent Decree for the additional environmental projects. Furthermore, the Consent Decree requires that the Authority improve and implement compliance programs and operations in order to assure compliance with environmental laws and regulations.

In September 1995, while preparing for Hurricane Luis, approximately 270,000 gallons of dilute sulfuric acid (low ph) wastewater were accidentally discharged from the Palo Seco power plant into the Bayamón River, affecting marine life and one percent of a nearby mangrove wetland. After investigations by EPA and the United States Department of Justice, the Authority was charged with violations of the Clean Water Act. On June 12, 1999, the Authority was ordered to pay a \$140,000 fine, which it has paid, and was placed on probation for two years. Prior to the expiration of the probation period, the Authority was briefly in technical violation of the conditions of the probation. Said violation has been corrected. As a result of the foregoing, and although the original probation period has expired, the Authority and the U.S. Department of Justice are currently negotiating an extension to the original probation period. The Authority expects that a settlement agreement will be filed before the United States District Court during June 2002.

In November 1999, pursuant to the provisions of the Consent Decree, the Authority filed a Notice of Dispute Resolution with the United States District Court for the District of Puerto Rico to contest EPA's interpretation of the applicable method to determine visible emission from the generating units. In this Notice, the Authority disputes the specific location where to "read" the visible emissions of the plume. In December 1999, the Authority filed another Notice of Dispute Resolution pursuant to the Consent Decree to dispute EPA's determination that the Costa Sur power plant is a repetitious violator of the visible emission requirements of the Consent Decree. The Authority has received several notices of violation in this respect, but the outcome of such notices depends upon the resolution of EPA's interpretations explained above. Both Notices of Dispute Resolution are pending before the United States District Court.

Compliance Programs

The Authority continues to develop and implement a comprehensive program to improve environmental compliance in all applicable environmental media. This program has been and continues to be updated to conform to new regulatory requirements.

As of March 31, 2002, the Authority has incurred approximately \$6.3 million in order to comply with said regulatory requirements. The Authority estimates that it will spend approximately \$28.9 million for such purposes during fiscal year 2003.

Air Quality Compliance

The Authority has increased its effort to reduce visible emissions at the Aguirre and Costa Sur power plants. While current operating permits allow the utilization of No. 6 fuel oil with up to 1.5% sulfur content, the Authority continues voluntarily to burn No. 6 fuel oil with 1.0% sulfur content. In general, the Authority is consistently maintaining over a 99% level of compliance with in-stack opacity requirements.

The Authority is also reducing visible emissions by improving boiler maintenance and utilizing fuel additives. Currently, on an experimental basis, the Authority is using water and oil-based fuel additives at the Aguirre power plant and expects to use the same at the Costa Sur power plant.

EPA issued an administrative order to allow the removal of the SCR (“Selected Catalytic Reduction”) system from the Authority’s combustion turbine plant in Arecibo. As a result of the issuance of said administrative order, the PSD (“Prevention of Significant Deterioration”) permit will be revised accordingly. The removal of the SCR system would have the effect of eliminating ammonia injection for Nitrogen Oxide emission control, resulting in expected savings of approximately \$5 million annually.

EcoEléctrica’s cogeneration project decreased the Authority’s dependence on fuel oil. The completion of the AES-PR cogeneration project will also enable the Authority to further reduce its dependence on fuel oil.

After implementing the Air Quality Compliance Programs pursuant to the Consent Decree, the Authority is expected to be in full compliance with all visible emission requirements.

Water Quality Compliance

During this fiscal year, the Authority achieved a 98% level of compliance with the Clean Water Act regulations.

The Authority has completed compliance plans for abating water pollution at the Aguirre, San Juan, Costa Sur, and Palo Seco power plants as required by the Consent Decree. For fiscal year 2003, the Authority expects to spend approximately \$3.14 million in water pollution abatement projects.

On April 13, 1995, the Authority submitted to EPA a 316(a) Reopener Clause Draft Final Plan of Study for the Costa Sur power plant, requesting that it be permitted to discharge into the Caribbean Sea heated water that was previously used as part of the plant’s combustion/generation process (“thermal effluent”). In a letter dated December 20, 2000, EPA indicated that it was prepared to deny the Authority’s 316(a) request for its thermal effluent discharge. After extensive negotiations, EPA agreed that the Authority should perform an assessment of possible alternatives. On March 21, 2001, the Authority submitted to EPA a proposed plan which included a phased review of alternatives for the discharge of its thermal effluent. Said plan also included an analysis that would determine the feasibility, reliability, potential effectiveness, and cost evaluation of these alternatives. In a letter dated August 23, 2001, EPA indicated that it would continue a cooperative effort with the Authority in order to develop a compliance plan for the disposition of the plants’ thermal effluent. Currently, the

Authority is trying to schedule a meeting with EPA in order to clarify EPA's position regarding the Authority proposed plans. The Authority expects to be able to discuss its proposed alternatives and receive a response from EPA soon.

Underground Injection Control Regulation

The Authority has prepared a compliance plan in order to comply with EQB's Underground Injection Control Regulation. The compliance plan consists of the licensing and construction of septic systems. In addition, the compliance plan includes the closing of systems where sanitary discharges can be connected to the facilities of the Puerto Rico Aqueduct and Sewer Authority. The Authority's Capital Improvement Program for fiscal year 2003 includes \$4.1 million for the compliance plan. Currently, the Authority is reviewing the compliance plan before final submission to the EQB.

Spill Prevention Control and Countermeasures Plan

To meet its obligations with respect to the Spill Prevention Control and Countermeasures Plan Act requirements and Consent Decree, the Authority will continue to implement corrective measures at all of its facilities. The compliance measures for this program are estimated to cost approximately \$37.6 million. The Authority estimates that it will spend approximately \$13.3 million during fiscal year 2003.

PCB Testing

The Authority has completed a ten-year EPA-mandated program to sample, test and identify its oil-filled transformers and other equipment in order to comply with applicable PCB regulations. As of March 31, 2002, the Authority had sampled and analyzed approximately 137,909 distribution transformers. The Authority continues to implement a program for the removal and disposal of all transformers with a PCB concentration of 50 ppm or greater. The Authority estimates that approximately 3,000 PCB or PCB contaminated distribution transformers still need to be removed. This program was initially scheduled to be completed by December 31, 2001. EPA, however, has granted the Authority an extension to said program. At the expected rate of disposal of 2,000 units per year, the Authority expects to complete the program by the first quarter of fiscal year 2004. For fiscal year 2003, the Authority has allocated \$4.0 million for the PCB removal and disposal program and an additional \$1 million for the removal and disposal of the remaining PCB distribution transformers.

Asbestos Abatement

The Authority is engaged in encapsulating and/or gradually removing asbestos-containing insulation from its power plants. For fiscal year 2003, the Authority has allocated \$1.3 million for the asbestos abatement program.

Capital Improvement Program

The Authority's Capital Improvement Program for the five fiscal years ending June 30, 2007 includes \$97.8 million in order to comply with existing Commonwealth and federal environmental laws and regulations. The Authority believes it is taking the necessary steps to comply with all applicable environmental laws and regulations and Consent Decree requirements. See "Projected Five-Year Capital Improvement and Financing Program" under *The System*.

INSURANCE

Coverage

The Authority maintains, among others, insurance policies covering all-risk property (excluding transmission and distribution lines), boiler and machinery and public liability. The Authority has placed all-risk property and boiler and machinery policies with a combined coverage of \$400 million per occurrence. The policies' self-retention in case of earthquake and windstorm losses is \$25 million, \$1 million for all other covered risks, except boiler and machinery losses which carry a \$2 million retention.

The proceeds of the all-risk property, boiler and machinery policies are used prior to drawing upon the Reserve Maintenance Fund or the Self-insurance Fund established under the 1974 Agreement.

The public general liability policy covers property damage and bodily injury to third parties with a \$50 million aggregate limit in excess of the self-retention limit of \$1 million per occurrence.

The Authority's transmission and distribution facilities are as susceptible to adverse weather conditions, such as hurricanes, as electric utilities located on the east coast of the United States mainland. The Authority is currently self-insured with respect to property damage for its transmission and distribution systems, as are most other U.S. utilities. Accordingly, while the Authority and Consulting Engineers believe that the Authority reserves are generally sufficient, there can be no assurance that the Authority will be able to provide adequate coverage for damage that might be incurred as a result of any future adverse weather conditions.

In the Authority's opinion, its insurance coverage adequately indemnifies it against property damage or bodily injury resulting from the possession, operation and maintenance of the System by the Authority.

The State Insurance Fund, a Commonwealth agency which provides worker's compensation insurance, is funded by mandatory contributions from employers.

Self-insurance Fund

The Authority has supplemented the 1974 Agreement to create a Self-insurance Fund, which is funded from Net Revenues (after deposits to the Sinking Fund and the Reserve Maintenance Fund). The Authority has no obligation to make deposits to, or to replenish, the Self-insurance Fund in the event of withdrawals therefrom. Amounts on deposit in the Self-insurance Fund are available for the payment of principal of and interest on the Power Revenue Bonds. As of March 31, 2002, approximately \$75.3 million were on deposit in the Self-insurance Fund. See "Disposition of Revenues" under Appendix I, *Summary of Certain Provisions of the 1974 Agreement Excluding Proposed Supplemental Agreement*.

LABOR RELATIONS

As of April 30, 2002, the Authority had 9,557 employees (including Irrigation System Employees), of which 490 were temporary unionized employees. Of such employees, 6,765 were represented by four local unions. The Electrical Industry and Irrigation Workers Union ("UTIER") represents 5,372 employees engaged in operations and maintenance. The three other unions represent construction workers (Insular Union of Industrial and Electrical Construction Workers Union or "UITICE"), professional employees (Independent Professional Employees Union or "UEPI"), and pilots (Power Authority Pilots Union or "UPAEE") employed by the Authority.

The agreement with UITICE expires on January 29, 2005. The agreement with UTIER expires on November 14, 2005 and the agreement with UEPI expires on December 18, 2004. The agreement with UPAEE expires on July 2, 2002. There is a preliminary agreement between the Authority and UPAEE, which is subject to

certain approvals, but is expected to be signed on or before July 2, 2002. This agreement with UPAAE would expire on July 2, 2006.

Of the 9,557 employees, 3,265 are employed in the transmission and distribution facilities directorate, 2,286 are employed in the generating facilities directorate, 1,624 are employed in the customer service directorate, and the remainder is employed in the administrative directorates and other areas. In order to improve the productivity of its employees, the Authority has instituted various programs to reduce absenteeism, increase safety measures, and reduce the level of drug use among its workers. In addition, the Authority continues to implement programs to provide both technical and supervisory training to its employees. The Authority believes that the implementation of these programs provides for more reliable service for its clients.

PENSION PLAN

Employees' Retirement System of Puerto Rico Electric Power Authority (the "Retirement System"), a separate trust fund created by the Authority, administers the Authority's pension plan, which provides employee retirement and death benefits. The pension plan provides for contributions by both the Authority, based on annual actuarial valuations, and the plan members. The contributions recorded as of June 30, 2001 and March 31, 2002 were \$34.9 million and \$32.8 million, respectively. This represents 7.01% and 5.56% for the fiscal year 2001, and 7.01% and 7.82% for the nine months ended March 31, 2002, of covered payroll for normal cost and unfunded actuarial accrued liability for each of the indicated years. Employee contributions and other withholdings are being paid to the Retirement System on a current basis. In the nine months ended March 31, 2001, total pension expense of the Authority was approximately \$32.8 million, including approximately \$17.3 million for past service costs. Unfunded past service liability to be borne entirely by the Authority approximated \$417 million as of June 30, 2001. As of June 30, 2001, the date of the last actuarial valuation of the Retirement System, the pension plan was 83% funded.

The Retirement System's financial statements are audited by a firm of independent public accountants that does not serve as independent accountants to the Authority. See *Independent Accountants*.

LITIGATION

There is no pending litigation of any nature restraining or enjoining or seeking to restrain or enjoin the issuance, sale or delivery of the Bonds or in any way contesting or affecting the validity of the Bonds, the resolutions or the proceedings of the Authority taken with respect to the authorization, issuance or sale thereof, or the pledge or application of any moneys under the 1974 Agreement or the existence or powers of the Authority.

The Authority is involved in various lawsuits arising in the normal course of business none of which, in the opinion of the Authority and its General Counsel, if decided against the Authority, would have a material adverse effect on the Authority's financial condition and/or operations. Among the cases currently pending, some deal with environmental issues. These are described above in "Environmental Litigation" under *Environmental Matters*.

In May 1998, the Municipality of Ponce filed a complaint against the Authority in the Court of First Instance, Superior Section San Juan Part requesting the payment by the Authority of the full contributions in lieu of taxes and electric energy sales set aside for prior fiscal years. The complaint challenges the Authority's disposition of Net Revenues in order to make deposits to certain funds under the 1974 Agreement and under a previous indenture for the purposes of paying costs of capital improvements and seeks a payment by the Authority in the amount by which the amount available to pay contributions in lieu of taxes and electric energy sales set aside to the Municipality of Ponce has been reduced as a result of such disposition. The Authority has filed a motion to dismiss the complaint. Currently, the case is in the discovery phase. The Court has designated a

special commissioner to study the allegations of the Municipality of Ponce. The Authority believes that because the Act provides that the contributions in lieu of taxes and electric energy sales set aside are only payable after complying with the Authority's deposit obligations under the 1974 Agreement and such previous indenture and shortfalls do not carry forward as future liabilities of the Authority as described above, it is legally entitled to make such deposits even if the effect is to reduce such contributions and set aside available to municipalities. As of May 31, 2002, 51 municipalities have filed complaints against the Authority requesting the payment by the Authority of the full contribution in lieu of taxes and electric energy sales set aside for prior fiscal years.

On May 18, 2000, Abengoa, Puerto Rico, S.E. ("Abengoa"), the Authority's contractor for the repowering of San Juan Units 5 and 6, unilaterally declared a termination of the contract and filed a complaint for breach of contract. The Authority filed a counter claim for breach of contract and for all damages caused to the Authority by the allegedly illegal contract termination. The Authority believes that the actions by the contractor will not materially affect the ability of the Authority to provide service nor will there be a material difference in the quality of service provided by the Authority.

TAX EXEMPTION

The Internal Revenue Code of 1986, as amended (the "Code"), includes requirements regarding the use, expenditure and investment of bond proceeds and the timely payment of certain investment earnings to the Treasury of the United States, if required, which requirements the Authority 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 Authority's 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 Authority has covenanted to comply, to the extent permitted by the Constitution of the Commonwealth 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 Authority from complying with the requirements of the Code.

In the opinion of Sidley Austin Brown & Wood LLP, Bond Counsel, subject to continuing compliance by the Authority with the tax covenant referred to above, under the provisions of the Acts of Congress now in force and under existing regulations, rulings and court decisions, interest on the Bonds will not be includable in gross income for federal income tax purposes. Interest on the Bonds 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 Sidley Austin Brown & Wood LLP 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 S Corporations with excess passive income, individual

recipients of Social Security or Railroad Retirement benefits, taxpayers who may be deemed to have incurred or continued indebtedness to purchase or carry tax-exempt obligations and taxpayers who may be eligible for the earned income tax credit.

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

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 is to 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 Bonds 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 Bonds is required to decrease his adjusted basis in such Bonds by the amount of amortizable bond premium attributable to each taxable year such Bonds are held. An owner of such Bonds 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 Bonds and with respect to the state, Commonwealth and local tax consequences of owning and disposing of such Bonds.

VERIFICATION OF MATHEMATICAL COMPUTATIONS

Samuel Klein and Company will verify from the information provided to them the mathematical accuracy as of the date of the closing on the 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, interest and call premium payment requirements, if any, of the Refunded Power Revenue Bonds. Samuel Klein and Company will express no opinion on the assumptions provided or as to the exemption from taxation of the interest on the Bonds.

UNDERWRITING

The Underwriters have jointly and severally agreed, subject to certain conditions, to purchase the Bonds from the Authority at an aggregate discount of \$2,878,216.83 from the initial public offering prices for such Bonds set forth or derived from information contained on the inside cover page hereof. The obligations of the Underwriters are subject to certain conditions precedent, and they will be obligated to purchase all of the Bonds, if any such Bonds are purchased. The Underwriters may offer to sell the Bonds to certain dealers and others at prices lower than the initial public offering prices. The offering prices may be changed from time to time by the Underwriters. The Authority has agreed to indemnify, to the extent permitted by law, the Underwriters against certain liabilities, including liabilities under federal securities laws.

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

MATERIAL RELATIONSHIPS

Washington Group International, Inc., independent Consulting Engineers to the Authority, has a contractual relationship with AES to provide engineering, procurement, and construction services in connection with a combined cycle power plant under construction in New Jersey.

See also *Government Development Bank for Puerto Rico*, below.

LEGAL MATTERS

The proposed form of opinions of Sidley Austin Brown & Wood LLP, New York, New York, Bond Counsel, is set forth in Appendix IV to this Official Statement. Certain legal matters will be passed upon for the Underwriters by Fiddler González & Rodríguez, LLP, San Juan, Puerto Rico.

LEGAL INVESTMENT

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

GOVERNMENT DEVELOPMENT BANK FOR PUERTO RICO

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

INDEPENDENT ACCOUNTANTS

The financial statements as of June 30, 2001 of the Authority included in Appendix II hereto have been audited by Ernst & Young LLP, San Juan, Puerto Rico, independent accountants, as stated in their report appearing therein. The financial statements of the Authority as of June 30, 2000 and for the year then ended have been audited by PricewaterhouseCoopers LLP, independent accountants.

The prospective financial information included in this Official Statement has been prepared by, and is the responsibility of the management of the Authority. Ernst & Young LLP has neither examined nor compiled the accompanying prospective financial information, and accordingly, Ernst & Young LLP does not express an opinion or any other form of assurance with respect thereto.

The Ernst & Young LLP report for fiscal year 2001 included in Appendix II to this Official Statement relates to the historical financial information of the Authority. Such report does not extend to the prospective financial information and should not be read to do so.

RATINGS

The Bonds have been assigned ratings of “Baa1” by Moody’s and “A-” by S&P. These ratings do not reflect the expected issuance by FSA, MBIA and XLCA or their respective insurance policies covering the Insured Bonds (the “Policies”). Moody’s and S&P have given the Insured Bonds ratings of “Aaa” and “AAA”, respectively, based on the expected issuance of the 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 the ratings will continue for any given period of time or will not be revised downward or withdrawn entirely by any or all of such rating agencies. Any such downward revision or withdrawal of the ratings could 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, the Authority has covenanted in its resolution authorizing the issuance of the Bonds for the benefit of the Beneficial Owners (as defined in such Resolution and generally the tax owners of the Bonds):

(a) to file within 275 days after the end of each fiscal year beginning after its fiscal year ending June 30, 2002, with each NRMSIR and with any Commonwealth state information depository (“SID”), core financial information and operating data for the prior fiscal year, including (i) the Authority’s audited financial statements, prepared in accordance with generally accepted accounting principles in effect from time to time, and (ii) material historical quantitative data (including financial information and operating data) on the Authority’s System and revenues, expenditures, financial operations and indebtedness generally found in this Official Statement; and

(b) to file in a timely manner, with each NRMSIR or with the Municipal Securities Rulemaking Board (“MSRB”), and with any Commonwealth SID, notice of failure of the Authority to comply with clause (a) above and notice of any of the following events with respect to the Bonds, if material:

- (i) principal and interest payment delinquencies;
- (ii) non-payment related defaults;
- (iii) unscheduled draws on debt service reserves reflecting financial difficulties;
- (iv) unscheduled draws on credit enhancements reflecting financial difficulties;
- (v) substitution of credit or liquidity providers, or their failure to perform;
- (vi) adverse opinions or events, affecting the tax exempt status of the Bonds;
- (vii) modifications to rights of security holders (including Beneficial Owners) of the Bonds;
- (viii) Bond calls;
- (ix) defeasances;
- (x) release, substitution, or sale of property securing repayment of the Bonds; and
- (xi) rating changes.

With respect to the following events:

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

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

Event (viii). The Authority does not undertake to provide the above-described event notice of a mandatory scheduled redemption, not otherwise contingent upon the occurrence of an event, if the terms, dates and amounts of redemption are set forth

in detail in this Official Statement under “*Description of the Bonds—Redemption Provisions*”, the only open issue is which Bonds will be redeemed in the case of a partial redemption, notice of redemption is given to the Bondholders as required under the terms of the Bonds, and public notice of the redemption is given pursuant to Securities Exchange Act of 1934 Release No. 34-23856 of the SEC, even if the originally scheduled amounts are reduced by prior optional redemptions or Bond purchases.

As of May 31, 2002, there is 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 J.J. Kenny Repository, 55 Water Street, 45th Floor, New York, New York 10041; FT Interactive Data, Attn: NRMSIR, 100 William Street, New York, New York 10038; and DPC Data Inc., One Executive Drive, Fort Lee, New Jersey 07024.

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

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

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 Authority written notice of any request to cure such breach, and the Authority shall have refused to comply within a reasonable time. All Proceedings shall be instituted only in a Commonwealth court located in the Municipality of San Juan, Puerto Rico for the equal benefit of all Beneficial Owners of the outstanding Bonds benefited by the Covenants, and no remedy shall be sought or granted other than specific performance of the Covenant at issue. Notwithstanding the foregoing, no challenge to the adequacy of the information provided in accordance with the filings mentioned in paragraphs (a) or (b) above may be prosecuted by any Beneficial Owner except in compliance with the remedial and enforcement provisions contained in Article VIII of the 1974 Agreement. See “Remedies of Bondholders” under *Summary of Certain Provisions of the 1974 Agreement Excluding Proposed Supplemental Agreement* in Appendix I.

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 Authority, 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 interests of Beneficial Owners, as determined by parties unaffiliated with the Authority; 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 Authority elects that the Covenants shall be deemed amended accordingly.

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

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

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

MISCELLANEOUS

The foregoing summaries of or references to certain provisions of the 1974 Agreement, the proposed Supplemental Agreement, the various acts and the Bonds are made subject to all the detailed provisions thereof to which reference is hereby made for further information and do not purport to be complete statements of any or all of such provisions.

There are appended to this Official Statement (i) summaries of the 1974 Agreement and the proposed Supplemental Agreement, (ii) the financial statements of the Authority for the fiscal years ended June 30, 2001 and June 30, 2000, together with the independent accountants' report of Ernst & Young LLP, San Juan, Puerto Rico for fiscal year 2001, (iii) a letter from the Authority's Consulting Engineers, Washington Group International, Inc., regarding its opinion as to certain engineering matters in this Official Statement, (iv) the proposed form of opinions of Sidley Austin Brown & Wood LLP, Bond Counsel, and (v) a specimen of each of the Policies relating to the Insured Bonds.

The information set forth in this Official Statement, except for certain information on page (i) and the information appearing in *Underwriting, Material Relationships, Appendices III, V, VI and VII* and the information pertaining to DTC, FSA, MBIA and XLCA, was supplied by the Executive Director of the Authority in his official capacity as such Executive Director and is included in this Official Statement on his authority. The information pertaining to DTC, FSA, MBIA and XLCA was supplied by DTC, FSA, MBIA and XLCA, respectively.

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

PUERTO RICO ELECTRIC POWER AUTHORITY

By: /s/ Héctor R. Rosario
 Executive Director

APPENDIX I

DEFINITIONS OF CERTAIN TERMS

The following statements are definitions of certain terms defined in Section 101 of the 1974 Agreement and in this Official Statement.

“Accreted Value” means with respect to any Capital Appreciation Bonds (i) as of any Valuation Date, the amount set forth for such date in the resolution authorizing such Capital Appreciation Bonds and (ii) as of any other date, the sum of (a) the Accreted Value on the preceding Valuation Date and (b) the product of (1) a fraction, the numerator of which is the actual number of days having elapsed from the preceding Valuation Date and the denominator of which is the actual number of days from such preceding Valuation Date to the next succeeding Valuation Date and (2) the difference between the Accreted Values for such Valuation Dates.

“Amortization Accrual” means for any period the amount of an Amortization Requirement that would accrue during such period if such Requirement accrued ratably on the basis of a year consisting of twelve (12) thirty-day months. Unless otherwise provided by the Authority, the monthly Amortization Requirement accrual for a term bond begins on the first day of each month in the fiscal year for which such Requirement has been established and shall end on the first day of the month succeeding the relevant Deposit Day.

As applied to the term bonds of any Series, “Amortization Requirement” for any fiscal year means the principal amount fixed or computed for such fiscal year for the retirement of such term bonds by purchase or redemption.

The Amortization Requirements for the term bonds of each Series shall be initially the respective principal amounts for each fiscal year as fixed in a resolution of the Board adopted prior to the issuance of the bonds of such Series. The aggregate amount of such Amortization Requirements for the term bonds of each Series shall be equal to the aggregate principal amount of the term bonds of such Series.

If at the close of any fiscal year the total principal amount of term bonds of any Series retired by purchase or redemption, or prior to the close of such fiscal year called for redemption, shall be in excess of the amount of the Amortization Requirements for the term bonds of such Series for such fiscal year, then the amount of the Amortization Requirements for the term bonds of such Series shall be reduced for such subsequent fiscal years in such amounts aggregating the amount of such excess as shall be determined by the Executive Director in an order filed with the 1974 Trustee on or before the 10th day of July following the close of such fiscal year.

If at the close of any fiscal year the total principal amount of term bonds of any Series retired by purchase or redemption, or called for redemption, prior to the close of such fiscal year shall be less than the amount of the Amortization Requirements for the term bonds of such Series for such fiscal year, then the amount of the Amortization Requirements for the term bonds of such Series for the next succeeding fiscal year shall be increased by the amount of the excess of such deficiency over the amount then held to the credit of the Redemption Account in the 1974 Sinking Fund.

The 1974 Trustee is required, on or before the 15th day of July in each fiscal year, to compute the Amortization Requirements for the then current fiscal year for the term bonds of each Series then outstanding. The Amortization Requirement for the then current fiscal year shall continue to be applicable during the balance of such current fiscal year, and no adjustment shall be made during such year by reason of term bonds purchased or redeemed or called for redemption during such current fiscal year.

“Capital Appreciation Bonds” means any bonds as to which interest is payable only at the maturity or prior redemption of such bonds. For the purposes of (i) receiving payment of the redemption price if a Capital Appreciation Bond is redeemed prior to maturity, or (ii) receiving payment of a Capital Appreciation Bond if the principal of all bonds is declared immediately due and payable following an event of default as provided in Section 802 of the 1974 Agreement, or (iii) computing the principal amount of bonds held by the registered owner of a

Capital Appreciation Bond in giving to the Authority or the 1974 Trustee any notice, consent, request, or demand pursuant to the 1974 Agreement for any purpose whatsoever, the principal amount of a Capital Appreciation Bond shall be deemed to be its Accreted Value. In the case of Capital Appreciation Bonds that are convertible to bonds with interest payable prior to maturity or prior redemption of such bonds, the term “Capital Appreciation Bonds” shall be limited to the period prior to such conversion, and after such conversion, the bonds shall be viewed as any other bonds of the same type for purposes of the 1974 Agreement.

“Current Expenses” means the Authority’s reasonable and necessary current expenses of maintaining, repairing and operating the System, including, but not limited to, all administrative expenses, insurance premiums, expenses of preliminary surveys not chargeable to capital expenditures, engineering expenses relating to operations and maintenance, fees and expenses of the 1974 Trustee and any paying agents, legal expenses, any payment to pension or retirement funds and all other expenses required to be paid by the Authority under the 1974 Agreement or by law or permitted by standard practices for public utility systems similar to the properties and business of the Authority, but shall not include any deposits to the credit of the 1974 Sinking Fund, the Reserve Maintenance Fund, the Subordinate Obligations Fund, the Self-insurance Fund or the Capital Improvement Fund.

“Deposit Day” means the date by which all of the moneys then held to the credit of the Revenue Fund shall be withdrawn by the Treasurer and deposited in the manner set forth in “Disposition of Revenues” in *Summary of Certain Provisions of the 1974 Agreement Excluding Proposed Supplemental Agreement* below.

“Designated Maturity Bonds” means the indebtedness incurred by the Authority under the terms of a separate trust agreement or resolution, which indebtedness has a maturity of at (east ten (10) years and is secured, as to the unamortized principal thereof, on a subordinate basis to the bonds and for which (i) no amortization of principal has been established or (ii) the aggregate amount of the amortized principal that has been established is less than the principal amount of the indebtedness; provided that interest on said indebtedness and any amortized principal of said indebtedness may be payable on a parity, respectively, with interest on bonds and Amortization Requirements on term bonds, in which case said interest and amortized principal shall be calculated as Principal and Interest Requirements on bonds for purposes of the 1974 Agreement and shall otherwise be deemed to be, and be payable as interest and Amortization Requirements on, bonds for purposes of the 1974 Agreement.

“Extendible Maturity Bonds” means bonds the maturities of which, by their terms, may be extended by and at the option of the bondholder or the Authority.

“Independent Consultant” means the consultant at the time employed by the Authority under the provisions of the 1974 Agreement to perform and carry out the duties of the Independent Consultant.

“Interest Accrual” means for any period the amount of interest that would accrue during such period if such interest accrued ratably on the basis of a year consisting of twelve (12) thirty-day months. Unless otherwise provided by the Authority, the monthly accrual in respect of interest on the bonds shall commence on the later to occur of the date of issue of the bonds of such Series and the date that is six months prior to the due date of such interest and shall end on the first day of the month following the relevant Deposit Day. In the case of Variable Rate Bonds, the amount deposited shall be based on the sum of the interest accrued through the business day preceding the relevant Deposit Day and the interest (calculated at the maximum rate of interest on such bonds, or if there is no such maximum rate, then at the rate on such bonds on the business day preceding the Deposit Day plus one percent (1%)) that would accrue on such Bonds from the Deposit Day to the later to occur of the first day of the next calendar month and any interest payment date on such Bonds occurring prior to the next Deposit Day.

“Net Revenues” means, for any particular period, the excess of the Revenues for such period over the Current Expenses for such period.

“Prerefunded Municipals” means any bonds or other obligations of any state of the United States of America or the Commonwealth or of any agency, instrumentality or local governmental unit of such state or the Commonwealth (a) which are (x) not callable prior to maturity or (y) as to which irrevocable instructions have been given to the trustee of such bonds or other obligations by the obligor to give due notice of redemption and to call such bonds for redemption on the date or dates specified in such instructions, (b) which are secured as to principal, redemption premium if any, and interest by a fund consisting only of cash or Government Obligations or Time

Deposits, secured in the manner set forth in Section 601 of the 1974 Agreement, which fund may be applied only to the payment of such principal of and interest and redemption premium, if any, on such bonds or other obligations on the maturity date or dates thereof or the specified redemption date or dates pursuant to such irrevocable instructions, as appropriate, and (c) as to which the principal of and interest on such Government Obligations or Time Deposits, which have been deposited in such fund along with any cash on deposit in such fund, are sufficient to pay principal of and interest and redemption premium, if any, on the bonds or other obligations on the maturity date or dates thereof or on the redemption date or dates specified in the irrevocable instructions referred to in the subclause (a) above, as appropriate.

“Principal Accrual” means for any period the amount of principal that would accrue on serial bonds during such period if such principal accrued ratably on the basis of a year consisting of twelve (12) thirty-day months. Unless otherwise provided by the Authority, the monthly accrual in respect of the principal of serial bonds shall commence on the first day of the twelfth month preceding the due date of such principal and shall end on the first day of the month succeeding the relevant Deposit Day.”

“Principal and Interest Requirements” means, for any fiscal year, as applied to the bonds of any Series issued under the 1974 Agreement, the sum of:

- (a) the amount required to pay the interest on all outstanding bonds of such Series which is payable on January 1 in such fiscal year and on July 1 in the following fiscal year,
- (b) the amount required to pay the principal of all outstanding serial bonds of such Series which is payable after July 31 in such fiscal year and on or prior to July 31 in the following fiscal year, and
- (c) the Amortization Requirement for the term bonds of such Series for such fiscal year.

The Principal and Interest Requirements shall be determined as required from time to time, by the 1974 Trustee. In computing such Principal and Interest Requirements for any fiscal year for the bonds of any Series, the 1974 Trustee shall assume that an amount of the term bonds of such Series equal to the Amortization Requirement for the term bonds of such Series for such fiscal year will be retired by purchase or redemption not later than July 1 in the following fiscal year.

To the extent all or a portion of the principal of, Amortization Requirements for or interest on any bonds of any Series are payable from sufficient moneys irrevocably set aside or deposited for such purpose with a bank or trust company (which may include the 1974 Trustee), or from Investment Obligations, as defined in the 1974 Agreement or from Time Deposits secured in the manner set forth in Section 601 of the 1974 Agreement, irrevocably set aside or deposited for such purpose with a bank or trust company (which may include the 1974 Trustee), the principal of and the interest on which Obligations or Deposits when due will provide sufficient moneys, to make such payments, such principal, Amortization Requirements or interest shall not be included in determining Principal and Interest Requirements; provided, however, that for purposes of compliance with the Authority’s rate covenant see “Rate Covenant” in *Summary of Certain Provisions of the 1974 Agreement Excluding Proposed Supplemental Agreement*) said definition shall include any interest payable from any amount deposited to the credit of the Bond Service Account in the 1974 Sinking Fund from the proceeds of bonds to pay interest to accrue thereon. Upon request of the 1974 Trustee, the Authority shall cause to be delivered to the 1974 Trustee a certificate of an independent verification agent as to the sufficiency of the maturing principal amounts of any Investment Obligations or Time Deposits, together with interest thereon, set aside or deposited to pay said principal, Amortization Requirements and interest. If the Authority has notified the Trustee that a SWAP agreement is in effect in respect of Variable Rate Bonds, then for all purposes of this paragraph, except for the purpose of determining the aggregate Principal and Interest Requirements in the covenant as to rates contained in Section 502 of the 1974 Agreement (see “Rate Covenant” in *Summary of Certain Provisions of the 1974 Agreement Excluding Proposed Supplemental Agreement*), the interest rate on such Variable Rate Bonds shall be the SWAP rate under such SWAP agreement.

For purposes of determining the aggregate Principal and Interest Requirements in the aforementioned covenant as to rates, and the maximum aggregate Principal and Interest Requirements for purposes of Sections 712, 208, 209 and 210 of the 1974 Agreement, the interest rate on Variable Rate Bonds shall be assumed to be one

hundred ten percent (110%) of the greater of (i) the average interest rate on such Variable Rate Bonds during the twelve months ending with the month preceding the date of calculation or such shorter period that such Variable Rate Bonds shall have been outstanding under the 1974 Agreement, and (ii) the rate of interest on such Variable Rate Bonds on the date of calculation. If Variable Rate Bonds are payable at the option of the bondholder and the source for payment of said put is a credit or liquidity facility, the “put” date or dates shall be ignored and the stated dates for Amortization Requirements and principal payments thereof shall be used for purposes of this calculation.

For purposes of determining the above requirements in the case of Put Bonds, the “put” date or dates shall be ignored if the source for payment of said put is a credit or liquidity facility and the stated dates for Amortization Requirements and principal payments shall be used. For purposes of determining the above requirements in the case of Extendible Maturity Bonds, the bonds shall be deemed to mature on the later of the stated maturity date or the date to which such stated maturity date has been extended. For purposes of determining the above requirements in the case of Capital Appreciation Bonds, the principal and interest portions of the Accreted Value of Capital Appreciation Bonds becoming due at maturity or by virtue of an Amortization Requirement shall be included in the calculations of accrued and unpaid interest and principal requirements in such manner and during such period of time as is specified in the resolution authorizing such Capital Appreciation Bonds.

Principal and Interest Requirements on bonds shall be deemed to include the amount required to pay interest on outstanding Designated Maturity Bonds and any amortized principal of said Designated Maturity Bonds for any fiscal year, if said interest and amortized principal are payable on a parity with interest and Amortization Requirements on bonds.

“Put Bonds” means bonds, other than Variable Rate Bonds, which by their terms may be tendered by and at the option of the holders thereof for payment prior to the stated maturity thereof.

“Reserve Account Insurance Policy” and “Reserve Account Letter of Credit” mean (1) the insurance policy, surety bond or other acceptable evidence of insurance, if any, or (2) the irrevocable, transferable letter of credit, if any, respectively, deposited in the 1974 Reserve Account in lieu of or in partial substitution for cash or securities on deposit therein, for the purpose of making the payments required to be made from the 1974 Reserve Account under Section 510 of the 1974 Agreement. The issuer providing such insurance or letter of credit shall be a municipal bond insurer or a banking association, bank or trust company (or branch thereof) whose policy or bond or letter of credit results in the rating of municipal obligations secured by such policy or bond or such letter of credit, respectively, to be rated, at the time of deposit into the 1974 Reserve Account, in one of the three highest grades by either Standard & Poor’s Corporation or Moody’s Investors Service, or if both such corporations no longer perform the functions of a securities rating agency, a nationally recognized rating agency.

“Revenues” or “Revenues of the System” means all money received by the Authority in connection with or as a result of its ownership or operation of the System, including income derived from the sale of electricity generated or distributed by the System, the proceeds of use and occupancy insurance on the System or any part thereof and income from the investment of moneys under the 1974 Agreement, except income from the investment of moneys in the 1974 Construction Fund, the Reserve Maintenance Fund, the Capital Improvement Fund and the Subordinate Obligations Fund to the extent such income has been derived from the investment of moneys in such Fund to be used to pay Subordinate Obligations incurred to pay the cost of any work or properties which have not been included by the Authority as part of the System as provided in “Disposition of Revenues” in *Summary of Certain Provisions of the 1974 Agreement Excluding Proposed Supplemental Agreement*. Except for the purpose of determining the amount of the Revenues in the covenant as to rates contained in Section 502 of the 1974 Agreement, Revenues shall not include any amounts paid to the Authority by a SWAP party in connection with Variable Rate Bonds.

“Subordinate Obligations” means any obligations of the Authority incurred as provided in “Disposition of Revenues” in *Summary of Certain Provisions of the 1974 Agreement Excluding Proposed Supplemental Agreement*.

“SWAP agreement” means an agreement between the Authority and a SWAP party whereby the SWAP party agrees to pay to the Authority amounts calculated on the basis of all or a portion of the interest on Variable Rate Bonds at or prior to the times such interest is due and payable in consideration of the Authority’s payment to the SWAP party of amounts set forth in the SWAP agreement.

“SWAP party” means a person who is party to a SWAP agreement and whose senior obligations are rated at the time of the execution and delivery of such SWAP agreement in one of the three highest rating categories (without regard to gradations within a category) by (i) Standard & Poor’s Corporation or its successor and (ii) Moody’s Investors Service or its successor.

“SWAP rate” means the fixed rate per annum on the principal amount of Variable Rate Bonds covered by a SWAP agreement equal to the percentage derived by dividing (i) the sum of the amounts in the last twelve months paid by the Authority in respect of interest on such bonds and to the SWAP party less the amount paid to the Authority by the SWAP party by (ii) such principal amount of Variable Rate Bonds; provided, however, that if such SWAP agreement has been in effect for less than twelve months, such percentage shall be multiplied by a fraction equal to 360 divided by the number of days between the effective date of such SWAP agreement and the date of calculation determined on the basis of 30-day months.

“System” means all the properties presently owned and operated by the Authority as a single integrated system, together with all works and properties which may be acquired or constructed by the Authority in connection with the production, distribution or sale of electric energy and the acquisition or construction of which shall be financed in whole or in part from the proceeds of bonds issued under the provisions of the 1974 Agreement or from moneys deposited to the credit of the 1974 Construction Fund, the Capital Improvement Fund or from Subordinate Obligations to the extent such works and properties have been included by the Authority as part of the System as provided in “Disposition of Revenues” in *Summary of Certain Provisions of the 1974 Agreement Excluding Proposed Supplemental Agreement*.

“Valuation Date” means with respect to any Capital Appreciation Bonds the date or dates set forth in the resolution authorizing such bonds on which Accreted Values are assigned to the Capital Appreciation Bonds.

“Variable Rate Bonds” means bonds issued with a variable, adjustable, convertible or similar interest rate which is not fixed in percentage at the date of issue for the term thereof but which may or may not be convertible to a fixed interest rate for the remainder of their term.

**SUMMARY OF CERTAIN PROVISIONS OF
THE 1974 AGREEMENT EXCLUDING PROPOSED
SUPPLEMENTAL AGREEMENT**

(See also Summary of Certain Provisions of Proposed Supplemental Agreement)

The following statements are brief summaries of certain provisions of the 1974 Agreement. Said statements do not purport to be complete and reference is made to the 1974 Agreement, copies of which are available for examination at the office of the 1974 Trustee.

Provision for Variable Rate Bonds, Put Bonds, Extendible Maturity Bonds, Capital Appreciation Bonds and other types of bonds

Under the 1974 Agreement, the Authority may issue Capital Appreciation Bonds, Variable Rate Bonds, Put Bonds, Extendible Maturity Bonds and other types of bonds which may from time to time be created. The interest rate calculation methods and interest rate payment dates, which need not be semi-annual, shall be established by the Authority prior to the issuance of particular Series of bonds. The features of Variable Rate Bonds shall be established prior to their issuance and may provide, in addition to provisions for conversion to a fixed interest rate, that bondholders may demand payment of principal and interest within a stated period. In this connection, the Authority may provide for the remarketing of bonds that have been tendered pursuant to the demand features and for a credit facility or liquidity facility which may be drawn upon to make principal and interest payments on the Variable Rate Bonds. The terms for Put Bonds may contain some of the above provisions. The terms for Extendible Maturity Bonds may include an option to extend the maturity of such bonds granted to bondholders and the Authority. The terms for Capital Appreciation Bonds shall include Valuation Dates, the Accreted Value on such dates, the manner in which and the period during which principal and interest shall be deemed to accrue on said bonds and the amount of any deposit required for the 1974 Reserve Account. (1974 Agreement, Sections 208, 209 and 210).

Security for the Power Revenue Bonds

The Power Revenue Bonds are secured by a pledge of moneys in the Puerto Rico Electric Power Authority Power Revenue Bonds Interest and Sinking Fund (the “1974 Sinking Fund”), a special fund created by the 1974 Agreement. (1974 Agreement, Section 507).

The Authority covenants to deposit with the 1974 Trustee, to the credit of the 1974 Sinking Fund, a sufficient amount of the Revenues, over and above the expenses of maintaining, repairing and operating the System and any reserve therefor, to pay the principal of and the interest on all Power Revenue Bonds as the same shall become due and payable and to create a reserve for such purpose. (1974 Agreement, Section 507).

The Power Revenue Bonds shall not be deemed to constitute a debt or obligation of the Commonwealth or any of its municipalities or other political subdivisions. (1974 Agreement, Section 701).

Issuance of Power Revenue Bonds—Sections 208, 209 and 210 of the 1974 Agreement

Section 208 of the 1974 Agreement provides for the issuance of Power Revenue Bonds for Improvements, as defined in the 1974 Agreement, including the repayment of advances therefor, and to provide moneys for deposit to the Reserve Account in the 1974 Sinking Fund (the “1974 Reserve Account”), subject to the conditions and limitations therein. Power Revenue Bonds may be issued under Section 208 if, among other things:

- (i) the Net Revenues for any 12 consecutive calendar months out of the 18 calendar months immediately preceding the date of the issuance of such bonds, adjusted to reflect the then current rate schedule, are not less than 120% of the maximum aggregate Principal and Interest Requirements for any

fiscal year thereafter on account of all outstanding Power Revenue Bonds (excluding the bonds then to be issued), and

(ii) the estimated average annual Net Revenues for the five fiscal years immediately following the fiscal year in which the issuance of such bonds occurs, adjusted to reflect the then current rate schedule and any rate schedule the Authority has covenanted to put in effect during such five fiscal years, shall be not less than 120% of the maximum aggregate Principal and Interest Requirements for any fiscal year thereafter on account of all outstanding Power Revenue Bonds and the bonds then to be issued. (1974 Agreement, Section 208).

Section 209 of the 1974 Agreement provides for the issuance of Power Revenue Bonds for any proper corporate purpose of the Authority (other than for refunding outstanding Power Revenue Bonds or for Improvements), upon the conditions and limitations set forth therein. Power Revenue Bonds may be issued under Section 209 if, among other things, the earnings tests described above for the issuance of bonds under Section 208 of the 1974 Agreement are satisfied. (1974 Agreement, Section 209).

Section 210 of the 1974 Agreement provides for the issuance of Power Revenue Bonds to refund prior to or at their maturities all or any part of the outstanding bonds of any Series issued under the 1974 Agreement, including the payment of any redemption premium, accrued interest and financing costs and for the purpose of providing moneys for deposit to the credit of the 1974 Reserve Account, subject to the conditions and limitations set forth therein. Power Revenue Refunding Bonds may be issued under Section 210 if, among other things, either (i) the earnings tests described above for the issuance of bonds under Section 208 of the 1974 Agreement (except that effect is given to the retirement of the bonds to be refunded) are satisfied or (ii) the maximum aggregate Principal and Interest Requirements for any fiscal year thereafter on account of all outstanding Power Revenue Bonds and the bonds then to be issued (after giving effect to the retirement of the bonds to be refunded) shall be less than the maximum aggregate Principal and Interest Requirements on account of all outstanding Power Revenue Bonds (excluding the bonds then to be issued). Power Revenue Refunding Bonds may be issued without compliance with the foregoing tests to refund serial bonds of any Series of Power Revenue Bonds maturing within one year thereafter (and to pay interest thereon to maturity, if deemed necessary by the Authority), if the Authority shall determine that the moneys in the 1974 Sinking Fund will not be sufficient for paying such serial bonds at their maturity. The proceeds of Power Revenue Refunding Bonds shall, to the extent practicable, be invested and reinvested by the Trustee, with the approval of the Executive Director, in Government Obligations, Prerefunded Municipals or in Time Deposits, secured in the manner set forth in Section 601 of the 1974 Agreement, and the moneys so invested shall be available for use when required. (1974 Agreement, Section 210).

Collection of Revenues

1974 General Fund

A special fund is created by the 1974 Agreement and designated the “Puerto Rico Electric Power Authority General Fund” (the “1974 General Fund”). The Authority covenants that all Revenues, other than income from investments made under the provisions of the 1974 Agreement, will be deposited as received in the 1974 General Fund. (1974 Agreement, Section 503). On or before the 15th day of May in each year the Authority must prepare a proposed budget of Current Expenses and of Capital Expenditures for the ensuing fiscal year, showing separately, the amount to be expended during such fiscal year from moneys deposited to the credit of the 1974 Construction Fund and the amount of the working cash funds required for each month during such fiscal year. A public hearing on the proposed budget must be held on June 1 or on the first business day thereafter, and the Authority must finally adopt the Annual Budget on or before July 1. (1974 Agreement, Section 504). The Authority covenants that moneys in the 1974 General Fund will be used first for the payment of Current Expenses of the System, and that, if the amount expended in any fiscal year for Current Expenses shall exceed the amount provided therefor in the Annual Budget, the Authority will report such excess and the reasons therefor to the Consulting Engineers and to the 1974 Trustee as soon as practicable but not later than the end of the sixth month following the month in which such excess shall have occurred. (1974 Agreement, Section 505).

1974 Revenue Fund

A special fund is created by the 1974 Agreement and designated the “Puerto Rico Electric Power Authority Power Revenue Fund” (the “1974 Revenue Fund”). The Treasurer of the Authority is required to transfer each month from the 1974 General Fund to the 1974 Revenue Fund an amount equal to the amount of all moneys held in the 1974 General Fund at the end of the preceding month less an amount to be held as a reserve for Current Expenses equal to not more than 1/6 of the amount shown by the Annual Budget to be necessary for Current Expenses for the current fiscal year, such transfers to be made on the books of the Authority as of the close of the preceding month. (1974 Agreement, Section 506).

Disposition of Revenues

1974 Sinking Fund, Reserve Maintenance Fund, Subordinate Obligations Fund, Self-insurance Fund and Capital Improvement Fund

On or before the 25th day of each month, the Treasurer shall withdraw from the 1974 Revenue Fund, all the moneys then in such Fund and deposit the moneys so withdrawn to the credit of the following Accounts and Funds in the following order:

1. the Bond Service Account in the 1974 Sinking Fund, until there has been accumulated therein an amount equal to the sum of (i) the Interest Accrual on all the outstanding Power Revenue Bonds to and including the first day of the next calendar month, and (ii) the Principal Accrual on the outstanding serial bonds of each Series of outstanding Power Revenue Bonds to and including the first day of the next calendar month;
2. the Redemption Account in the 1974 Sinking Fund, until there has been deposited therein an amount equal to the Amortization Accrual for the term bonds of each Series of Power Revenue Bonds then outstanding to and including the first day of the next calendar month;
3. the 1974 Reserve Account until the balance therein is equal to the interest payable on all outstanding Power Revenue Bonds within the next ensuing 12 months; provided, however, that the monthly deposit in respect of any Series of Power Revenue Bonds issued under Section 208 or 209 of the 1974 Agreement need not exceed 1/60 of the amount of the increase in the interest payable within the next ensuing 12 months resulting from the issuance of bonds of such Series, and provided, further, that the monthly requirements for deposits to the 1974 Reserve Account shall be cumulative; and that in the case of Variable Rate Bonds, the minimum amount to be deposited in the 1974 Reserve Account which shall be funded over the period required herein, shall be based initially on the interest rate in effect on the date of issuance of the Variable Rate Bonds and then shall be adjusted on the 25th day of each subsequent month based on the actual interest accrued from the 25th day of the previous month to the date of adjustment, except that in the case of Variable Rate Bonds in respect of which the Authority has notified the Trustee that a SWAP agreement is in effect, the Trustee shall use the SWAP rate in calculating the interest payable on such Bonds within the next ensuing twelve (12) months; and that in the case of Capital Appreciation Bonds, the minimum amount required to be deposited in the Reserve Account shall be an amount derived from the interest rate which has been used to calculate the assumed yield on such bonds through their maturity times the Accreted Value of such bonds on the Valuation Date occurring at or after the first day of the twelfth succeeding month to the date of calculation of this requirement, as may be further specified in the resolution authorizing Capital Appreciation Bonds;
4. the Puerto Rico Electric Power Authority Reserve Maintenance Fund (the “Reserve Maintenance Fund”), a special fund created by the 1974 Agreement, such amount of any balance remaining after making the deposits mentioned in paragraphs 1, 2 and 3 above as may be recommended by the Consulting Engineers; provided that the monthly requirements for deposit to the Reserve Maintenance Fund shall be cumulative, and provided further that in the event that the Authority shall covenant in respect of any Subordinate Obligation to limit the monthly deposit to the Reserve Maintenance Fund as described below in *Subordinate Obligations Fund*, the monthly deposit required by this paragraph shall be equal to the least of

- (i) the amount described above in this paragraph,
- (ii) \$400,000, and
- (iii) an amount that when added to the amount then on deposit in the Reserve Maintenance Fund shall make the total amount on deposit equal to \$10,000,000;

5. one or more special accounts in the Puerto Rico Electric Power Authority Subordinate Obligations Fund (the “Subordinate Obligations Fund”), a special fund created under the 1974 Agreement, such amount of any balance remaining after making the deposits mentioned under paragraphs 1, 2, 3 and 4 above that together with amounts then on deposit in the Subordinate Obligations Fund will make the total amount then on deposit equal to any amounts required to be paid or accrued with respect to any Subordinate Obligations prior to the Deposit Day of the next succeeding month from or to the Subordinate Obligations Fund;

6. if the Authority shall have covenanted with respect to Subordinate Obligations to limit its deposit to the Reserve Maintenance Fund in accordance with the provisions of the second proviso of paragraph 4 above and in fact the deposit to said Fund pursuant to paragraph 4 was limited to the amount described in clause (ii) or (iii) of such paragraph, the Reserve Maintenance Fund, such amount of any balance remaining after making the deposits under paragraphs 1, 2, 3, 4 or 5 above as may be required to make the total amount deposited in the Reserve Maintenance Fund in such month equal to the amount described in clause (i) of clause (4) above;

7. the Puerto Rico Electric Power Authority Self-insurance Fund (the “Self-insurance Fund”), a special fund created by the 1974 Agreement, such amount of any balance remaining after making the deposits mentioned in paragraphs 1, 2, 3, 4, 5 and 6 above as may be determined by the Authority from time to time; and

8. the Puerto Rico Electric Power Authority Capital Improvement Fund (the “Capital Improvement Fund”), a special fund created by the 1974 Agreement, such amount of any balance remaining after making deposits mentioned under paragraphs 1, 2, 3, 4, 5, 6 and 7 above as may be determined by the Authority, with the approval of the Consulting Engineers; provided that the monthly requirements for deposit to the Capital Improvement Fund shall be cumulative.

Any balance remaining after making the deposits under paragraphs 1 through 8 above may be used for any lawful purpose of the Authority. (1974 Agreement, Section 507).

If amounts applied to the payment of interest, principal and redemption price on bonds are paid by a credit or liquidity facility issuer, the amounts deposited in the Bond Service Account and the Redemption Account in the 1974 Sinking Fund allocable to said payment (other than a payment of the purchase price of bonds pursuant to a “put”) may be paid to said credit or liquidity facility issuer. (1974 Agreement, Section 509).

Moneys in the 1974 Reserve Account shall be used by the 1974 Trustee first for the purpose of paying the interest on the Power Revenue Bonds and maturing principal of serial bonds whenever moneys in the Bond Service Account are insufficient for such purposes and thereafter for the purpose of making the required deposits to the Redemption Account mentioned in paragraph 2 above whenever the withdrawal from the 1974 Revenue Fund is insufficient for such purpose. Excess moneys in the 1974 Reserve Account shall be transferred to the Bond Service Account or may be used to reduce any Reserve Account Insurance Policy or Letter of Credit. (1974 Agreement, Section 510). The Authority may deposit a Reserve Account Insurance Policy or Letter of Credit into the 1974 Reserve Account, in lieu, or in partial substitution, of any required deposit into the 1974 Reserve Account. Said Reserve Account Insurance Policy or Letter of Credit may be secured by a lien on Revenues not inconsistent with the provisions of the 1974 Agreement and shall be payable or available to be drawn upon, as the case may be (upon the giving of notice as required thereunder), on any date on which moneys are required to be paid out of the 1974 Reserve Account pursuant to Section 510 of the 1974 Agreement. If a disbursement is made under any Reserve Account Insurance Policy or Letter of Credit, the Authority shall be obligated either to reinstate the limits of such

Reserve Account Insurance Policy or Letter of Credit following such disbursement or to deposit into the 1974 Reserve Account moneys in accordance with the provisions of Section 507 of the 1974 Agreement in the amount of the disbursement made under such Reserve Account Insurance Policy or Letter of Credit. The Authority may at any time substitute (i) all or a portion of the moneys held to the credit of the 1974 Reserve Account with a Reserve Account Insurance Policy or Letter of Credit, (ii) all or a portion of any Reserve Account Insurance Policy on deposit in the 1974 Reserve Account with moneys or a Reserve Account Letter of Credit, or (iii) all or a portion of any Reserve Account Letter of Credit on deposit in the 1974 Reserve Account with moneys or a Reserve Account Insurance Policy. Any moneys on deposit in the 1974 Reserve Account in substitution of which a Reserve Account Insurance Policy or Letter of Credit is deposited shall, to the extent not required to fund any deficiencies in the amount then required to be on deposit in the 1974 Reserve Account, be released and immediately paid over to the Authority to be used by the Authority for any proper corporate purpose. Prior to the expiration date of any Reserve Account Insurance Policy or Letter of Credit then on deposit to the credit of the 1974 Reserve Account, the Authority shall be required to (x) cause the term of such Reserve Account Insurance Policy or Letter of Credit to be extended, (y) replace any such Reserve Account Insurance Policy with moneys (which may include, without limitation, moneys available under the Reserve Account Insurance Policy or from any other source available for such purpose) or a Reserve Account Letter of Credit, or (z) replace any such Reserve Account Letter of Credit with moneys (which may include, without limitation, moneys available under the Reserve Account Letter of Credit or from any other source available for such purpose) or a Reserve Account Insurance Policy; provided, that in the event that the Authority has not extended or replaced the expiring Reserve Account Insurance Policy or Letter of Credit by the fifth business day prior to its date of expiration, the expiring Reserve Account Insurance Policy or Letter of Credit shall, on such date, be drawn upon and the moneys so made available shall thereupon be deposited in the 1974 Reserve Account. (1974 Agreement, Section 510).

Moneys in the Reserve Maintenance Fund shall be used only for the purpose of paying the cost of unusual or extraordinary maintenance or repairs, maintenance or repairs not recurring annually and renewals and replacements, including major items of equipment. The Reserve Maintenance Fund also serves as an additional reserve for the payment of the principal of and the interest on the Power Revenue Bonds and meeting the Amortization Requirements to the extent that moneys in the 1974 Sinking Fund, including moneys in the 1974 Reserve Account, are insufficient for such purpose. (1974 Agreement, Section 512).

Moneys in the Self-insurance Fund shall be used only for the purpose of paying the cost of repairing, replacing or reconstructing any property damaged or destroyed from, or extraordinary expenses incurred as a result of, a cause which is not covered by insurance required by the 1974 Agreement. See "Insurance" below. The Self-insurance Fund also serves as an additional reserve for the payment of the principal of and the interest on the Power Revenue Bonds and meeting the Amortization Requirements to the extent that moneys in the 1974 Sinking Fund, including the 1974 Reserve Account, and in the Reserve Maintenance Fund are insufficient for such purpose. (1974 Agreement, Section 512A).

Moneys in the Capital Improvement Fund shall be used only for the purpose of paying the cost of anticipated extensions and Improvements which cost has not otherwise been provided for from the proceeds of Power Revenue Bonds. The Capital Improvement Fund also serves as an additional reserve for the payment of principal of and the interest on Power Revenue Bonds and meeting the Amortization Requirements to the extent that moneys in the 1974 Sinking Fund, including the 1974 Reserve Account, in the Reserve Maintenance Fund and in the Self-insurance Fund are insufficient for such purpose. (1974 Agreement, Section 512B).

Subordinate Obligations Fund

Moneys in the Subordinate Obligations Fund shall be paid out or pledged by the Authority as necessary to enable the Authority to meet its Subordinate Obligations. Subordinate Obligations may be incurred or issued by the Authority for any proper corporate purpose of the Authority.

The Authority may covenant with the holders of any Subordinate Obligations to limit the deposits to the Reserve Maintenance Fund as authorized by paragraph 4 above and to add to the conditions, limitations and restrictions under which Power Revenue Bonds may be issued under the provisions of 1974 Agreement.

Subordinate Obligations shall be payable out of and may be secured by a pledge of (i) available amounts in the Subordinate Obligations Fund and (ii) any other available funds of the Authority. Any such payment or pledge shall be expressly subordinate and junior in all respects to the lien and charge of the Power Revenue Bonds upon the Revenues.

Before incurring any Subordinate Obligations the proceeds of which shall be applied to acquire or construct any works or properties by the Authority in connection with the production, distribution or sale of electric energy, the Authority shall specify by resolution whether or not such works or properties are to be included as part of the System. (1974 Agreement, Section 516).

1974 Construction Fund

A special fund is created by the 1974 Agreement and designated the “Puerto Rico Electric Power Authority Power System Construction Fund” (the “1974 Construction Fund”). The proceeds of any Power Revenue Bonds issued for the purpose of paying the cost of acquiring or constructing Improvements, together with the moneys received from any other source for such purpose, except proceeds which are (i) applied to the repayment of advances, (ii) deposited in the 1974 Reserve Account, (iii) deposited in the Bond Service Account as capitalized interest or (iv) used for the payment of financing expenses, shall be deposited in the 1974 Construction Fund and held by the Authority in trust. (1974 Agreement, Sections 208 and 401). Payments from the 1974 Construction Fund are made by the Executive Director or by any officer or employee of the Authority designated by him for such purpose. (1974 Agreement, Section 402).

Rate Covenant

The Authority covenants that it will at all times fix, charge and collect reasonable rates and charges for the use of the services and facilities furnished by the System so that the Revenues will be at all times sufficient to pay the Current Expenses of the System and to provide an amount at least equal to 120% of the aggregate Principal and Interest Requirements for the next fiscal year on account of all outstanding Power Revenue Bonds, reduced by any amount deposited in the Bond Service Account from the proceeds of bonds to pay interest to accrue thereon in such fiscal year.

The Authority further covenants that if at any time the Revenues shall not be sufficient to satisfy the foregoing covenant as to rates, it will revise the rates and charges for the services and facilities furnished by the System and, if necessary, it will revise its regulations in relation to the collection of bills for such services and facilities, so that such deficiency will be made up before the end of the next ensuing fiscal year. Should any deficiency not be made up in such next ensuing fiscal year, the requirement therefor, shall be cumulative and the Authority shall continue to revise such rates until such deficiency shall have been completely made up. (1974 Agreement, Section 502).

Investment of Funds

The 1974 Agreement provides for the following types of investments:

(a) Government Obligations, which are (i) direct obligations of, or obligations the principal of and interest on which are unconditionally guaranteed by, the United States Government, including securities evidencing ownership interests in such obligations or in specified portions thereof (which may consist of specific portions of the principal of or interest on such obligations), (ii) bonds, debentures or notes issued by any of the following federal agencies: Banks for Cooperatives, Federal Intermediate Credit Banks, Federal Home Loan Banks, Export-Import Bank of the United States, Government National Mortgage Association, Federal Land Banks, or the Federal National Mortgage Association (including participation certificates issued by such Association) and (iii) all other obligations issued or unconditionally guaranteed as to principal and interest by any agency or person controlled or supervised by and acting as an instrumentality of the United States Government pursuant to authority granted by the Congress;

(b) Investment Obligations, which are (i) Government Obligations, (ii) obligations of any state or territory of the United States or political subdivision thereof (other than obligations rated lower than the three highest grades by a nationally recognized rating agency), (iii) repurchase agreements with commercial banks fully secured by Government Obligations and (iv) any other investment obligations permitted for governmental instrumentalities under the laws of the Commonwealth which are rated in any of the three highest grades by a nationally recognized rating agency or which are collateralized by Investment Obligations; and

(c) Time Deposits, which are time deposits, certificates of deposit or similar arrangements with the 1974 Trustee, Government Development Bank for Puerto Rico or any bank or trust company which is a member of the Federal Deposit Insurance Corporation having a combined capital and surplus aggregating not less than \$100,000,000. (1974 Agreement, Section 101).

Moneys in the Bond Service Account, the Redemption Account and the 1974 Revenue Fund shall be invested by the 1974 Trustee or by the Authority, as the case may be, in Government Obligations which shall mature, or which shall be subject to redemption by the holder thereof at the option of such holder, not later than the respective dates when such moneys will be required for the purposes intended, or in Time Deposits; provided, that each such Time Deposit shall permit the moneys so placed to be available for use when required for the purposes intended.

Any moneys in the 1974 Construction Fund, the Reserve Maintenance Fund, the Self-insurance Fund, the Capital Improvement Fund and the 1974 Reserve Account shall be invested by the 1974 Trustee or the Authority, as the case may be, in Investment Obligations which shall mature, or which shall be subject to redemption by the holder thereof at the option of such holder, in the case of the 1974 Construction Fund, the Self-insurance Fund, the Capital Improvement Fund and the Reserve Maintenance Fund, not later than the respective dates when the moneys invested will be required for the purposes intended, and in the case of the 1974 Reserve Account, as to approximately 50% of such moneys, not later than five years after the date of such investment, and as to the balance of such moneys, as directed by order of the Executive Director or other authorized officer of the Authority. In lieu of such investments, moneys in the 1974 Construction Fund, the Reserve Maintenance Fund, the Self-insurance Fund, the Capital Improvement Fund and the 1974 Reserve Account may be invested in Time Deposits which shall permit the moneys so placed to be available for use at the times provided for investments in Investment Obligations. (1974 Agreement, Section 602).

Any moneys in the Self-insurance Fund may also be invested by the Authority in any investments authorized by law for the Retirement System of the Employees of the Government for Puerto Rico and its Instrumentalities, but the Authority shall invest not less than the lesser of \$25,000,000 and the entire balance in such Fund in Investment Obligations with an average weighted maturity of not more than three years.

Prior to investing any moneys in the Self-insurance Fund in other than Investment Obligations, the Authority shall obtain an Independent Consultant's report recommending what portion of moneys held in the Self-insurance Fund the Authority shall maintain invested in Investment Obligations and shall, after duly considering the report, formally adopt, subject to the consent of Government Development Bank for Puerto Rico, and maintain an investment policy first determining the minimum portion of the moneys held for the credit of the Self-insurance Fund to remain invested in Investment Obligations and then setting forth prudent investment principles, considerations and goals, including liquidity, diversification of assets, safety and rate or rates of return, that will govern the investment strategies and goals for the balance of the Self-insurance Fund and shall advise the Trustee in writing of those investments other than Investment Obligations that are authorized by said investment policy. (1974 Agreement, Section 602).

Accounting

The Authority covenants that it will keep accurate records and accounts, according to standard practices for public utility systems similar to the properties and business of the Authority and applicable in such circumstances, of all items of cost and expenditures relating to the System, the Revenues collected and the application of the Revenues. The Authority further covenants that in the first month of each fiscal year it will cause an audit for the preceding fiscal year to be made of its books and accounts pertaining to the System by an independent firm of

certified public accountants widely known in the United States and approved by the 1974 Trustee. (1974 Agreement, Section 710). The Authority records Revenues and Current Expenses on the accrual basis.

Release of Property

The Authority covenants that so long as any Power Revenue Bonds shall be outstanding it will not sell, lease or otherwise dispose of or encumber the System or any part thereof and will not create or permit to be created any charge or lien on the Revenues ranking equally with or prior to the charge or lien on the Revenues of the Power Revenue Bonds. The Authority may, however, from time to time, sell machinery, fixtures, tools or other movable property or materials if the Authority shall determine that such articles are no longer needed or useful in connection with the construction or operation and maintenance of the System. Any such moneys received may be applied to replace any such properties sold or disposed of or shall be deposited in the Redemption Account or the 1974 Construction Fund. Other property forming part of the System, not needed or serving no useful purpose in connection with the System, may be sold, leased or transferred provided the proceeds of which shall be deposited in the Redemption Account or the 1974 Construction Fund and the rentals be deposited in the 1974 Revenue Fund.

Notwithstanding the previous paragraph, the Authority may abandon, sell, lease or transfer any property forming a part of the System, if, among other things, the Net Revenues for any 12 consecutive calendar months out of the 18 calendar months next preceding the date of such abandonment, sale, lease or transfer, adjusted to give effect to such abandonment, sale, lease or transfer and any replacement and to reflect the rate schedule then in effect, are not less than 120% of the maximum aggregate Principal and Interest Requirements for any fiscal year thereafter on account of all outstanding Power Revenue Bonds and if the 1974 Reserve Account is fully funded. Any transferee of said property may be considered in lieu of or in addition to the Authority for purposes of such coverage if the transferee agrees to assume the Authority's obligations under the 1974 Agreement. Said coverage test need not be met if the transferee is a public corporation or other governmental entity provided the coverage is not reduced due to such transfer. The proceeds of such sale shall be deposited in the Redemption Account or in the 1974 Construction Fund, at the option of the Authority, or shall be applied to the replacement of the property so sold. The rentals under any such lease shall be deposited in the 1974 Revenue Fund.

In addition, the Authority may lease portions of the System or make contracts or other arrangements or grant licenses or easements with respect to the operation or use of the System, if certain reports and certificates of the Consulting Engineers are provided that confirm, among other things, that operational covenants will be binding on the lessee or other contracting entity and that the lease, contract, license, easement or other arrangement provides for rent or other payments that are projected to be sufficient with other projected Net Revenues of the System to make all payments of the Principal and Interest Requirements for all Power Revenue Bonds. Rents received under any such lease, contract, license, easement or other management shall be included as Revenues. (1974 Agreement, Section 712).

Insurance

The Authority covenants that it will at all times carry insurance in a responsible insurance company or companies authorized and qualified under the laws of Puerto Rico to assume the risk thereof, covering such properties belonging to the System as are customarily insured, and against loss or damage from such causes as are customarily insured against, by companies engaged in similar business.

The Authority covenants that, immediately after any loss or damage, it will cause to be prepared plans and specifications for repairing, replacing or reconstructing the damaged property, and will forthwith proceed with the repair, replacement or reconstruction of the damaged or destroyed property unless it shall determine that the repair, replacement or reconstruction of such property is not essential to the efficient operation of the System. Any proceeds of any insurance not applied within 18 months after receipt by the Treasurer to repairing, replacing or reconstructing damaged or destroyed property shall be deposited in the Redemption Account or the 1974 Construction Fund, at the option of the Authority, unless the Authority shall be prevented from doing so by conditions beyond its control or unless the holders of 51% in aggregate principal amount of the Power Revenue Bonds then outstanding shall otherwise direct. (1974 Agreement, Section 707).

Consulting Engineers and Independent Consultant

The Authority covenants that so long as any of the Power Revenue Bonds are outstanding it will employ as Consulting Engineers an independent engineer or engineering firm having a wide and favorable repute in the United States for skill and experience in the construction and operation of electric systems. It shall be the duty of the Consulting Engineers to prepare an annual report setting forth their recommendations as to revisions of rates and charges. It shall be the duty of the Consulting Engineers to include in such report their recommendations as to the amount to be deposited in the Reserve Maintenance Fund, the Capital Improvement Fund and the Self-insurance Fund. (1974 Agreement, Section 706).

The Authority covenants that so long as any Power Revenue Bonds are outstanding it will employ as Independent Consultant one or more independent firms having a wide and favorable repute in the United States for expertise in risk management and other insurance matters related to the construction and operation of electric systems. It shall be the duty of the Independent Consultant to prepare at least biennially a report setting forth its recommendations, based on a review of the insurance then maintained by the Authority in accordance with the 1974 Agreement and the status of the Self-insurance Fund, of any changes in coverage, including its recommendations of policy limits and deductibles and self-insurance, and investment strategies for the Self-insurance Fund. (1974 Agreement, Sections 706 and 707).

Modifications

The Authority and the 1974 Trustee may, without the consent of the holders of the Power Revenue Bonds, enter into such supplemental agreements as shall not be inconsistent with the 1974 Agreement, to cure any ambiguity, to correct or supplement any provision in the 1974 Agreement which may be inconsistent with any other provision therein, to make any other provisions which shall not be inconsistent with the provisions of the 1974 Agreement, provided such action shall not adversely affect the interest of the bondholders, or to grant to or confer upon the 1974 Trustee for the benefit of the bondholders any additional rights, remedies, powers, authority or security that may lawfully be granted to or conferred upon the bondholders or the 1974 Trustee, or to add to the conditions, limitations and restrictions on the issuance of bonds under the provisions of the 1974 Agreement other conditions, limitations and restrictions thereafter to be observed, or to add to the covenants and agreements of the Authority in the 1974 Agreement other covenants and agreements thereafter to be observed by the Authority or to surrender any right or power reserved to or conferred upon the Authority by the 1974 Agreement. (1974 Agreement, Section 1101).

The holders of not less than 60% in aggregate principal amount of the Power Revenue Bonds at the time outstanding shall have the right, from time to time (anything contained in the 1974 Agreement to the contrary notwithstanding), to consent to and approve the execution by the Authority and the 1974 Trustee of such agreement or agreements supplemental thereto as shall be deemed necessary or desirable by the Authority for the purpose of modifying, altering, amending, adding to, repealing or rescinding, in any particular, any of the terms or provisions contained in the 1974 Agreement or in any supplemental agreement; provided, however, that nothing contained in the 1974 Agreement shall permit, or be construed as permitting, (a) an extension of the maturity of any Power Revenue Bond, or (b) a reduction in the principal amount of any Power Revenue Bond or the redemption premium or the rate of interest thereon, or (c) the creation of a lien upon or a pledge of the Revenues other than the lien and pledge created by the 1974 Agreement, or (d) a preference or priority of any Power Revenue Bond or Bonds over any other Power Revenue Bond or Bonds, or (e) a reduction in the aggregate principal amount of the Power Revenue Bonds required for consent to such supplemental agreement. (1974 Agreement, Section 1102).

Remedies of Bondholders

Among the events described in the 1974 Agreement as “events of default” are the following:

- (a) payment of the principal of and redemption premium, if any, on any of the Power Revenue Bonds shall not be made when the same shall become due and payable, or

- (b) payment of any installment of interest shall not be made when the same shall become due and payable, or
- (c) the Authority shall for any reason be rendered incapable of fulfilling its obligations under the 1974 Agreement, or
- (d) default in meeting any Amortization Requirement, with the specified period of grace, or
- (e) if notice has been received by the 1974 Trustee and the Authority from the bank or other institution providing a credit or liquidity facility or other entity guaranteeing or securing bonds that an event of default has occurred under the agreement underlying said facility or if the issuer of a credit or liquidity facility or other entity has failed to make the facility available or to reinstate the interest component of the facility in accordance with its terms (but only to the extent provided for in the resolution authorizing the issuance of the Power Revenue Bonds secured by the credit or liquidity facility). (1974 Agreement, Section 802).

In the event of any such default the 1974 Trustee may, and upon the written request of the holders of not less than 20% in aggregate principal amount of all Power Revenue Bonds then outstanding shall, declare the principal of the Power Revenue Bonds then outstanding to be due and payable, and, providing it shall be indemnified to its satisfaction, the 1974 Trustee may, and upon the written request of the holders of not less than 10% in aggregate principal amount of the Power Revenue Bonds then outstanding shall, proceed to protect and enforce its rights and the rights of the bondholders under the 1974 Agreement by such suits, actions or special proceedings in equity or at law, or by such proceedings in the office of any board or officer having jurisdiction, either for the appointment of a receiver of the System as authorized by the Act or for the specific performance of any covenant or agreement or for the enforcement of any proper legal or equitable remedy, as the 1974 Trustee shall deem most effectual to protect and enforce the rights aforesaid; provided, however, that the 1974 Trustee shall not be required to proceed for the appointment of a receiver unless it shall have received the written request of the holders of not less than 25% in aggregate principal amount of such bonds then outstanding. (1974 Agreement, Sections 803, 804 and 902).

It is the intent of the 1974 Agreement that all proceedings shall be instituted and maintained for the benefit of all holders of outstanding Power Revenue Bonds. (1974 Agreement, Sections 808 and 809).

Defeasance

The 1974 Agreement provides that if, when the Power Revenue Bonds shall have become due and payable or shall have been duly called for redemption or irrevocable instructions to call said bonds for redemption or payment shall have been given by the Authority to the 1974 Trustee, the whole amount of the principal and the interest and the premium, if any, so due and payable upon all of the Power Revenue Bonds then outstanding shall be paid or sufficient moneys, or Government Obligations or Prerefunded Municipals or Time Deposits secured in the manner set forth in Section 601 of the 1974 Agreement, the principal of and the interest on which when due will provide sufficient moneys, shall be held by the 1974 Trustee or the paying agents for such purpose under the provisions of the 1974 Agreement, and provision shall be made for paying all other sums payable by the Authority, then and in that case the right, title and interest of the 1974 Trustee thereunder shall cease, determine and become void, and the 1974 Trustee in such case, on demand of the Authority, shall release the 1974 Agreement. For purposes of determining whether sufficient amounts have been deposited for defeasance, the interest to become due on Variable Rate Bonds shall be calculated at the maximum rate permitted by the terms thereof, and the principal, premium and interest to become due on Put Bonds and Extendible Maturity Bonds shall mean the maximum amount payable upon the exercise of put options by holders of said bonds or extensions of maturity by the holders of said bonds or the Authority. (1974 Agreement, Section 1201).

Bonds Not Deemed Outstanding

The Power Revenue Bonds and portions of Power Revenue Bonds which have been duly called for redemption under the provisions of Article III of the 1974 Agreement, or with respect to which irrevocable

instructions to call for redemption or payment at or prior to maturity have been given to the 1974 Trustee in form satisfactory to it, and for the payment of principal or the redemption price and the accrued interest of which sufficient moneys, or Government Obligations or Prerefunded Municipals or Time Deposits secured in the manner set forth in Section 601 of the 1974 Agreement, shall be held in separate accounts by the 1974 Trustee or by the paying agents in trust for the holders of the bonds or portions thereof to be paid or redeemed, all as provided in the 1974 Agreement, shall not thereafter be deemed to be outstanding under the provisions of the 1974 Agreement. (1974 Agreement, Section 307)

SUMMARY OF CERTAIN PROVISIONS OF PROPOSED SUPPLEMENTAL AGREEMENT

The following is a summary of certain provisions of the proposed Supplemental Agreement. The summary does not purport to be complete and reference is made to the proposed Supplemental Agreement, copies of which are available in substantially final form for examination at the principal corporate trust office of the 1974 Trustee.

Third Supplemental Agreement

The 1974 Agreement will be supplemented to provide that the Authority may grant a lien on Revenues on a parity with the lien of the holders of Power Revenue Bonds to providers of credit or liquidity facilities securing such bonds.

*Combined Financial Statements
and Supplemental Information*

Puerto Rico Electric Power Authority

June 30, 2001

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Puerto Rico Electric Power Authority
Combined Financial Statements and
Supplemental Information

June 30, 2001

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Report of Independent Auditors

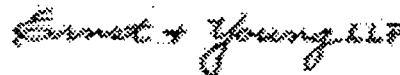
To the Governing Board of the
Puerto Rico Electric Power Authority

We have audited the accompanying balance sheet of the Puerto Rico Electric Power Authority (the Authority), a component unit of the Commonwealth of Puerto Rico, as of June 30, 2001, and the related combined statements of income, changes in capitalization and cash flows for the year then ended. These financial statements are the responsibility of the Authority's management. Our responsibility is to express an opinion on these financial statements based on our audit. The financial statements of the Authority for the year ended June 30, 2000 were audited by other auditors whose report dated September 30, 2000, expressed an unqualified opinion on those statements.

We conducted our audit in accordance with auditing standards generally accepted in the United States and the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements present fairly, in all material respects, the financial position of the Authority as of June 30, 2001, and its results of operations and cash flows for the year then ended in conformity with accounting principles generally accepted in the United States.

Our audit was conducted for the purpose of forming an opinion on the financial statements of the Puerto Rico Electric Power Authority taken as a whole. The supplemental information included in Schedules II - VII is presented for purposes of additional analysis and is not a required part of the financial statements. Such information has been subjected to the auditing procedures applied in the audit of the financial statements and, in our opinion, is fairly stated in all material respects in relation to the financial statements taken as a whole, and are prepared in accordance with the terms of the 1974 Agreement (described herein).



September 28, 2001 (except for the
last paragraph of Note 17, as to
which the date is October 26, 2001)

Stamp No. 1733680
affixed to original
of this report.

Puerto Rico Electric Power Authority
Combined Balance Sheets

	June 30	
	2001	2000
	<i>(In Thousands)</i>	
Assets		
Utility plant:		
Plant in service	\$ 5,596,586	\$ 5,445,867
Accumulated depreciation	<u>(2,788,112)</u>	<u>(2,588,253)</u>
	2,808,474	2,857,614
Construction in progress	<u>1,363,269</u>	<u>1,108,127</u>
Total utility plant, net	<u>4,171,743</u>	<u>3,965,741</u>
Restricted assets:		
Cash and cash equivalents held by trustee for payment of principal and interest on bonds	261,568	244,391
Investments held by trustee	319,021	297,491
Construction fund and other special funds	<u>123,041</u>	<u>91,613</u>
Total restricted assets	<u>703,630</u>	<u>633,495</u>
Current assets:		
Cash and cash equivalents	92,364	70,534
Receivables, net	404,900	402,859
Fuel oil, at average cost	76,400	66,459
Materials and supplies, at average cost	146,435	164,700
Prepayments and other assets	<u>26,134</u>	<u>14,959</u>
Total current assets	<u>746,233</u>	<u>719,511</u>
Other non-current receivables	<u>64,224</u>	<u>74,357</u>
Deferred debits:		
Unamortized debt issue cost	28,128	24,050
Other	<u>22,593</u>	<u>22,736</u>
Total deferred debits	<u>50,721</u>	<u>46,786</u>
Total assets	<u>\$ 5,736,551</u>	<u>\$ 5,439,890</u>

	June 30	
	2001	2000
	<i>(In Thousands)</i>	
Capitalization and liabilities		
Capitalization:		
Contributed capital	\$ 139,984	\$ 139,983
Retained earnings	324,571	282,677
	<u>464,555</u>	<u>422,660</u>
Long-term debt, excluding current portion	3,951,216	3,485,426
	<u>4,415,771</u>	<u>3,908,086</u>
Noncurrent liabilities:		
Deferred credit for purchase of power	46,894	49,366
Sick leave benefits to be liquidated after one year	130,212	126,945
Supplemental spouse survivor benefits	41,900	47,040
Pension benefits exchanged for forfeited sick leave	5,392	5,392
Note payable to Government Development Bank for Puerto Rico (GBD)	-	263,000
	<u>224,398</u>	<u>491,743</u>
Total noncurrent liabilities	224,398	491,743
Current portion of long-term debt and notes payable which will be paid from restricted assets	290,939	262,842
	<u>290,939</u>	<u>262,842</u>
Current liabilities:		
Notes payable to banks	125,000	125,000
Accounts payable and accrued liabilities	442,341	431,774
Accrued interest	112,562	103,419
Customers' deposits	125,540	117,026
	<u>805,443</u>	<u>777,219</u>
Total current liabilities	805,443	777,219
	<u>805,443</u>	<u>777,219</u>
Total capitalization and liabilities	<u>\$5,736,551</u>	<u>\$5,439,890</u>

See accompanying notes.

Puerto Rico Electric Power Authority
 Combined Statements of Income

	Year ended June 30	
	2001	2000
	<i>(In Thousands)</i>	
Operating revenues	\$2,331,989	\$1,987,336
Operating expenses:		
Operations:		
Fuel	944,760	801,433
Purchased power	177,330	64,518
Other production	56,566	56,014
Transmission and distribution	107,258	97,238
Customer accounting and collection	83,908	77,087
Administrative and general	140,183	152,164
Maintenance	215,180	221,502
Depreciation	233,169	209,960
Total operating expenses	1,958,354	1,679,916
Operating income	373,635	307,420
Interest income	45,239	29,110
Other income	9,309	15,671
Income before interest charges and contribution in lieu of taxes	428,183	352,201
Interest charges:		
Interest on bonds	238,043	218,619
Interest on other long-term debt	2,415	6,240
Other interest	3,028	2,911
Amortization of debt discount, issuance costs and refunding loss	17,498	16,666
Allowance for funds used during construction	(22,966)	(12,138)
Total interest charges, net	238,018	232,298
Income before contribution in lieu of taxes	190,165	119,903
Contribution in lieu of taxes	(148,271)	(98,495)
Net income	\$ 41,894	\$ 21,408

See accompanying notes.

Puerto Rico Electric Power Authority
 Combined Statements of Changes in Capitalization
 June 30, 2001

	Contributed Capital	Retained Earnings	Long-Term Debt, Excluding Current Portion	Total Capitalization
	<i>(In Thousands)</i>			
Balance as of June 30, 1999	\$139,983	\$261,269	\$3,611,676	\$4,012,928
Transfers to current liabilities	-	-	(143,512)	(143,512)
Accretion of capital appreciation bonds	-	-	17,262	17,262
Net income	-	21,408	-	21,408
Balance as of June 30, 2000	139,983	282,677	3,485,426	3,908,086
Transfers to current liabilities	-	-	(157,248)	(157,248)
Proceeds from issuance of bonds, net of defeased bonds, original discounts, and including accretion of capital appreciation bonds	-	-	623,038	623,038
Net income	-	41,894	-	41,894
Balance as of June 30, 2001	\$139,983	\$324,571	\$3,951,216	\$4,415,770

See accompanying notes.

Puerto Rico Electric Power Authority
Combined Statements of Cash Flows

	Year ended June 30	
	2001	2000
	<i>(In Thousands)</i>	
Operating activities		
Cash flows from operating activities:		
Operating income	\$ 373,635	\$ 307,420
Adjustment to reconcile operating income to net cash provided by operating activities:		
Depreciation	233,169	209,960
Amortization of asbestos removal costs	2,469	1,977
Provision for uncollectible accounts	3,000	2,800
Provision for obsolete material	2,000	-
Reserve for injuries and damages	4,000	-
Contribution in lieu of taxes	(148,271)	(98,495)
Changes in assets and liabilities that increase (decrease) cash:		
Receivables	(28,105)	(98,682)
Fuel oil	(9,941)	(28,109)
Materials and supplies	16,360	(9,082)
Prepayments and other assets	381	(3,284)
Deferred debits	(16,100)	(7,452)
Noncurrent liabilities, excluding note payable to GDB	(4,345)	9,602
Accounts payable and accrued liabilities	6,627	104,931
Customers' deposits	8,514	8,361
Total adjustments	<u>69,758</u>	<u>92,527</u>
Net cash flows provided by operating activities	<u>443,393</u>	<u>399,947</u>
Cash flows from noncapital financing activities:		
Principal paid on general obligation notes	-	(5,000)
Proceeds from waiver to AES Puerto Rico, L.P.	-	15,000
Principal paid on fuel line of credit	(1,040,000)	(1,065,000)
Proceeds from fuel line of credit	1,040,000	1,065,000
Interest paid on fuel line of credit	(8,068)	(7,100)
Net cash flows (used in) provided by noncapital financing activities	<u>(8,068)</u>	<u>2,900</u>
Cash flows from capital and related financing activities:		
Construction expenditures	(405,860)	(426,125)
Proceeds received from FEMA	-	41,616
Allowance for funds used during construction	22,966	12,138
Net increase in construction funds	23,585	(68,244)
Power revenue bonds:		
Proceeds from issuance of bonds, net of original discount	600,002	-
Principal paid on revenue bonds maturities	(144,863)	(140,861)
Interest paid on revenue bonds	(210,993)	(201,677)
Payment of bond anticipation notes	(299,000)	-
Proceeds from bond anticipation notes	36,000	233,000
Interest paid on bond anticipation notes	(6,044)	(2,599)
Net cash flows used in capital and related financing activities	<u>(384,207)</u>	<u>(552,752)</u>

Puerto Rico Electric Power Authority
 Combined Statements of Cash Flows (continued)

	Year ended June 30	
	2001	2000
	<i>(In Thousands)</i>	
Cash flows from investing activities:		
Purchases of investment securities	(1,480,156)	(1,629,842)
Proceeds from sale and maturities of investment securities	1,456,331	1,644,723
Interest on investments	38,223	49,564
Net cash flows provided by investing activities	14,398	64,445
Net increase (decrease) in cash and cash equivalents	65,516	(85,460)
Cash and cash equivalents at beginning of year	336,528	421,988
Cash and cash equivalents at end of year	\$ 402,044	\$ 336,528
Cash and cash equivalents:		
Unrestricted	\$ 92,364	\$ 70,534
Restricted:		
Cash and cash equivalents held by trustee for payment of principal and interest on outstanding bonds	261,568	244,391
Cash and cash equivalents held in construction and other special funds	48,112	21,603
	\$ 402,044	\$ 336,528

See accompanying notes.

Puerto Rico Electric Power Authority
Notes to Combined Financial Statements
June 30, 2001

1. Reporting Entity

Puerto Rico Electric Power Authority (the Authority) is a public corporation and governmental instrumentality of the Commonwealth of Puerto Rico (the Commonwealth) created on May 2, 1941 pursuant to Act No. 83, as amended, re-enacted, and supplemented, of the Legislature of Puerto Rico (the Act) for the purpose of conserving, developing and utilizing the water and power resources of Puerto Rico in order to promote the general welfare of the Commonwealth. Under the entity concept, the Authority is a component unit of the Commonwealth. The Authority produces, transmits, and distributes substantially all of the electric power consumed in Puerto Rico.

The financial statements of the Authority include the financial position and operations of the Puerto Rico Irrigation Systems (Irrigation Systems). The Irrigation Systems is a division of the Authority pursuant to the provisions of the Act, and Acts Nos. 83 and 84, approved on June 20, 1955, regarding the Puerto Rico Irrigation Service, South Coast, and Isabela Irrigation Service, respectively, and the Lajas Valley Public Irrigation Law, approved on June 10, 1953, as amended.

The Authority has broad powers including, among others, to issue bonds for any of its corporate purposes. The Authority is required under the terms of a Trust Agreement, dated January 1, 1974, as amended (the 1974 Agreement), and the Act to determine and collect reasonable rates for electric service in order to produce revenues sufficient to cover all operating and financial obligations, as defined.

2. Summary of Significant Accounting Policies

The following is a summary of the most significant accounting policies followed by the Authority in preparing its financial statements:

Basis of Accounting

The accounting and reporting policies of the Authority conform with the accounting rules prescribed by the Governmental Accounting Standards Board (GASB). As such, it functions as an enterprise fund. The Authority maintains its accounting records on the accrual method of accounting in conformity with generally accepted accounting principles. Although the Authority is not under Federal Energy Regulatory Commission (FERC) regulations, the Authority has adopted the uniform system of accounts prescribed by the FERC.

The Authority follows the provisions of GASB Statement No. 20, "Accounting and Financial Reporting for Proprietary Funds and Other Governmental Entities that Use Proprietary Fund Accounting," which requires proprietary activities to apply all applicable GASB pronouncements as well as all Financial Accounting Standards Board (FASB) Statements and Interpretations, and

Puerto Rico Electric Power Authority
Notes to Combined Financial Statements

2. Summary of Significant Accounting Policies (continued)

Basis of Accounting (continued)

Accounting Principles Board Opinions and Accounting Research Bulletins issued on or before November 30, 1989, unless the pronouncements conflict or contradict GASB pronouncements. This pronouncement permits the adoption of all FASB Statements and Interpretations issued after November 30, 1989, except for those that conflict or contradict GASB pronouncements. The Authority, as allowed by the GASB, decided not to implement any FASB Statement or Interpretation issued after November 30, 1989.

Use of Estimates in the Preparation of Financial Statements

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amount of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Because of uncertainties inherent in the estimation process, it is possible that actual results could differ from those estimates.

Utility Plant

Utility plant is carried at cost, which includes labor, materials, overhead, and an allowance for the cost of funds used during construction (AFUDC). AFUDC represents the cost of borrowed funds used to finance construction work in progress. AFUDC is capitalized as an additional cost of property and as a reduction of interest expense. Capitalized interest expense is reduced by interest income earned on related investments acquired with proceeds of tax exempt borrowings. Such costs are recovered from customers as a cost of service through depreciation charges in future periods. Capitalized interest expense in the years ended June 30, 2001 and 2000 amounted to \$23 million and \$12.1 million, respectively. These amounts are net of interest income earned on investments amounting to \$45.2 million and \$29.1 million, respectively.

Maintenance, repairs, and the cost of renewals of minor items of property units are charged to expense. Replacements of major items of property are charged to the plant accounts. The cost of retired property, together with removal cost less salvage, is charged to accumulated depreciation with no gain or loss recognized.

Depreciation

Depreciation is computed on the straight-line method at rates considered adequate to allocate the cost of the various classes of property over their estimated service lives. The annual composite rate of depreciation, determined by the Authority's consulting engineers, was approximately 4.25% and 3.91% for 2001 and 2000, respectively.

Puerto Rico Electric Power Authority
Notes to Combined Financial Statements

2. Summary of Significant Accounting Policies (continued)

Investments

The Authority follows the provisions of GASB Statement No. 31, "Accounting and Financial Reporting for Certain Investments and for External Investment Pools," which requires the reporting of investments at fair value in the balance sheet and the recording of changes in fair value in the statement of income. The fair value is based on quoted market prices.

The funds under the 1974 Trust Agreement may be invested in:

- Government obligations, which are direct obligations of, or obligations whose principal and interest is guaranteed by the U.S. Government, or obligations of certain of its agencies or instrumentalities.
- Investment obligations of any of the states or territories of the United States or political subdivisions thereof (other than obligations rated lower than the three highest grades by a nationally recognized rating agency) and repurchase agreements with commercial banks fully secured by U.S. Government obligations.
- Time deposits with GDB or the Authority's Trustee under the 1974 Agreement or any bank or trust company member of the Federal Deposit Insurance Corporation having a combined capital and surplus of not less than \$100 million.

Effective April 1999, the 1974 Agreement was amended to provide that permitted investments of moneys to the credit of the Self-insurance Fund will be expanded (subject to the Authority's adoption of an investment policy with the consent of GDB) to coincide with the investments permitted for the pension fund for employees of the Commonwealth of Puerto Rico and its instrumentalities. Such investments include various debt instruments, such as mortgage loans and leases, common and preferred stock, real property and various other financial instruments.

Cash and Cash Equivalents

For purposes of the statements of cash flows, the Authority considers all highly liquid debt instruments with maturities of three months or less when purchased to be cash equivalents. Cash and cash equivalents included in the restricted funds are considered cash equivalents for purposes of the statements of cash flows.

Receivables

Receivables are stated net of estimated allowances for uncollectible accounts, which are determined based upon past collection experience and current economic conditions.

Puerto Rico Electric Power Authority
Notes to Combined Financial Statements

2. Summary of Significant Accounting Policies (continued)

Unamortized Debt Expense

Debt expenses and discounts incurred in the issuance of bonds are deferred and amortized using the straight-line method, which approximates the interest method, over the term of the related debt.

The excess of reacquisition cost over the carrying value of long-term debt is deferred and amortized to expense using the straight-line method over the remaining life of the original debt or the life of the new debt, whichever is shorter.

Materials and Supplies

Materials and supplies inventories are carried at average cost and are stated at the lower of cost or market.

Asbestos Containment Deferred Costs

Maintenance costs incurred in the containment of asbestos are deferred and included in other deferred debits. Such costs are amortized as recovered in billings over an estimated life of 12 years.

Pension Plan

Pension expense is equal to the statutory required contribution to the employees' retirement system. A pension liability or asset is reported equal to the cumulative difference between annual required contributions and actual contributions.

Accounting for Compensated Absences

Accumulated unpaid vacation and sick leave pay are accrued when earned and an additional amount is accrued as a liability for the employer salary-related benefits associated with compensated absences using salary rates in effect at the balance sheet date.

The cost of compensated absences expected to be paid in the next twelve months is classified as accounts payable and accrued liabilities while amounts expected to be paid after twelve months are classified as noncurrent liabilities.

Revenue Recognition, Fuel Costs and Purchase Power

Clients are billed monthly, except for rural clients who are billed bimonthly. Revenues are recorded based on services rendered during each accounting period, including an estimate for unbilled services. Revenues include amounts resulting from a fuel and purchased power cost recovery clause (Fuel Adjustment Clause) which is designed to permit full recovery through customer billings of fuel costs and purchased power. Fuel costs and purchased power are reflected in operating expenses as the fuel is consumed.

Puerto Rico Electric Power Authority
Notes to Combined Financial Statements

2. Summary of Significant Accounting Policies (continued)

Contributions in Lieu of Taxes and Governmental Subsidies

The Act exempts the Authority from all taxes that otherwise would be levied on its properties and revenues by the Commonwealth and its Municipalities, except as follows:

Municipalities

To the extent net revenues, as defined, are available, the Authority is required under the Act to make a contribution in lieu of taxes of 6% of gross electric sales. For these purposes, net revenues include gross electric energy sales (with certain exemptions) computed on the basis of an annual average fuel oil price of up to a maximum of \$30 per barrel. The Authority, subject to its obligations under the 1974 Agreement, may modify the maximum annual average fuel price per barrel to a higher level to provide the Municipalities with sufficient income to absorb their billings for electricity consumption plus the necessary amounts to fulfill their obligation to the Authority. The contribution in lieu of taxes to Municipalities can be used to offset accounts receivable balances owed by the Municipalities to the Authority as permitted by law. Should, in any given year, the Authority's net revenues not be sufficient to cover the calculated maximum contribution in lieu of taxes, said contribution shall be reduced to the amounts available, and the excess does not carry forward as a liability for future years.

Commonwealth of Puerto Rico

To the extent net revenues are available the Authority is also required under the Act to set aside an additional 5% of gross electric sales for the purpose of (i) financing improvements, (ii) offsetting other subsidies (other than cost of fuel adjustments to certain residential clients) of the Commonwealth, and (iii) any other lawful corporate purpose. However, 20% of the 5% electric energy sales set aside for the Commonwealth must be applied against the cost of the Authority's fuel oil subsidy program. Another one-fifth of electric energy sales set aside must be paid to the Secretary of the Treasury for distributing among the Municipalities (in addition to contribution in lieu of taxes described above). Amounts assigned to (ii) above, are classified as a contribution in lieu of taxes in the accompanying statements of income and reduce the related accounts receivable in the balance sheets.

Contributed Capital

The Authority records contributed capital as income.

Puerto Rico Electric Power Authority
Notes to Combined Financial Statements

2. Summary of Significant Accounting Policies (continued)

New Accounting Principle

GASB issued Statement No. 34 in June 1999. This statement substantially changes the Governmental financial reporting model for state and local governments. Also, under GASB 34, certain disclosure requirements will be added. The provisions of this Statement are effective for financial statements of fiscal years beginning after June 15, 2001. The Authority did not implement GASB 34 in fiscal year 2001.

Reclassifications

Certain reclassifications have been made to the 2000 financial statements to conform with the 2001 financial statements presentation.

3. Utility Plant

As of June 30, utility plant consist of:

	2001	2000
	(In Thousands)	
Distribution	\$1,854,205	\$ 1,779,033
Transmission	912,515	865,702
Production	1,400,143	1,396,978
Other production	533,782	511,027
Hydroelectric	85,679	85,677
General	779,714	776,986
Irrigation systems	30,548	30,464
	5,596,586	5,445,867
Less - Accumulated depreciation	(2,788,112)	(2,588,253)
	\$2,808,474	\$ 2,857,614

4. Cash and Cash Equivalents

The 1974 Agreement established the General Fund, the Revenue Fund, and certain other funds (see Note 5). All revenues (other than income from investments and construction funds obtained from financing) are deposited in these funds. The monies held in these funds are presented as unrestricted cash and cash equivalents in the combined balance sheets.

Puerto Rico Electric Power Authority
Notes to Combined Financial Statements

4. Cash and Cash Equivalents (continued)

At June 30, 2001, the carrying amount and bank balance of cash deposits held by the Authority and restricted cash deposits held by the Trustee under the 1974 Agreement, are as follows (in thousands):

	2001		2000	
	Carrying Amount	Bank Balance	Carrying Amount	Bank Balance
Unrestricted	\$ 92,364	\$ 61,367	\$ 70,534	\$ 74,748
Restricted:				
Held by the Trustee	261,568	259,505	244,391	244,391
Held by the Authority	48,112	24,723	21,603	19,366
	\$402,044	\$345,595	\$336,528	\$338,505

Cash deposits, except for minor amounts, are covered by the Federal Deposit Insurance Corporation or collateral held on behalf of the Authority by the Secretary of the Treasury of the Commonwealth of Puerto Rico (the Secretary) or its agent in the name of the Secretary.

5. Restricted Assets

At June 30, 2001 and 2000, certain investments and cash deposits of the Authority were restricted to comply with long-term principal and interest debt service requirements (sinking funds) as well as for self-insurance. These restricted assets are held by the Trustee under the 1974 Agreement, (see Note 8) in the following funds:

Bond Service Account and Redemption Account - Current year requirements for principal of and interest on Power Revenue Bonds. As of June 30, 2001, cash and cash equivalents in this account amounted to \$262 million (2000 - \$244 million).

1974 Reserve Account - Reserve for payment of principal of and interest on Power Revenue Bonds in the event moneys in Bond Service Account or Redemption Account are insufficient for such purpose.

1974 Self-insurance Fund - Fund to pay the cost of repairing, replacing or reconstructing any property damaged or destroyed from, or extraordinary expenses incurred as a result of, a cause which is not covered by insurance required under the 1974 Agreement. The 1974 Self-insurance Fund also serves as an additional reserve for the payment of the principal of and interest on the Power Revenue Bonds, and meeting the amortization requirements to the extent that moneys in the Bond Service Account, the Redemption Account and the 1974 Reserve Account are insufficient for such purpose.

Puerto Rico Electric Power Authority
Notes to Combined Financial Statements

5. Restricted Assets (continued)

At June 30, investments held by the Trustee consist of (in thousands):

	2001	2000
1974 Reserve Account	\$245,633	\$228,553
1974 Self - insurance Fund	73,388	68,938
	\$319,021	\$297,491

Investments held by Trustee under the 1974 Agreement are invested exclusively in securities of the U.S. Government and its agencies.

The Authority also has cash and investment securities held by the trust department of a commercial bank restricted for the following purposes:

1974 Construction Fund - Special fund created by the 1974 Agreement. The proceeds of any Power Revenue Bonds issued for the purpose of paying the cost of acquiring or constructing improvements, together with the money received from any other source for such purpose, except proceeds which are (i) applied to the repayment of advances, (ii) deposited in the 1974 Reserve Account, (iii) deposited in the Bond Service Account as capitalized interest or (iv) used for the payment of financing expenses, shall be deposited in the 1974 Construction Fund and held by the Authority in trust.

Reserve Maintenance Fund - Fund to pay the cost of unusual or extraordinary maintenance or repairs, not recurring annually and renewals and replacements, including major items of equipment. The Reserve Maintenance Fund also serves as an additional reserve for the payment of principal and interest on the Power Revenue Bonds and meeting the amortization requirements to the extent that moneys in the 1974 Sinking Fund, including money in the 1974 Reserve Account, are insufficient for such purpose.

Cogeneration Fund - Fund created on December 15, 1997 pursuant to an agreement between the Authority and EcoEléctrica L.P., a joint venture of private companies, for the purpose of enabling the Authority to pay certain expenses in connection with the Authority's activities concerning cogeneration planning and implementation.

Other Fund - During fiscal year 1999, one of the partners of EcoEléctrica, L.P. (EcoEléctrica) sold its interest in the partnership to a utility company. Pursuant to the agreement between the Authority and EcoEléctrica, the Authority received \$29.6 million as a waiver of certain contractual provisions. During fiscal year 2000, the Authority received \$18 million from AES Puerto Rico, L.P. (AES) as a waiver of certain contractual provisions of its co-generation contract. The Authority will use the proceeds received from EcoEléctrica and AES to reduce the cost of power to be purchased under the respective agreements thus reducing its customers' invoices.

Puerto Rico Electric Power Authority
Notes to Combined Financial Statements

5. Restricted Assets (continued)

At June 30, the 1974 Construction Fund and other special funds consist of (in thousands):

	2001		2000	
	Cash and Cash Equivalents	Investments	Cash and Cash Equivalents	Investments
1974 Construction Fund	\$40,619	\$ 921	\$16,774	\$ 921
Reserve Maintenance Fund	2,397	30,178	80	23,711
Cogeneration Fund	5,096	-	4,749	-
Other Fund	-	43,794	-	45,378
	\$48,112	\$74,893	\$21,603	\$ 70,010

Following is the composition of the investments in the 1974 Construction Fund and other special funds (in thousands):

	2001	2000
U.S. Government obligations	\$45,467	\$45,462
Corporate bonds	9,058	6,956
Equity securities	20,368	17,592
	\$74,893	\$70,010

Puerto Rico Electric Power Authority
Notes to Combined Financial Statements

6. Accounts Receivable

At June 30, receivables consist of (in thousands):

	2001	2000
Electric and related services:		
Government agencies and municipalities	\$ 93,126	\$113,577
Residential, industrial, and commercial	238,640	194,712
Recoveries under fuel adjustment clause under (over) billed	(6,098)	(4,742)
Unbilled services	120,368	114,808
Commonwealth subsidy (fuel adjustment clause) for certain residential clients	37,924	44,251
Miscellaneous accounts and others	15,895	25,605
	499,855	488,211
Allowance for uncollectible accounts	(35,355)	(33,155)
	464,500	455,056
Accrued interest on investments	4,623	3,924
Accounts receivable from FEMA and insurance company	-	18,236
Less - Other non-current receivables, mostly related to Commonwealth	(64,223)	(74,357)
	\$404,900	\$402,859

On October 29, 1991, the Authority entered into an agreement with the Commonwealth for the payment of the outstanding fuel adjustment subsidy receivable amounting to approximately \$94 million. Under this agreement, the Commonwealth will pay that amount over a fifteen-year period in installments of approximately \$6.3 million per year, without interest. As of June 30, 2001, the outstanding fuel adjustment subsidy receivable amounted to approximately \$37.9 million.

In addition, the Authority has other subsidies and reimbursable costs receivable from the Commonwealth which are reduced by means of charges (accounted for as a contribution in lieu of taxes and to the extent net revenues, as defined, are available) against a portion of the 5% of gross electric sales it is required to set aside under the Act. The portion of such receivables and other governmental receivables not expected to be collected during the next fiscal year are reflected in the accompanying balance sheets as other noncurrent receivables.

Puerto Rico Electric Power Authority
Notes to Combined Financial Statements

7. Defeasance of Debt

During 1999 and in prior years, the Authority has refunded in advance certain Power Revenue Bonds and other obligations by placing the proceeds of new debt in an irrevocable trust to provide for future debt service payments on such bonds. Accordingly, the trust accounts, assets, and liabilities for the defeased bonds are not included in the Authority's financial statements. At June 30, 2001, \$94.1 million of Power Revenue Bonds series M, N, O, P, R, T, and X, which remain outstanding are considered defeased.

8. Long-Term Debt

At June 30, long-term debt consists of:

	2001	2000
	(In Thousands)	
Power Revenue Bonds payable:		
publicly offered at various dates		
from 1988 to 2000, interest ranging from 3.8% to 7.6%,		
maturing to 2028	\$4,295,860	\$3,803,434
RUS issues – interest of 5%, maturing to 2030	158,690	166,503
	4,454,550	3,969,937
Less unamortized discount and debt reacquisition costs	(217,395)	(226,669)
	4,237,155	3,743,268
Revenue bonds payable, net		
Note payable	5,000	5,000
	4,242,155	3,748,268
Less current portion of long-term debt	(290,939)	(262,842)
	\$3,951,216	\$3,485,426

Power Revenue Bonds Payable

The Authority has issued Power Revenue Bonds pursuant to the 1974 Agreement principally for the purpose of financing the cost of improvements, as such term is defined in the 1974 Agreement, and subject to the conditions and limitations set forth therein.

In the 1974 Agreement, the Authority covenants to fix, charge, and collect rates so that revenues will be sufficient to pay current expenses and to provide the greater of (i) the required deposits or transfers under the Sinking Fund, the 1974 Self-insurance Fund and the Reserve Maintenance Fund or (ii) 120% of the aggregate principal and interest requirements for the next fiscal year on account of all outstanding Power Revenue Bonds.

Puerto Rico Electric Power Authority
Notes to Combined Financial Statements

8. Long-Term Debt (continued)

Power Revenue Bonds Payable (continued)

Gross revenues, exclusive of income on certain investments, less current expenses as defined in the Agreement have been pledged to repay Power Revenue Bonds principal and interest (see Note 5).

During fiscal year 2001, the Authority issued the Power Revenue Bonds, Series HH. The Authority issued these Bonds to finance a portion of the cost of various projects under its capital improvement program and to retire bond anticipation notes of the Authority issued for that purpose.

A summary of the net proceeds of the Power Revenue Bonds, Series HH, and application of the proceeds follows:

Principal amount of Series HH Bonds Plus:	\$612,240,000
Accrued Interest	2,494,154
Less:	
Original issue discount	<u>2,104,800</u>
Net proceeds	<u><u>\$612,629,354</u></u>
Application of net proceeds:	
Payment of the bond anticipation notes issued to GDB for capital improvements	\$299,000,000
Deposit to the 1974 Construction Fund	301,001,606
Deposit to the 1974 Bond Service Account	2,494,154
Cost of Issuance	<u>10,133,594</u>
Total	<u><u>\$612,629,354</u></u>

A summary of the Power Revenue Bonds Series HH issued during fiscal year 2001 follows:

Term Bonds:	
Due July 1, 2029	\$283,515,000
Due July 1, 2030	40,330,000
Serial Bonds	<u>288,395,000</u>
	<u><u>\$612,240,000</u></u>

The Term Bonds bear interest rates of 5.25% and 5.375, respectively. The Serial Bonds bear interest rates of 4.20% to 5.75% and mature from 2003 to 2020. Interest on the Term Bonds and Serial Bonds will be payable on each January 1 and July 1.

Puerto Rico Electric Power Authority
Notes to Combined Financial Statements

8. Long-Term Debt (continued)

Power Revenue Bonds Payable (continued)

The scheduled payment of and interest on the Series HH Bonds when due, except for bonds maturing on July 1, 2003, is guaranteed under an insurance policy issued concurrently with the delivery of the Series HH Bonds by Financial Security Assurance Inc.

The series HH bonds maturing after July 1, 2010, except for the Series HH Bonds maturing on July 1, 2030, may be redeemed at the option of the Authority prior to maturity, from any available moneys (other than moneys deposited in the 1974 Sinking Fund in respect of an amortization requirement), upon not less than thirty (30) days' prior notice by mail, either in whole or part, and if in part, in such order of maturity as directed by the Authority, on July 1, 2010, and on any interest payment date thereafter, at the following prices (expressed as percentages of the principal amount) plus accrued interest to the date fixed for redemption:

Redemption Date	Redemption Price
July 1, 2010 through June 30, 2011	101%
July 1, 2011 and thereafter	100%

The Series HH Bonds maturing July 1, 2030 may be redeemed at the option of the Authority prior to maturity, from any available moneys (other than moneys deposited in the 1974 Sinking Fund in respect of an amortization requirement), upon not less than thirty (30) days' prior notice by mail, either in whole or in part, on July 1, 2005, and on any interest payment date thereafter, at the following prices (expressed as percentages of the principal amount) plus accrued interest to the date fixed for redemption:

Redemption Date	Redemption Price
July 1, 2005 through June 30, 2006	101%
July 1, 2006 and thereafter	100%

Notes Payable

On December 15, 1997, the Authority borrowed \$5,000,000 from EcoEléctrica (the Note) for the purpose of enabling the Authority to pay certain expenses in connection with Authority's activities concerning cogeneration planning and implementation. The Note bears interest at a rate per annum equal to LIBOR minus three percent (3%) and will be paid at the earliest of various events described in the Note agreement. As of June 30, 2001, the interest rate was 3.77% (2000 - 2.24%).

Puerto Rico Electric Power Authority
Notes to Combined Financial Statements

8. Long-Term Debt (continued)

Scheduled Maturities of Long-Term Debt

The scheduled maturities of long-term debt with interest thereon at June 30, 2001, including sinking fund debt service requirements, are as follows:

Year ending June 30	Power Revenue Bonds	RUS Power Revenue Bonds	EcoEléctrica Note	Total
	(In Thousands)			
2002	\$607,067	\$23,380	\$5,000	\$635,447
2003	373,499	15,719	-	389,218
2004	374,911	15,104	-	390,015
2005	370,992	13,525	-	384,517
2006-2009	1,415,419	52,547	-	1,477,966
2010-2014	1,545,812	57,326	-	1,603,138
2015-2019	1,230,249	41,884	-	1,272,133
2020-2024	906,681	17,565	-	924,246
2025-2030	507,195	8,619	-	515,814
	<u>7,341,825</u>	<u>245,669</u>	<u>5,000</u>	<u>7,592,494</u>
Less:				
Unamortized discount	(61,392)	-	-	(61,392)
Excess reacquisition costs	(156,003)	-	-	(156,003)
Interest	(3,045,965)	(86,979)	-	(3,132,944)
	<u>4,078,465</u>	<u>158,690</u>	<u>5,000</u>	<u>4,242,155</u>
Current portion, net of discount and excess reacquisition costs	<u>(274,163)</u>	<u>(11,776)</u>	<u>(5,000)</u>	<u>(290,939)</u>
Long-term debt, excluding current portion	<u>\$3,804,302</u>	<u>\$146,914</u>	<u>\$ -</u>	<u>\$3,951,216</u>

Puerto Rico Electric Power Authority
Notes to Combined Financial Statements

9. Notes Payable to Banks and GDB

On July 3, 1995, the Authority, GDB, and certain banks entered into an agreement for a revolving line of credit to be used for financing fuel purchases. Under the agreement the Authority borrowed \$125 million. The average effective interest rate during each year and at year-end was 6.76% and 4.12%, respectively, for 2001; and 5.63% and 6.74%, respectively, for 2000.

10. Accounts Payable and Accrued Liabilities

	2001	2000
	(In Thousands)	
Accounts payable, accruals, and withholdings in process of payment	\$239,382	\$250,049
Additional accruals and withholdings:		
Injuries and damages and other	24,877	20,938
Accrued vacation and payroll benefits	48,708	54,052
Accrued sick leave and payroll benefits - exclusive of benefits to be liquidated after one year of approximately \$130.2 million and \$126.9 million in 2001 and 2000, respectively	15,385	16,174
Accrued accident leave	3,973	3,973
Accrued compensation	24,186	22,150
Accrued (prepaid) pension plan contribution and withholding from employees:		
Employees' Retirement System	3,188	4,529
Supplemental unfunded benefit obligation spouse-survivor benefit - exclusive of benefit to be liquidated after one year of approximately \$41 million in 2001 and \$47 million in 2000	10,344	5,204
Supplemental unfunded pension obligation exchanged for forfeited sick leave benefits - exclusive of benefits to be liquidated after one year of approximately \$5.4 million in 2001 and 2000, respectively	10,242	10,242
Employees health plan	17,972	16,010
Contract retainage	20,789	21,045
Contribution in lieu of taxes	6,381	1,800
Other accrued liabilities	16,914	5,608
	\$442,341	\$431,774

Puerto Rico Electric Power Authority
Notes to Combined Financial Statements

11. Employees' Retirement Benefits

Pension Plan

Plan Description

All of the Authority's permanent full-time employees are eligible to participate in the Authority's Pension Plan, a single employer defined benefit pension plan (the Plan) administered by the Employees' Retirement System of the Puerto Rico Electric Power Authority (the System). The System issues a publicly available financial report that includes financial statements and required supplementary information for the Plan. That report may be obtained by writing to the Retirement System of the Puerto Rico Electric Power Authority, PO Box 13978, San Juan, Puerto Rico 00908-3978.

Benefits include maximum retirement benefits of 75% of average basic salary (based on the three highest annual basic salaries) for employees with 30 years of service; also, reduced benefits are available upon early retirement. The Plan was amended on February 9, 1993 to provide revised benefits to new employees limiting the maximum retirement basic salary to \$50,000. The plan was further amended in January 1, 2000 to provide improved retirement benefits to employees with 25 years or more of credited service. Disability and death benefits are also provided. Separation benefits fully vest upon reaching 10 years of credited service. Disability and death benefits are also provided.

If a member's employment is terminated before he becomes eligible for any other benefits under this Plan, he shall receive a refund of his member contribution plus interest compounded annually. The Plan is not subject to the requirements of the Employees Retirement Income Security Act of 1974 (ERISA).

Funding Policy and Annual Pension Cost

The contribution requirements of plan members and the Authority are established and may be amended by the Authority. The Annual Pension Cost (APC) and the Annual Required Contribution (ARC) were computed as part of an actuarial valuation performed as of June 30, 1998 and projected to June 30, 2000 and 2001 based on current year demographic data.

Supplemental Benefits not Funded Through the System

Supplemental benefits were unfunded and such benefits were reimbursed to the System when paid up to December 31, 1999. Effective January 1, 2000, the Board of Trustees of the System approved the transfer of the obligation for supplemental benefits provided by the Authority and not funded through the System (supplemental pension obligations exchanged for forfeited sick leave benefits and the supplemental spousal survivor benefits) to the Retirement System. Also, the Board of Trustees of the System accepted an amortization period for the Plan of 40 years which commenced on June 30, 1996.

Puerto Rico Electric Power Authority
Notes to Combined Financial Statements

11. Employees' Retirement Benefits (continued)

Supplemental Pension Obligations Exchanged for Forfeited Sick Leave Benefits

The Authority's employees with over 20 years of service are entitled to exchange accrued sick leave for supplemental pension benefits and/or be paid in cash the value of such sick leave upon separation from employment.

The forfeited sick leave benefit expense is recognized based on an actuarial projection. The benefit obligation was determined based on an actuarial valuation as of June 30, 1994.

An accrued liability of \$16.5 million and \$15.6 million exists as of June 30, 2001 and 2000, respectively, including the current and non-current portions. The expense for the years ended June 30, 2001 and 2000 amounted to approximately \$10.2 million and \$9.5 million, respectively.

Puerto Rico Electric Power Authority
Notes to Combined Financial Statements

11. Employees' Retirement Benefits

The authority's annual pension cost for the year ended June 30, 2001 and related information for the Plan and supplemental benefits follows:

	Pension Plan
Contribution rates:	
Authority	12.57%
Plan members	10.41%
Annual pension cost (thousands)	\$34,952
Contributions made and accruals (thousands)	\$34,952
Actuarial valuation date	6/30/2000
Actuarial cost method	Entry age
Amortization method	Level percentage of pay, closed (4.5% payroll increases per year)
Remaining amortization period	36 years
Asset valuation method	3-year smoothed market
Actuarial assumptions:	
Investment rate of return (net of administrative expenses)*	8.5%
Projected salary increases*	6.0%
*Includes inflation at	3.5%
Cost-of-living adjustments	From 8% per year for yearly pension up to \$3,600 and 4% per year for yearly pension between \$3,600 and \$7,200. For yearly Pensions in Excess of \$7,200, the minimum adjustment is \$600 per year.

Puerto Rico Electric Power Authority
Notes to Combined Financial Statements

11. Employees' Retirement Benefits

Fiscal Year Ending	Three-Year Trend Information (In Millions)		
	Annual Pension Cost (APC)	Percentage of APC Contributed	Net Pension Obligation
Pension Plan			
06/30/98	\$29.20	100%	\$ -
06/30/99	28.80	100%	\$ -
06/30/00	39.80	100%	\$ -
06/30/01	35.00	100%	\$ -

The annual required contribution amounted to \$34 million.

Post Retirement Health Benefits

The Authority also provides certain health care benefits for retired employees and spouses. Substantially all of the Authority's employees may become eligible for those benefits if they reach normal retirement while working for the Authority.

Costs of benefits provided by the Authority are based on a cost plus plan, except the prescribed medicine cost, which is based on a fixed cost premium. Such costs include claims received from the plan administrators, a charge for an administration fee and an accrual for incurred but not reported claims. The costs of health care benefits to retirees amounted to approximately \$37.8 million in 2001 and \$31.6 million in 2000. Currently, 8,886 retirees meet eligibility requirements.

Puerto Rico Electric Power Authority
Notes to Combined Financial Statements

12. Revenues from Major Clients and Related Parties

Electric operating revenues from major clients and related parties are as follows:

	2001	2000
	(In Thousands)	
	<hr/>	
Governmental sector, principally instrumentalities, agencies and corporations of the Commonwealth of Puerto Rico	\$269,355	\$249,097
Municipalities	103,124	98,678
	<hr/>	
	\$372,479	\$347,775
	<hr/>	

13. Contribution in Lieu of Taxes

	2001	2000
	(In Thousands)	
	<hr/>	
Municipalities	\$121,890	\$83,772
Commonwealth:		
Hotels	3,297	2,641
Fuel adjustment subsidy	22,379	11,046
Other subsidies (offset against outstanding accounts receivable and reimbursable costs)	705	1,036
	<hr/>	
	\$148,271	\$98,495
	<hr/>	

14. Retained Earnings

Retained earnings at June 30, 2001 and 2000 include \$73.4 million and \$68.9 million, respectively, which have been appropriated principally to provide a reserve for damaged or destroyed property of the Authority not fully covered by insurance as required by the 1974 Agreement. Funds set aside for self-insurance purposes are deposited in the Self-Insurance Fund held by the Trustee (see Note 5).

Puerto Rico Electric Power Authority
Notes to Combined Financial Statements

15. Commitments and Contingencies

Environmental Matters

Facilities and operations of the Authority are subject to regulations under numerous Federal and Commonwealth environmental laws, including the Clean Air Act, Clean Water Act, and the National Pollutant Discharge Elimination System (NPDES). In February 1992, the Environmental Protection Agency (EPA) performed an inspection of various facilities of the Authority and became aware of deficiencies in different areas, principally air opacity; water quality; spill prevention control and countermeasures; and underground storage tanks. As a result, the Authority agreed to, among other things, make certain capital improvements and undertake Supplemental Environmental Projects (SEPs). The Authority also agreed to use fuel oil not exceeding a sulfur content of 1.5%, a vanadium content of 150 PPM and an asphaltene content of 8% at its generating plants.

In addition, in 1999, the Authority and EPA reached an agreement whereby the Authority agreed to pay a civil penalty of \$1.5 million and to implement additional compliance projects costing \$4.5 million, both of which the Authority has accrued as of June 30, 2000, and to undertake improvements to its existing compliance programs and its operations in order to assure compliance with environmental laws and regulations.

In November 1999, the Authority filed a Notice of Dispute Resolution with the United States District Court for the District of Puerto Rico to dispute EPA's interpretation of the applicable method to determine visible emissions from the Authority's generating units. The specific location where to "read" the opacity of the plume is under advisement with the Court.

Commitments to Purchase Power

In October 1994, the Authority signed a contract with AES Puerto Rico, L.P. (AES) to purchase power of approximately 454 megawatts generated from a coal fluidized bed combustion facility. The term of the agreement is for twenty-five (25) years. This project is currently in its final construction stage.

In March 1995, the Authority also signed a contract with EcoEléctrica, L.P. (EcoEléctrica) to purchase power of approximately 507 megawatts from a gas-fire combined cycle power plant. The term of the agreement is for twenty-two (22) years. This plant has commenced generating power.

Under both agreements, the cost of the purchased power will be based on the quantity of energy delivered and dependable capacity available, as more fully explained in the Agreements. The Authority also has the option to purchase the generating facilities if certain conditions, as defined in the agreements, are met. However, in no event will the exercise price of the purchase options be below fair value. The Authority is not responsible for and does not guarantee the debt or operations of AES or EcoEléctrica. Both agreements obligate the Authority to purchase power only if generated by the plants.

Puerto Rico Electric Power Authority
Notes to Combined Financial Statements

15. Commitments and Contingencies

Risk Management

The Authority is exposed to various risks of losses related to torts; thefts of, damage to, and destruction of assets; errors and omissions; injuries to employees; and natural disasters. The Authority obtains coverage, among others, for up to a maximum of \$250,000 for each general and liability claim, and \$2,000,000, for each boiler and machinery and property liability claim. The property liability policy imposes windstorm and earthquake deductibles at 2% and 5% of the locations value subject to a maximum deductible of \$25 million per occurrence. The Authority purchases commercial insurance for claims in excess of coverage provided through the property and casualty insurance program. The Authority considers its Self-insurance Fund sufficient to provide for its self-insurance risk (see Note 5). Claims expenditures and liabilities are recorded when it is probable that a loss has occurred and the amount of that loss can be reasonably estimated.

The Authority has a cost plus health insurance program covering substantially all employees. The Authority contracted an administrator for the processing, approval and payment of claims plus an administrative fee. The accrual for employees health plan includes the liability for claims processed and an estimate for claims incurred but not reported.

The State Insurance Fund Corporation (SIF) provides workers' compensation to the Authority. In addition, the Authority is self-insured to pay the difference between the SIF payment and (i) 100% of the employee salary during the first 104 weeks and (ii) 80% of the employee salary for 52 additional weeks.

In addition, the Authority is self insured for its transmission and distribution lines. Transmission and distribution lines amounted to approximately \$2.6 billion and \$2.7 billion at June 30, 2001 and 2000, respectively.

The retained earnings and restricted assets set aside in the Self-insurance Fund for self insurance amounted to approximately \$73.4 million in 2001 and \$68.9 million in 2000.

Changes in the balances of the health insurance program and other self-insurance risks during fiscal years 2001 and 2000 were as follows:

	Liability Beginning Balance	Expenses	Payments	Liability End Balance
	(In Thousand)			
2001	\$40,921	\$95,344	\$89,443	\$46,822
2000	\$37,804	\$85,173	\$82,056	\$40,921

Puerto Rico Electric Power Authority
Notes to Combined Financial Statements

15. Commitments and Contingencies (continued)

Contingencies

The Authority is a defendant or codefendant in several lawsuits incidental to its business, some involving substantial amounts. In those instances that management and legal counsel believe that the outcome of the litigation will be unfavorable to the Authority, a provision has been made to cover the estimated liability. Management, based on discussions with legal counsel, believes that the additional liability, if any, resulting from the ultimate resolution of these matters will not have a material effect on the Authority's financial position or results of operations.

On May 18, 2000, Abengoa, Puerto Rico, S.E. (Abengoa), the Authority's contractor for the repowering of San Juan steam plant units 5 and 6, unilaterally declared a termination of the contract and filed a complaint for breach of contract. The Authority has moved for time to answer the complaint and has filed a counter claim for the cost of the project and for all damages caused to the Authority by the alleged illegal contract termination. The Authority believes that the actions by the contractor will not materially affect the ability of the Authority to provide service nor will there be a material difference in the quality of service provided by the Authority.

In May 1998, the Municipality of Ponce filed a complaint against the Authority in the San Juan Superior Court requesting the payment by the Authority of the full contributions in lieu of taxes and electric energy sales set aside for prior fiscal years. The complaint challenges the application of the Net Revenues by the Authority in making deposits to certain funds under the 1974 Agreement and under a prior trust indenture (now terminated) for the purposes of paying costs of capital improvements and seeks a payment by the Authority in the amount by which the amount available to pay contributions in lieu of taxes and electric energy sales set aside to the Municipality of Ponce has been reduced as a result of such application. The Authority has filed a motion to dismiss the complaint. Since the filing of the suit by the Municipality of Ponce, eighteen other municipalities have filed similar claims. The Authority understands that because the Act provides that the contributions in lieu of taxes and electric energy sales set aside are only payable after complying with the Authority's deposit obligations under the 1974 Agreement and the prior indenture and shortfalls do not carry forward as future liabilities of the Authority as described above, it is legally entitled to make such deposits even if the effect is to reduce such contributions and set aside available to municipalities.

a. Hurricane Georges

On September 21, 1998, Hurricane Georges passed through the Commonwealth causing substantial damage. The Commonwealth was declared an emergency zone by President Clinton, thus making it eligible for emergency assistance from the Federal Emergency Management Agency (FEMA).

The Authority's total damages from Hurricane Georges, including restoration costs, amounted to approximately \$219.7 million, consisting of \$9.1 million in damages to the generating plants, \$177.8 million in damages to the transmission and distribution system and \$32.8 million in other damages. Damages amounting to \$121.5 million were charged to accumulated depreciation with no gain or loss recognized.

Puerto Rico Electric Power Authority
Notes to Combined Financial Statements

15. Commitments and Contingencies (continued)

a. Hurricane Georges (continued)

As of June 30, 2000, the Authority has submitted claims to FEMA totaling \$159.7 million and has received payments of \$149.8 million, consisting of \$133.8 million in FEMA payments and \$16.0 million in matching contributions from the Government of the Commonwealth. Also, the Authority submitted claims in the amount of approximately \$12.7 million to private insurers to cover damages to the generating units.

b. Construction and Other Commitments

As of June 30, 2001, the Authority has commitments of approximately \$357.5 million on active construction, maintenance, and engineering services contracts.

16. Supplemental Disclosures of Noncash Capital and Financing Information

The accreted value of capital appreciation bonds equals the original principal amount of such capital appreciation bonds plus interest accrued from its date of issuance. During the years ended June 30, 2001 and 2000, the accrued interest on capital appreciation bonds amounted to \$17.2 million and \$17.3 million, respectively.

17. Subsequent Events

The Authority is expected to issue Power Revenue Bonds to finance a portion of the cost of various projects under its capital improvement program and to pay certain bond anticipation notes. This bond issuance is expected to occur during the first quarter of the fiscal year ending June 30, 2002.

On October 26, 2001, the Authority entered into a long term agreement for its optical fiber cable requirements with Puerto Rico Information Network, Inc., a private not-for-profit corporation (PRIN). Under this agreement PRIN is required to design, build and transfer to the Authority title to all fiber optic cable installed on the Authority's rights-of-way (mainly its transmission lines). The agreement also provides for the long term lease to PRIN of any surplus capacity of the cables installed. In addition, the Authority is obligated to make purchase price payments of \$43.7 million in October 2002 to acquire the fiber optic telecommunication system.

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Supplemental Information

Puerto Rico Electric Power Authority

Supplementary Information

June 30, 2001

(In Millions)

Actuarial Valuation Date	Actuarial Value of Assets (a)	Actuarial Accrued Liability (AAL) (b)	Unfunded AAL (UAAL) (b - a)	Funded Ratio (a/b)	Covered Payroll (c)	UAAL Percentage of Covered Payroll (b) - (a)/(c)
<u>Pension Plan</u>						
6/30/98*	\$1,267.9	\$1,495.2	\$227.3	85%	\$273.8	83%
6/30/99**	1,443.0	1,537.9	94.9	94%	276.8	34%
6/30/00	1,549.6	1,799.4	249.8	86%	278.1	90%

Note 1: The system, as permitted by the GASB, reflects its investments at an average fair market value of the last three years to determine its actuarial funding.

* Estimated valuation, projected from actual 6/30/97 valuation.

** Estimated valuation, projected from actual 6/30/98 valuation. Does not reflect benefit improvements effective January 1, 2000.

Puerto Rico Electric Power Authority

Note to Schedules II-VII - Information Required by the 1974 Agreement

As of June 30, 2001 and 2000 and the Years then Ended

Schedules II - VII present certain information which is required by the 1974 Agreement. The Net Revenues data, as defined in the 1974 Agreement (Net Revenues), presented in Schedules II and III differ in some important respects from generally accepted accounting principles (GAAP). Such differences are explained below; Schedule II also presents a reconciliation of Net Revenues with GAAP.

The most significant differences between Net Revenues and GAAP are the following:

- 1) Revenues do not include investment income on investments in the construction fund (see Note 5 to the financial statements);
- 2) Depreciation and interest expense on bonds covered by the 1974 Agreement are not included as deductions in calculating Net Revenues;
- 3) Amortization of debt discount and issuance costs and the allowance for funds used during construction are not considered in the computation in calculating Net Revenues;
- 4) Contribution in lieu of taxes is not considered a deduction for purposes of Net Revenues;
- 5) Net Revenues do not include revenues or expenses of the Irrigation Systems (see Note 1 to the financial statements).

For further details and information on the definition of Net Revenues, please refer to the 1974 Agreement.

Puerto Rico Electric Power Authority
Sources and Disposition of Net Revenues
Under the Provisions of the 1974 Agreement for the Years Ended June 30, 2001 and 2000
Statements of Income (GAAP) and Reconciliation of Net Income
(In Thousands)

	2001			2000		
	1974 Agreement	Statement of Income (GAAP)	Reconciliation of Net Income	1974 Agreement	Statement of Income (GAAP)	Reconciliation of Net Income
Reconciliation of components of net income:						
Revenues:						
Operating revenues	\$2,329,103	\$2,331,989	\$ 2,886	\$1,984,227	\$1,987,337	\$ 3,110
Revenues from Commonwealth for rural electrification	705	705		881	881	
Other operating revenues	8,210	8,210		10,240	10,240	
Other	35,059	35,059		29,936	29,936	
Construction fund investment income and gain on sale of other properties		10,575	10,575		3,724	3,724
	<u>2,373,077</u>	<u>2,386,538</u>		<u>2,025,284</u>	<u>2,032,118</u>	
Current expenses:						
As shown	1,722,689	1,725,186		1,466,823	1,469,956	
Other interest		3,028			2,911	
Total as defined	<u>1,722,689</u>	<u>1,728,214</u>	(5,525)	<u>1,466,823</u>	<u>1,472,867</u>	(6,044)
Net revenues, as defined	<u>650,388</u>			<u>558,461</u>		
Depreciation		<u>233,169</u>	(233,169)		<u>209,960</u>	(209,960)
Disposition of Revenues: (not classified in order of payment)						
Interest on debt	243,774	243,774		227,288	227,288	
Amortization of bond defeasance		14,182			14,239	
Allowance for funds used during construction		(22,966)			(12,138)	
Net interest on long-term debt	<u>243,774</u>	<u>234,990</u>	8,784	<u>227,288</u>	<u>229,389</u>	(2,101)
Power revenue bonds:						
Principal	146,989		146,989	145,058		145,058
Internal Funds	97,185		97,185	71,838		71,838
Reserve Maintenance Fund	7,000		7,000	7,000		7,000
Contribution in lieu of taxes	155,440	148,271	7,169	107,277	98,494	8,783
Total expenses (GAAP)		<u>2,344,644</u>			<u>2,010,710</u>	
Net revenues, as defined	<u>\$ 650,388</u>			<u>\$ 558,461</u>		
Net income		<u>\$ 41,894</u>	<u>\$ 41,894</u>		<u>\$ 21,408</u>	<u>\$ 21,408</u>

See accompanying Notes.

SCHEDULE III

Puerto Rico Electric Power Authority

*Supplemental Schedule of Sources and Disposition
of Net Revenues under the Provisions of the 1974 Agreement
for the Years Ended June 30, 2001 and 2000
(In Thousands)*

	<u>2001</u>	<u>2000</u>
Sources of Net Revenues:		
Revenues:		
Electric revenues	\$2,329,103	\$1,984,227
Revenues from the Commonwealth for rural electrification	705	881
Other operating revenues	8,210	10,240
Other (principally interest)	35,059	29,936
	<u>2,373,077</u>	<u>2,025,284</u>
Current Expenses:		
Operations:		
Fuel	944,760	801,432
Purchased Power	177,330	64,518
Other production	56,301	55,690
Transmission and distribution	105,034	94,793
Customer accounting and collection	213,666	76,598
Administrative and general	83,453	151,069
Maintenance	139,117	219,812
Expenses related to Hurricane Georges	3,028	-
Interest (Other than long term debt)	-	2,911
	<u>1,722,689</u>	<u>1,466,823</u>
Net revenues, as defined	<u>\$ 650,388</u>	<u>\$ 588,461</u>
Disposition of Net Revenues:		
Revenue fund:		
Power revenue bonds - sinking fund requirements:		
Interest	\$ 238,043	\$ 218,621
Principal	146,989	145,058
Reserve	-	-
Reserve maintenance fund	7,000	7,000
Debt discount and expenses	-	-
Balance available for capital improvements and other needs	100,501	74,265
	<u>492,533</u>	<u>444,944</u>
General obligation notes:		
Interest	2,415	6,240
Principal	-	-
	<u>2,415</u>	<u>6,240</u>
Contribution in lieu of taxes and other:	<u>155,440</u>	<u>107,277</u>
Net revenues, as defined	<u>\$ 650,388</u>	<u>\$ 558,461</u>

See accompanying Notes.

SCHEDULE IV

Puerto Rico Electric Power Authority
 Supplemental Schedule of Funds Under the Provisions of the 1974 Agreement
 (In Thousands)

	For the years ended June 30							
	2001				2000			
	Total	Held by Authority Other Assets	Restricted Deposits with Trustee Other Assets	Non-Current Assets	Total	Held by Authority Other Assets	Restricted Deposits with Trustee Other Assets	Non-Current Assets
By Account								
1974 Agreement (restricted):								
Sinking Fund – principal and interest	\$261,568		\$261,568		\$244,391		\$244,391	
Reserve account	245,637			\$245,637	228,554			\$228,554
Self Insurance Fund	73,384			73,384	68,936			68,936
Reserve Maintenance Fund	32,612	32,612			23,792	\$23,792		
Construction Fund								
Rural Utilities Service (RUS)	1,388	467	921		1,308	387	921	
Other	40,152	40,152			16,387	16,387		
Cogeneration Fund	5,096	5,096			4,749	4,749		
PREPA Client Fund	43,793	43,793			45,378	45,378		
General purpose (unrestricted):								
General	89,947	89,947			68,187	68,187		
Working funds	2,417	2,417			2,347	2,347		
Total	\$795,944	\$214,484	\$262,489	\$319,021	\$704,029	\$161,227	\$245,312	\$297,490
By type of assets held								
Working funds	\$2,417	2,417			\$ 2,347	\$ 2,347		
Cogeneration Fund	5,096	5,096			4,749	4,749		
PREPA Client Fund								
Cash in bank and time deposits (by depository institutions):								
Banco Popular de Puerto Rico	7,621	7,621			13,558	13,558		
Citibank, N. A.	54,447	54,447			30,076	30,076		
State Street Bank and Trust Co., N.A.	261,568		261,568		244,391		\$244,391	
Banco Bilbao Vizcaya	15	15			41	41		
Banco Bilbao Vizcaya, Mayaguez, PR	2,073	2,073			559	559		
First Bank, San Juan, Puerto Rico	782	782			480	480		
Banco Santander, Santurce, Puerto Rico	24,051	24,051			16,245	16,245		
Roig Commercial Bank, Humacao, P.R.	173	173			57	57		
Western Bank, Mayaguez, Puerto Rico	785	785			7,171	7,171		
	359,028	97,460	261,568		319,674	75,283	244,391	
Investment Securities	436,966	117,024	921	319,021	384,355	85,944	921	297,490
Total	\$795,994	\$214,484	\$262,489	\$319,021	\$704,029	\$161,227	\$245,312	\$297,490

See accompanying Notes.

Puerto Rico Electric Power Authority
 Supplement Schedule of Changes in Cash and Investments by Funds
 Year ended June 30, 2001
(In Thousands)

	General Purposes Funds				
	Total	General Fund	Revenue Fund	Working Fund	
Balances at June 30, 2000	\$ 704,028	\$ 65,792	\$ 2,395	\$2,347	\$ -
Operations:					
Net revenues	-	(650,388)	155,440	-	-
Funds provided from internal operations	501,164	501,164	-	-	-
1974 Agreement investment income	-	(9,685)	-	-	-
Offset of current year's contribution in lieu of taxes against certain government accounts receivable	-	115,509	(115,509)	-	-
Offset of current year's 5% contribution in lieu of taxes against Commonwealth of Puerto Rico debt and transfers to General Obligations Notes Fund	-	33,550	(33,550)	-	-
Funds used for construction	(405,638)	-	-	-	-
Funds used for restoration of plant	-	-	-	-	-
Proceeds from waiver granted to EcoElectrica	-	-	-	-	-
Financing:					
Proceeds received from FEMA	-	-	-	-	-
Proceeds from new bond issues-net of original issue discount	600,002	-	-	-	-
Defeased bonds-net of original issue discount	-	-	-	-	-
Accretion of capital appreciation bonds	17,236	17,236	-	-	-
Amortization of debt discount and excess reacquisition costs	17,498	17,498	-	-	-
Sinking Funds and account transfers	-	-	-	-	-
Notes issued for construction	36,000	-	-	-	-
Notes issued for fuel purchases	1,040,000	1,040,000	-	-	-
Payment of notes	(1,339,000)	(1,040,000)	-	-	-
Payment of interest	(225,105)	(8,068)	-	-	-
Payment of current maturities of long-term debt	(144,863)	-	-	-	-
Changes in assets and liabilities:					
Working funds	-	(70)	-	70	-
Accounts receivable (includes non-current)	(24,684)	(24,684)	-	-	-
Fuel oil	(9,941)	(9,941)	-	-	-
Materials and supplies	16,360	16,360	-	-	-
Prepayments and other	409	409	-	-	-
Deferred debits	1,766	1,766	-	-	-
Accounts payable and accrued liabilities (includes non-current)	2,248	2,248	-	-	-
Customer deposits	8,514	8,514	-	-	-
Interfund transfers, etc.	-	4,164	(8,745)	-	-
Total before interfund accounts	795,994	81,374	31	2,417	-
Add (deduct) interfund accounts	-	8,542	-	-	-
Balances at June 30, 2001	\$ 795,994	\$ 89,916	\$ 31	\$2,417	\$ -

See accompanying Notes.

Sinking Fund				Other Funds			
Interest 1974 Agreement	Principal 1974 Agreement	Reserve 1974 Agreement	Self Insurance Fund	Construction 1974 Agreement	Reserve Maintenance Fund	Cogeneration Fund	Clients Fund
\$102,659	\$141,732	\$228,553	\$68,936	\$17,696	\$23,791	\$4,749	\$45,378
241,359	146,989	-	-	99,600	7,000	-	-
-	-	-	-	-	-	-	-
-	-	-	-	9,685	-	-	-
-	-	-	-	-	-	-	-
-	-	-	-	(405,638)	-	-	-
-	-	-	-	-	-	-	-
-	-	-	-	-	-	-	-
-	-	-	-	600,002	-	-	-
-	-	-	-	-	-	-	-
-	-	-	-	-	-	-	-
-	-	-	-	-	-	-	-
-	-	-	-	36,000	-	-	-
-	-	-	-	-	-	-	-
(210,993)	(144,863)	-	-	(299,000)	-	-	-
-	-	-	-	(6,044)	-	-	-
-	-	-	-	-	-	-	-
-	-	-	-	-	-	-	-
-	-	-	-	-	-	-	-
-	-	-	-	-	-	-	-
-	-	-	-	-	-	-	-
-	-	-	-	-	-	-	-
-	-	-	-	-	-	-	-
(18,848)	3,533	17,084	4,448	(2,219)	1,821	347	(1,585)
114,177	147,391	245,637	73,384	50,082	32,612	5,096	43,793
				(8,542)			
<u>\$ 114,177</u>	<u>\$147,391</u>	<u>\$245,637</u>	<u>\$73,384</u>	<u>\$ 41,540</u>	<u>\$32,612</u>	<u>\$5,096</u>	<u>\$43,793</u>

Puerto Rico Electric Power Authority
 Supplement Schedule of Changes in Cash and Investments by Funds
 Year ended June 30, 2000
(In Thousands)

	General Purposes Funds				
	Total	General Fund	Revenue Fund	Working Fund	General Obligations Notes Fund
Balances at June 30, 1999	\$ 751,125	\$ 73,835	\$ 22	\$2,317	\$ -
Operations:					
Net revenues	-	(558,461)	107,277	-	103
Funds provided from internal operations	419,521	419,521	-	-	-
1974 Agreement investment income	-	(3,724)	-	-	-
Offset of current year's contribution in lieu of taxes against certain government accounts receivable	-	83,772	(83,772)	-	-
Offset of current year's 5% contribution in lieu of taxes against Commonwealth of Puerto Rico debt and transfers to General Obligations Notes Fund	-	23,505	(23,505)	-	-
Funds used for construction	(413,987)	-	-	-	-
Funds used for restoration of plant	-	-	-	-	-
Proceeds from waiver granted to EcoElectrica	15,000	-	-	-	-
Financing:					
Proceeds received from FEMA	41,616	41,616	-	-	-
Proceeds from new bond issues-net of original issue discount	-	-	-	-	-
Defeased bonds-net of original issue discount	-	-	-	-	-
Accretion of capital appreciation bonds	17,262	17,262	-	-	-
Amortization of debt discount and excess reacquisition costs	16,666	16,666	-	-	-
Sinking Funds and account transfers	-	15,994	-	-	-
Notes issued for construction	233,000	-	-	-	-
Notes issued for fuel purchases	1,065,000	1,065,000	-	-	-
Payment of notes	(1,065,000)	(1,065,000)	-	-	-
Payment of interest	(211,376)	(7,100)	-	-	-
Payment of current maturities of long-term debt	(145,861)	-	-	-	(5,000)
Changes in assets and liabilities:					
Working funds	-	(30)	-	30	-
Accounts receivable (includes non-current)	(95,882)	(95,882)	-	-	-
Fuel oil	(28,109)	(28,109)	-	-	-
Materials and supplies	(9,082)	(9,082)	-	-	-
Prepayments and other	(1,307)	(1,307)	-	-	-
Deferred debits	(7,452)	(7,452)	-	-	-
Accounts payable and accrued liabilities (includes non-current)	114,533	114,533	-	-	-
Customer deposits	8,361	8,361	-	-	-
Interfund transfers, etc.	-	(12,820)	2,373	-	4,897
Total before interfund accounts	704,028	91,098	2,395	2,347	-
Add (deduct) interfund accounts	-	(25,306)	-	-	-
Balances at June 30, 2000	\$ 704,028	\$ 65,792	\$ 2,395	\$2,347	\$ -

See accompanying Notes.

Sinking Fund				Other Funds			
Interest 1974 Agreement	Principal 1974 Agreement	Reserve 1974 Agreement	Self Insurance Fund	Construction 1974 Agreement	Reserve Maintenance Fund	Cogeneration Fund	Clients Fund
\$134,817	\$ 105,804	\$217,621	\$ 94,750	\$ 71,512	\$15,941	\$4,949	\$29,557
221,047	145,058	-	-	77,976	7,000	-	-
-	-	-	-	-	-	-	-
-	-	-	-	3,724	-	-	-
-	-	-	-	-	-	-	-
-	-	-	-	-	-	-	-
-	-	-	-	(413,987)	-	-	-
-	-	-	-	-	-	-	-
-	-	-	-	-	-	-	15,000
-	-	-	-	-	-	-	-
-	-	-	-	-	-	-	-
-	-	-	-	-	-	-	-
(29,234)	31,220	12,020	(30,000)	-	-	-	-
-	-	-	-	233,000	-	-	-
-	-	-	-	-	-	-	-
(201,677)	-	-	-	(2,599)	-	-	-
-	(140,861)	-	-	-	-	-	-
-	-	-	-	-	-	-	-
-	-	-	-	-	-	-	-
-	-	-	-	-	-	-	-
-	-	-	-	-	-	-	-
-	-	-	-	-	-	-	-
-	-	-	-	-	-	-	-
(22,294)	511	(1,088)	4,186	22,764	850	(200)	821
102,659	141,732	228,553	68,936	(7,610)	23,791	4,749	45,378
-	-	-	-	25,306	-	-	-
<u>\$102,659</u>	<u>\$141,732</u>	<u>\$228,553</u>	<u>\$ 68,936</u>	<u>\$ 17,696</u>	<u>\$23,791</u>	<u>\$4,749</u>	<u>\$45,378</u>

Puerto Rico Electric Power Authority
 Supplemental Schedule of Changes in Long-Term
 Debt and Current Portion of Long-Term Debt
 Years ended June 30, 2001 and 2000
(In Thousands)

	<u>2001</u>	<u>2000</u>
Long-term debt excluding current portion:		
Balance at the beginning of year	\$3,485,426	\$3,611,676
Transfers to current liabilities:		
Power revenue bonds	(152,248)	(143,512)
General obligation notes	-	-
Note payable	(5,000)	-
	<u>(157,248)</u>	<u>(143,512)</u>
Total transfers		
Remainder	3,328,178	3,468,164
New issues:		
Power revenue bonds	612,240	-
Power revenue refunding bonds	-	-
Note payable to EcoElectrica	-	-
Debt discount on new bond issues - net	(6,438)	-
Defeasance of bonds	-	-
Debt discount and excess reacquisition costs on cancelled bonds - net	-	-
Accretion of capital appreciation bonds	17,236	17,262
	<u>17,236</u>	<u>17,262</u>
Balance at the end of year	<u>\$3,951,216</u>	<u>\$3,485,426</u>
Current portion of long-term debt:		
Balance at beginning of year	\$ 262,842	\$ 250,147
Transfer from long-term debt	157,248	143,512
Payments to bondholders:		
Power revenue - July 1	(141,088)	(136,891)
Power revenue - January 1	(3,775)	(3,970)
Obligations under capital lease	-	-
General obligation notes	-	(5,000)
	<u>(144,863)</u>	<u>(145,861)</u>
Total payments		
Amortization of debt discount and excess reacquisition costs	15,712	15,044
Balance at end of year	<u>\$ 290,939</u>	<u>\$ 262,842</u>

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June 13, 2002

Puerto Rico Electric Power Authority
San Juan, Puerto Rico

Dear Sirs:

Washington Group International, Inc. (“Washington”), operating through its affiliate Washington Engineers P.S.C., serves as the Consulting Engineers under the provisions of the Trust Agreement, dated as of January 1, 1974, as amended, by and between Puerto Rico Electric Power Authority (the “Authority”) and State Street Bank and Trust Company, N.A., in the Borough of Manhattan, City and State of New York, successor trustee. Such Trust Agreement is referred to herein as the “Agreement”, and the trustee under the Agreement is referred to herein as the “Trustee”. The Agreement requires the Consulting Engineers annually to prepare and file with the Authority and the Trustee a report with their recommendations as to any necessary or advisable revisions of rates and charges and such other advices and recommendations as they may deem desirable. In addition, the report will include the amount that should be deposited monthly during the next fiscal year to the credit of the Reserve Maintenance Fund; the amount, if any, to be deposited to the Self-insurance Fund in the next fiscal year; and, the amount to be deposited to the Capital Improvement Fund in the next fiscal year. The most recent such recommendations and report provided to the Authority and the Trustee was dated as of June 2001.

In preparing this letter and in reaching the conclusions and opinions contained herein and referred to in the Official Statement to which this letter is appended, Washington has relied upon inquiries, observations and analyses made and conducted by it in the performance of its duties under the Agreement and upon its professional experience. Washington also has relied upon various financial, economic, political and other information and projections provided to it by the Authority and other sources, some of such information and projections having been accepted by Washington without it having conducted an independent investigation thereof. In addition, Washington has made assumptions which it believes to be reasonable to make including, but not limited to, the following:

1. that the Authority will adhere to its proposed schedule of programmed regular maintenance;
2. that the Authority will continue to maintain the effective availability of its generating units;

3. that the Authority's current capacity expansion plan will be realized as to increases in capacity and approximate timing;
4. that the Authority's forecasts of costs and availability of fuels are reasonable;
5. that financing will be available to the Authority at reasonable rates, in adequate amounts and at appropriate times;
6. that the Authority will not be adversely affected by labor disputes and will have adequate levels of labor productivity;
7. that there will be no material changes in the requirements of regulatory authorities, the Legislature of Puerto Rico will not enact any legislation that will adversely affect the Authority, nor will there be unforeseen technological developments;
8. that the demographic, statistical, economic and other information regarding Puerto Rico obtained by Washington from publicly available sources is reliable;
9. that the Authority will not be unduly affected by natural disasters; and
10. that the Authority will not experience unforeseeable or extraordinary conditions not included in usual estimates and opinions of engineers.


Based upon and subject to the foregoing which should be read in conjunction with and as part of the following conclusions, it is our considered opinion with respect to the Authority that:

1. The Authority's production, transmission and distribution plant is in good repair and sound operating condition;
2. The Authority's generating capacity expansion plan is adequate and should allow the Authority to meet targeted electric reliability criteria;
3. The Authority's projections of future load growth and estimates of peak load referred to in the Official Statement, to which this letter is appended, under the caption "Adequacy of Capacity" are reasonable for base planning purposes;
4. The Authority's revenue and base capacity planning forecasts (and the methodologies and assumptions on which they are based) are reasonable for planning purposes and are generally consistent with electric utility industry practices;
5. The Authority's current projected capital improvement program is reasonable and the estimated expenditures are consistent with the Authority's future needs;
6. The Authority's estimates of future growth form a reasonable basis for its projected operating results;
7. The Authority's electric rates and charges should generate sufficient revenues to pay its current expenses and debt service and to finance that portion of its capital improvement program that is currently anticipated to be financed with current operating revenues; and

8. The 507 MW of capacity presently being provided by a cogenerator and the 454 MW of capacity expected to be available in the third quarter of 2002 as described in the Official Statement to which this letter is appended, and their role in the Authority's capacity expansion program should not cause the Authority to experience a meaningful reduction in control over its revenue producing capability as a result of the purchase rather than self-generation of electricity. The methodology used by the Authority in determining its avoided cost of generating or otherwise obtaining an equivalent amount of energy, pursuant to the Public Utilities Regulatory Policies Act of 1978, as amended (which requires the Authority to pay an amount based upon such avoided cost for power generated and made available to the Authority), is reasonable.

Very truly yours,

WASHINGTON GROUP INTERNATIONAL, INC.

A handwritten signature in black ink, appearing to read "George W. Romano, Jr.", written in a cursive style.

George W. Romano, Jr.
Manager,
Utility Management
Services Department

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TOKYO

July __, 2002

Puerto Rico Electric Power Authority
San Juan, Puerto Rico

Gentlemen:

We have examined the Puerto Rico Electric Power Authority Act (Act No. 83 of the Legislature of Puerto Rico, approved May 2, 1941, as amended and re-enacted by Act No. 19, approved April 8, 1942, as amended) creating Puerto Rico Electric Power Authority (formerly called Puerto Rico Water Resources Authority and herein called the “Authority”), a governmental instrumentality of the Commonwealth of Puerto Rico, and also Act No. 111, approved May 6, 1941, as amended by Act No. 153, approved May 14, 1943 (said Acts No. 83, No. 19, No. 111 and No. 153, as amended, being herein collectively called the “Authority Act”).

We have also examined certified copies of the proceedings of the Governing Board of the Authority in authorizing the execution and delivery of the Agreement hereinafter referred to and certified copies of the proceedings and other proofs submitted relative to the authorization, issuance and sale of

\$401,785,000
PUERTO RICO ELECTRIC POWER AUTHORITY
POWER REVENUE REFUNDING BONDS, SERIES KK
Dated the date hereof.

Issued in such denominations, transferable and exchangeable, bearing interest at such rates and payable on such dates, maturing on July 1 in the years and in such principal amounts, all as set forth in the resolution of the Authority authorizing the issuance of said Series KK Bonds (the “Bonds”). The Bonds are not subject to redemption.

We have also examined one of the Bonds as executed and authenticated.

From such examination, we are of the opinion that:

1. The Authority Act is valid.
2. Said proceedings have been validly and legally taken.
3. The Bonds have been duly authorized and issued to refund the Authority's outstanding Puerto Rico Electric Power Authority Power Revenue and Power Revenue Refunding Bonds set forth in said resolution authorizing the issuance of the Bonds.
4. As authorized by the Authority Act and by said proceedings, a trust agreement, dated as of January 1, 1974, as amended (herein called the "Agreement"), has been duly executed by and between the Authority and State Street Bank and Trust Company, N.A., successor Trustee, which contains reasonable and sufficient covenants and provisions in accordance with law with respect to the custody and application of the proceeds of bonds issued thereunder, the collection and disposition of revenues, the maintenance, repair and operation of the electric power properties of the Authority (such properties, together with all improvements, renewals and replacements thereof and extensions and additions thereto, being herein called the "System"), 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 all bonds issued thereunder.
5. The Agreement provides for the issuance of additional Puerto Rico Electric Power Authority Power Revenue Bonds under the conditions and limitations therein set forth.
6. The Bonds are valid and binding special obligations of the Authority, payable solely from the Puerto Rico Electric Power Authority Power Revenue Bonds Interest and Sinking Fund established under the Agreement, to the credit of which Fund the Authority has covenanted to deposit a sufficient amount of revenues of the System, over and above the expenses of repair, maintenance and operation, to pay the principal of and interest on all bonds issued under the provisions of the Agreement (including the Bonds) as the same become due and payable and to create a reserve for such purpose, which Fund is pledged to and charged with the payment of the principal of and the interest on all bonds issued under the Agreement (including the Bonds).
7. The Agreement provides for the fixing and collecting by the Authority of rates and charges for the use of the services and facilities of the System sufficient for the payment of the expenses of the Authority incurred in the repair, maintenance and operation of the System and for the payment of the principal of and the interest on all bonds issued under the provisions of the Agreement (including the Bonds) as the same become due and payable including reserves for such purposes.
8. The bonds issued under the provisions of the Agreement do not constitute a debt of the Commonwealth of Puerto Rico or of any of its municipalities or other political subdivisions, and neither the Commonwealth of Puerto Rico nor any such municipality or other political subdivision is liable thereon, and such bonds are payable only out of the revenues of the System, to the extent provided in the Agreement.

9. 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 the use, expenditure and investment of bond proceeds and the timely payment of certain investment earnings to the Treasury of the United States, if required, interest on the Bonds is not includable in gross income for federal income tax purposes, and (ii) the Bonds and the interest thereon are exempt from state, Commonwealth of Puerto Rico and local income taxation. No opinion is expressed as to the effect of any action taken or not taken after the date of this opinion without our approval (except for such action or omission to act as is otherwise provided in the Agreement or in the aforementioned resolution authorizing the issuance of the Bonds) or in reliance upon advice of counsel other than ourselves on the exclusion from gross income of the interest on the Bonds 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 federal 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 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.

The Authority has covenanted to comply with the requirements of the Code, to the extent permitted by the Constitution and laws of the Commonwealth of Puerto Rico, so that interest on the Bonds will remain exempt from federal income taxes to which it is not subject on the date of issuance of the Bonds. We are not aware of any provisions of the Constitution or laws of the Commonwealth of Puerto Rico which would prevent the Authority 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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July __, 2002

Puerto Rico Electric Power Authority
San Juan, Puerto Rico

Gentlemen:

We have examined the Puerto Rico Electric Power Authority Act (Act No. 83 of the Legislature of Puerto Rico, approved May 2, 1941, as amended and re-enacted by Act No. 19, approved April 8, 1942, as amended) creating Puerto Rico Electric Power Authority (formerly called Puerto Rico Water Resources Authority and herein called the “Authority”), a governmental instrumentality of the Commonwealth of Puerto Rico, and also Act No. 111, approved May 6, 1941, as amended by Act No. 153, approved May 14, 1943 (said Acts No. 83, No. 19, No. 111 and No. 153, as amended, being herein collectively called the “Authority Act”).

We have also examined certified copies of the proceedings of the Governing Board of the Authority in authorizing the execution and delivery of the Agreement hereinafter referred to and certified copies of the proceedings and other proofs submitted relative to the authorization, issuance and sale of

\$98,125,000
PUERTO RICO ELECTRIC POWER AUTHORITY
POWER REVENUE BONDS, SERIES LL
Dated the date hereof.

Issued in such denominations, transferable and exchangeable, bearing interest at such rates and payable on such dates, maturing on July 1 in the years and in such principal amounts, all as set forth in the resolution of the Authority authorizing the issuance of said Series LL Bonds (the “Bonds”). The Bonds are not subject to redemption.

We have also examined one of the Bonds as executed and authenticated.

From such examination, we are of the opinion that:

1. The Authority Act is valid.
2. Said proceedings have been validly and legally taken.
3. The Bonds have been duly authorized and issued to provide funds for paying the cost of capital improvements to the electric power properties of the Authority (such properties, together with all improvements, renewals and replacements thereof and extensions and additions thereto, being herein called the "System").
4. As authorized by the Authority Act and by said proceedings, a trust agreement, dated as of January 1, 1974, as amended (herein called the "Agreement"), has been duly executed by and between the Authority and State Street Bank and Trust Company, N.A., successor Trustee, which contains reasonable and sufficient covenants and provisions in accordance with law with respect to the custody and application of the proceeds of bonds issued thereunder, the collection and disposition of revenues, the maintenance, repair and operation of the System, 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 all bonds issued thereunder.
5. The Agreement provides for the issuance of additional Puerto Rico Electric Power Authority Power Revenue Bonds under the conditions and limitations therein set forth.
6. The Bonds are valid and binding special obligations of the Authority payable solely from the Puerto Rico Electric Power Authority Power Revenue Bonds Interest and Sinking Fund established under the Agreement, to the credit of which Fund the Authority has covenanted to deposit a sufficient amount of revenues of the System, over and above the expenses of repair, maintenance and operation, to pay the principal of and interest on all bonds issued under the provisions of the Agreement (including the Bonds) as the same become due and payable and to create a reserve for such purpose, which Fund is pledged to and charged with the payment of the principal of and interest on such bonds (including the Bonds).
7. The Agreement provides for the fixing and collecting by the Authority of rates and charges for the use of the services and facilities of the System sufficient for the payment of the expenses of the Authority incurred in the repair, maintenance and operation of the System and for the payment of the principal of and the interest on all bonds issued under the provisions of the Agreement (including the Bonds) as the same become due and payable, including a reserve for such purpose.
8. The bonds issued under the provisions of the Agreement (including the Bonds) do not constitute a debt of the Commonwealth of Puerto Rico or of any of its municipalities or other political subdivisions, and neither the Commonwealth of Puerto Rico nor any such municipality or other political subdivision is liable thereon, and such bonds (including the Bonds) are payable only out of the revenues of the System, to the extent provided in the Agreement.

9. 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 the use, expenditure and investment of bond proceeds and the timely payment of certain investment earnings to the Treasury of the United States, if required, interest on the Bonds is not includable in gross income for federal income tax purposes, and (ii) the Bonds and the interest thereon are exempt from state, Commonwealth of Puerto Rico and local income taxation. No opinion is expressed as to the effect of any action taken or not taken after the date of this opinion without our approval (except for such action or omission to act as is otherwise provided in the Agreement or in the aforementioned resolution authorizing the issuance of the Bonds) or in reliance upon advice of counsel other than ourselves on the exclusion from gross income of the interest on the Bonds 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 federal 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 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.

The Authority has covenanted to comply with the requirements of the Code, to the extent permitted by the Constitution and laws of the Commonwealth of Puerto Rico, so that interest on the Bonds will remain exempt from federal income taxes to which it is not subject on the date of issuance of the Bonds. We are not aware of any provisions of the Constitution or laws of the Commonwealth of Puerto Rico which would prevent the Authority 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.
350 Park Avenue, New York, N.Y. 10022-6022

(212) 826-0100

Form 500NY (5/90)

FINANCIAL GUARANTY INSURANCE POLICY

MBIA Insurance Corporation
Armonk, New York 10504

Policy No. [NUMBER]

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

[PAR]
[LEGAL NAME OF ISSUE]

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

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

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

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

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

COUNTERSIGNED:

Resident Licensed Agent
SPECIMEN

City, State

STD-RCS-6
4/95

MBIA Insurance Corporation

resident
SPECIMEN

Attest:

Assistant Secretary

(THIS PAGE INTENTIONALLY LEFT BLANK)



250 Park Avenue
 New York, New York 10177
 Telephone: (646) 658-5900

MUNICIPAL BOND INSURANCE POLICY

ISSUER: []

Policy No: []

BONDS: []

Effective Date: []

XL Capital Assurance Inc. (XLCA), a New York stock insurance company, in consideration of the payment of the premium and subject to the terms of this Policy (which includes each endorsement attached hereto), hereby agrees unconditionally and irrevocably to pay to the trustee (the "Trustee") or the paying agent (the "Paying Agent") (as set forth in the documentation providing for the issuance of and securing the Bonds) for the benefit of the Owners of the Bonds or, at the election of XLCA, to each Owner, that portion of the principal and interest on the Bonds that shall become Due for Payment but shall be unpaid by reason of Nonpayment.

XLCA will pay such amounts to or for the benefit of the Owners on the later of the day on which such principal and interest becomes Due for Payment or one (1) Business Day following the Business Day on which XLCA shall have received Notice of Nonpayment (provided that Notice will be deemed received on a given Business Day if it is received prior to 10:00 a.m. New York time on such Business Day; otherwise it will be deemed received on the next Business Day), but only upon receipt by XLCA, 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 XLCA. Upon such disbursement, XLCA shall become the owner of the Bond, any appurtenant coupon to the Bond or the right to receipt of payment of principal and 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 XLCA hereunder. Payment by XLCA to the Trustee or Paying Agent for the benefit of the Owners shall, to the extent thereof, discharge the obligation of XLCA under this Policy.

In the event the Trustee or Paying Agent has notice that any payment of principal or interest on a Bond which has become Due for Payment and which is made to an Owner by or on behalf of the Issuer of the Bonds has been recovered from the Owner pursuant to a final judgment by a court of competent jurisdiction that such payment constitutes an avoidable preference to such Owner within the meaning of any applicable bankruptcy law, such Owner will be entitled to payment from XLCA to the extent of such recovery if sufficient funds are not otherwise available.

The following terms shall have the meanings specified for all purposes of this Policy, except to the extent such terms are expressly modified by an endorsement to 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", when referring to the principal of Bonds, is when the stated maturity date or a mandatory redemption date for the application of a required sinking fund installment has been reached and does not refer to any earlier date on which payment is due by reason of call for redemption (other than by application of required sinking fund installments), acceleration or other advancement of maturity, unless XLCA shall elect, in its sole discretion, to pay such principal due upon such acceleration; and, when referring to interest on the Bonds, is when the stated date for payment of interest has been reached. "Nonpayment" means the failure of the Issuer to have provided sufficient funds to the Trustee or Paying Agent for payment in full of all principal and interest on the Bonds which are Due for Payment. "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 XLCA 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.

XLCAP-005
 Form of Municipal Policy [Specimen]

XLCA may, by giving written notice to the Trustee and the Paying Agent, appoint a fiscal agent (the "Insurer's Fiscal Agent") for purposes of this Policy. From and after the date of receipt by the Trustee and the Paying Agent of such notice, which shall specify the name and notice address of the Insurer's Fiscal Agent, (a) copies of all notices required to be delivered to XLCA pursuant to this Policy shall be simultaneously delivered to the Insurer's Fiscal Agent and to XCLA and shall not be deemed received until received by both and (b) all payments required to be made by XLCA under this Policy may be made directly by XLCA or by the Insurer's Fiscal Agent on behalf of XLCA. The Insurer's Fiscal Agent is the agent of XLCA 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 XLCA to deposit or cause to be deposited sufficient funds to make payments due hereunder.

Except to the extent expressly modified by an endorsement hereto, (a) this Policy is non-cancelable by XLCA, and (b) the Premium on this Policy is not refundable for any reason. This Policy does not insure against loss of any prepayment or other acceleration payment which at any time may become due in respect of any Bond, other than at the sole option of XLCA, nor against any risk other than Nonpayment. This Policy sets forth the full undertaking of XLCA and shall not be modified, altered or affected by any other agreement or instrument, including any modification or amendment thereto.

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, XLCA has caused this Policy to be executed on its behalf by its duly authorized officers.

SPECIMEN

Name:
Title:

SPECIMEN

Name:
Title: