

\$517,305,000
Puerto Rico Electric Power Authority
Power Revenue Bonds, Series NN

The Power Revenue Bonds, Series NN (the “Bonds”) are being issued pursuant to a Trust Agreement, dated as of January 1, 1974, as amended, with U.S. Bank Trust National Association, New York, New York, successor trustee (the “1974 Agreement”).

The Bonds, the outstanding bonds of 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 book-entry only system of The Depository Trust Company (“DTC”). Purchasers of the Bonds will not receive definitive Bonds.
- Some of the Bonds will be subject to redemption, commencing on July 1, 2013, as described herein.
- Interest on the Bonds will be payable on January 1, 2004 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 an insurance policy to be issued concurrently with the delivery of the Bonds by MBIA Insurance Corporation as set forth on the inside cover page.
- 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 of Puerto Rico and local income taxation. However, see *Tax Exemption* beginning on page 48 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.
- It is expected that the Bonds will be available for delivery to DTC on or about August 19, 2003.

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. O’Neill & Borges, San Juan, Puerto Rico will pass upon certain legal matters for the Underwriters.

The Bonds are not a debt or obligation of the Commonwealth of Puerto Rico or any of its municipalities or other political subdivisions, other than the Authority, and neither the Commonwealth of Puerto Rico 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.

JPMorgan

Merrill Lynch & Co.

Banc of America Securities LLC

Citigroup

Lehman Brothers

Morgan Stanley

Raymond James & Associates, Inc.

Samuel Ramírez & Co.

UBS Financial Services Inc.

Wachovia Bank, National Association

August 8, 2003

\$517,305,000
Puerto Rico Electric Power Authority
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<u>Maturity</u> <u>(July 1)</u>	<u>Principal</u> <u>Amount</u>	<u>Interest</u> <u>Rate</u>	<u>Yield</u>
2018	\$21,435,000	5.50%	4.80%**
2019*	\$22,615,000	5.25%	4.54%
2020	\$23,805,000	5.50%	4.98%
2021*	\$25,110,000	5.25%	4.71%
2022*	\$26,430,000	5.25%	4.78%
2023*	\$27,820,000	5.25%	4.83%
2024	\$29,280,000	5.125%	5.26%

\$170,495,000 5.125% Term Bonds Due July 1, 2029 – Yield 5.33%
 \$124,570,000 5.00% Term Bonds Due July 1, 2032* – Yield 5.03%
 \$ 45,745,000 4.75% Term Bonds Due July 1, 2033* – Yield 5.03%

* Insured by MBIA Insurance Corporation.

** Yield to July 1, 2013 call date.

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 of Puerto Rico, 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 of Puerto Rico 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 THE AUTHORITY'S 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 MBIA Insurance Corporation ("MBIA") contained under the caption *Bond Insurance* and in Appendix V herein, none of the information in this Official Statement has been supplied or verified by MBIA, and MBIA makes 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 Power Revenue Bonds, Series NN (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 U.S. Bank Trust National Association, successor trustee (the “1974 Trustee”). The Bonds, the other Puerto Rico Electric Power Authority Power Revenue Bonds to be outstanding after the issuance of the Bonds, 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 Bonds maturing on July 1, 2019, 2021, 2022, 2023, 2032 and 2033 (the “MBIA Insured Bonds”), will be insured by a municipal bond insurance policy (the “MBIA Bond Insurance Policy”) to be issued by MBIA Insurance Corporation concurrently with the delivery of the Bonds.

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

In order to give potential purchasers of the Bonds general information on the Commonwealth of Puerto Rico (the “Commonwealth”), this Official Statement incorporates by reference the sections under the headings “Introduction” and “The Economy” of the Commonwealth of Puerto Rico Financial Information and Operating Data Report, dated April 1, 2003, which is attached as Appendix I to the Official Statement of the Commonwealth, dated April 16, 2003, relating to the issuance by the Commonwealth of its Public Improvement Refunding Bonds, Series 2003 B and Series 2003 C, which has been filed with each nationally recognized municipal securities information repository (“NRMSIR”). The Financial Information and Operating Data Report was not prepared by the Authority, and the Authority does not assume any responsibility for its accuracy or completeness. The Commonwealth does not guarantee the Bonds and is not otherwise responsible for their payment.

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 Financial Information and Operating Data Report that is 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 to the extent set forth in the preceding paragraph 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 or portions thereof 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 supplies virtually all of the electric power consumed in the Commonwealth of Puerto Rico and 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 April 30, 2003, it served approximately 1.4 million clients and had utility plant totaling approximately \$7.6 billion, including \$2.2 billion of production plant in service and \$3.0 billion of transmission and distribution plant in service, all based on original cost. The Authority's production facilities, together with two cogeneration facilities with long-term power purchase contracts with the Authority, have a dependable generating capacity of 5,359 megawatts ("MW"). As of April 30, 2003, the Authority had 2,335 circuit miles of transmission lines and 29,958 circuit miles of distribution lines. In September 2002, the Authority realized a historical peak load of 3,376 MW.

For the twelve months ended April 30, 2003, the average percentage of the Authority's generating capacity available for service ("equivalent availability"), which includes the two co-generation facilities mentioned above, was 82%, up from 72% for fiscal year 1995. Improved availability, together with the Authority's progress in implementing its capacity expansion plan and improving its transmission and distribution system, have led to gains in the reliability of the Authority's electrical service to its clients.

Operating Results

During the period from fiscal year 1998 through fiscal year 2002, 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 2.3%. During this period, Revenues and Current Expenses increased at a compound annual rate of 6.1% and 7.2%, respectively. Excluding the cost of fuel oil and purchased power, both of which costs are passed on to clients through a separate charge included in electric service rates, Revenues and Current Expenses increased during such period at a compound annual rate of 3.0% and 2.5%, respectively, primarily due to higher energy demand.

During the first ten months of fiscal year 2003, energy sales in kWh increased by 4.8% and Revenues and Current Expenses increased by 16.1% and 19.5%, respectively, compared to the same period for the prior fiscal year. The increase in Revenues and Current Expenses was mainly due to an increase of \$7.67 per barrel (or 34.2%) in the price of fuel oil. Excluding the costs of fuel oil and purchased power, Revenues and Current Expenses increased by 5.3% and 3.2%, respectively, compared to the same period for the prior fiscal year.

Net Revenues increased at a compound annual rate of 3.4% during the period from fiscal year 1998 to fiscal year 2002. For the first ten months of fiscal year 2003, Net Revenues increased by 7.3% compared to the same period in fiscal year 2002.

Demand for energy is related to the level of economic and business activity in the Commonwealth, energy costs and climatological factors. The Commonwealth Planning Board's preliminary reports of the performance of the Puerto Rico economy during fiscal year 2002 indicate that the economy registered a decline of 0.2% in real gross product. The Planning Board reports indicate that real gross product increased by 1.6% in fiscal year 2001, 3.0% in fiscal year 2000, 4.1% in fiscal year 1999 and 3.2% in fiscal year 1998. For fiscal year 2003, the Planning Board is forecasting an increase in real gross product of 1.7%. 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, 2002 and for the ten-month periods ended April 30, 2002 and 2003. This table presents Net Revenues 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, 2001 and 2002 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)					Ten Months Ended	
	Fiscal Years Ended June 30,					April 30,	
	1998	1999	2000	2001	2002	2002	2003
Electric energy sales (in millions of kWh)	17,457	16,989	18,145	18,723	19,130	15,746	16,496
Percentage change from year before	8.3%	(2.7)%	6.8%	3.2%	2.2%	1.4%	4.8%
Peak load (in MW)	3,021	3,057	3,133	3,202	3,297	3,297	3,376
Percentage change from year before	4.4%	1.2%	2.4%	2.2%	3.0%	3.0%	2.4%
Total Revenues	\$1,733,675	\$1,563,953	\$2,025,284	\$2,373,077	\$2,193,681	\$1,807,145	\$2,097,187
Less: Current Expenses	<u>1,186,157</u>	<u>1,052,761</u>	<u>1,466,823</u>	<u>1,722,689</u>	<u>1,566,595</u>	<u>1,292,214</u>	<u>1,544,545</u>
Net Revenues.....	<u>\$ 547,518</u>	<u>\$ 511,192</u>	<u>\$ 558,461</u>	<u>\$ 650,388</u>	<u>\$ 627,086</u>	<u>\$ 514,931</u>	<u>\$ 552,642</u>
Principal and Interest Requirements.....	<u>\$ 316,138</u>	<u>\$ 348,963</u>	<u>\$ 346,417</u>	<u>\$ 367,796</u>	<u>\$ 392,043</u>	-	-
Ratio of Net Revenues to Principal and Interest Requirements.....	1.73	1.46	1.61	1.77	1.60	-	-

System Improvements and Additional Capacity

In order to meet the expected growth in demand, diversify its fuel sources to reduce its historic reliance on oil-fired generating units, and continue to improve the reliability of its service, the Authority has been investing in the improvement, rehabilitation and life extension of its generating, transmission and distribution facilities and has acquired additional capacity pursuant to long-term power purchase agreements with the operators of two privately owned cogeneration facilities.

The Authority entered into a long-term contract with EcoEléctrica, L.P. ("EcoEléctrica") to purchase 507 MW of dependable generating capacity from a natural gas-fired cogeneration plant built by EcoEléctrica and located in Peñuelas, Puerto Rico, which commenced commercial operation on March 21, 2000. The Authority also entered into a long-term contract with AES Puerto Rico, L.P. ("AES-PR") to purchase 454 MW of dependable generating capacity from a coal-fired cogeneration facility built by AES-PR and located in Guayama, Puerto Rico, which commenced commercial operation on November 29, 2002. These contracts allow the Authority to reduce its dependency on fuel oil while passing on to EcoEléctrica and AES-PR the risks of operating the cogeneration facilities. The contracts include these companies' commitment to provide a fixed capacity and higher availability levels than the Authority currently achieves.

The Authority is currently in the licensing phase of replacing two 44 MW steam units in San Juan, removed from service in fiscal year 1997, with new generating units that are projected to provide a total of 464 MW of combined cycle capacity. This project is expected to be operational during fiscal year 2006. The Authority is also 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. The Authority is constructing new 230 kV transmission lines to complete the transmission loop on the eastern part of the island, which project is expected to be operational in fiscal year 2004. In addition, the Authority is constructing a new 230

kV transmission line between the South Coast steam plant and the transmission center of Aguas Buenas. The new transmission line is expected to be operational in fiscal year 2006.

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, 2002 and the projected capital improvement program and financing sources for the five fiscal years ending June 30, 2007. See “Historical Capital Improvement and Financing Program” and “Projected Five-Year Capital Improvement and Financing Program” under *The System*.

**Capital Improvements
(dollars in thousands)**

<u>Capital Improvements</u>	<u>Fiscal Years</u>			
	<u>1998-2002 Total</u>	<u>% of Total</u>	<u>2003-2007 Total</u>	<u>% of Total</u>
Production Plant.....	\$ 749,105	37.1%	\$ 716,369	34.3%
Transmission facilities.....	330,650	16.4	480,169	23.0
Distribution facilities.....	607,265	30.0	525,335	25.2
Other.....	332,571	16.5	366,271	17.5
	<u>\$2,019,591</u>	<u>100.0%</u>	<u>\$2,088,144</u>	<u>100.0%</u>
 <u>Financing Sources</u> 				
Internally generated funds.....	\$ 421,187	20.9%	\$ 491,635	23.5%
Borrowed funds.....	1,598,404	79.1	1,596,509	76.5
	<u>\$2,019,591</u>	<u>100.0%</u>	<u>\$2,088,144</u>	<u>100.0%</u>

PLAN OF FINANCING

The Authority is issuing the Bonds pursuant to Section 208 of the 1974 Agreement to finance a portion of the cost of various projects under its capital improvement program and to repay drawings under a line of credit made available by Government Development Bank for Puerto Rico (“Government Development Bank”) for such purpose.

Estimated Sources and Uses of Funds for the Bonds

Sources:	
Principal amount of the Bonds	\$517,305,000.00
Net original issue premium	<u>1,069,071.40</u>
Total Sources.....	<u>\$518,374,071.40</u>
Uses:	
Deposit to 1974 Construction Fund	\$410,913,000.00
Repayment of Government Development Bank line of credit.....	90,000,000.00
Underwriting discount, municipal bond insurance premium and estimated legal, printing and other financing expenses	<u>17,461,071.40</u>
Total Uses.....	<u>\$518,374,071.40</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.

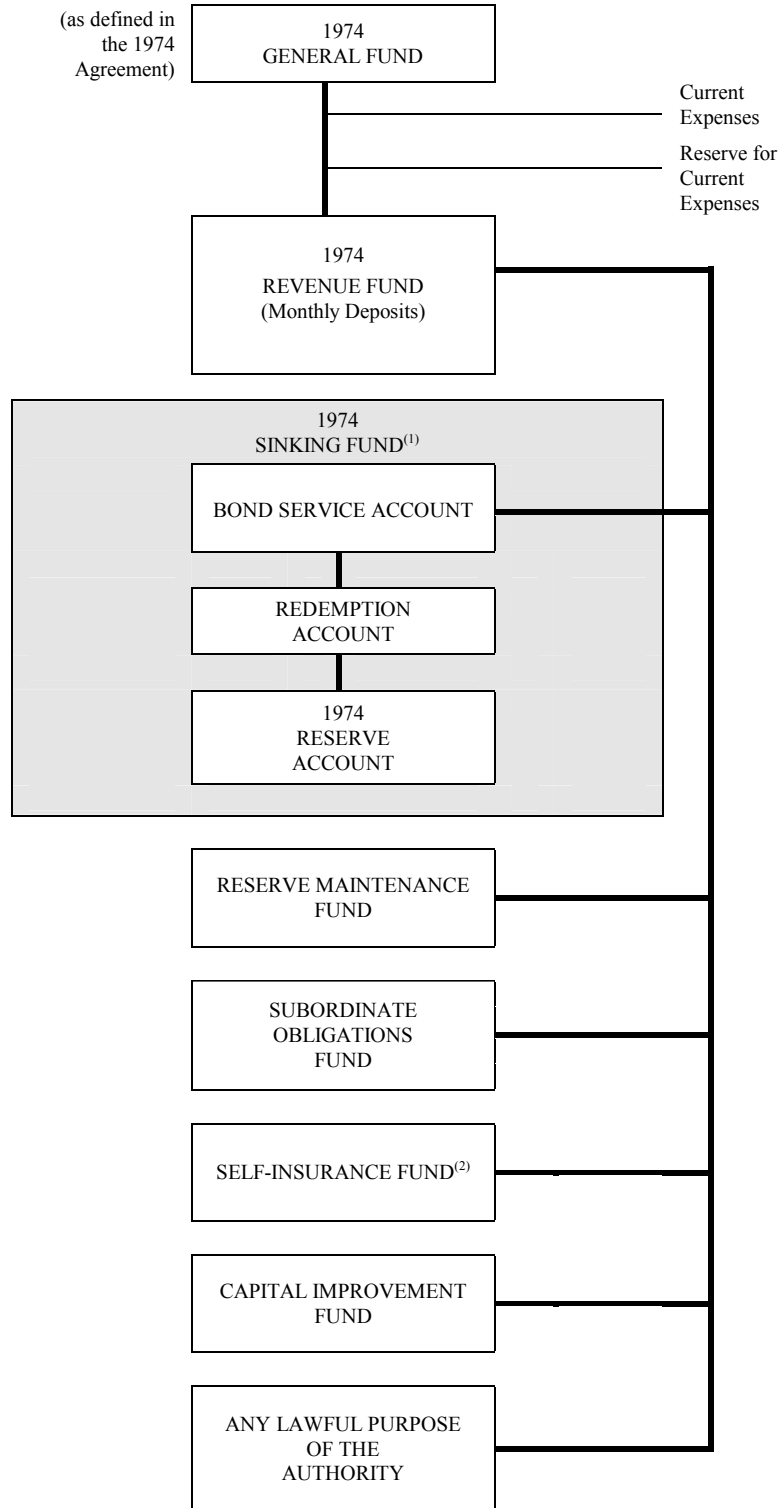
Source of Payment

The Power Revenue Bonds are payable solely from the Revenues of the System after payment of the Current Expenses of the Authority and any reserve therefor. For purposes of the 1974 Agreement and this Official Statement, the “System” means all the properties owned and operated by the Authority as a single integrated system in connection with the production, distribution or sale of electric energy, the acquisition or construction of which was financed in whole or in part from the proceeds of Power Revenue Bonds or from the proceeds of bonds issued under a previous indenture, or from moneys deposited to certain accounts established under the 1974 Agreement, or (to the extent specified by the Authority) from certain subordinated obligations; “Revenues” means all moneys received by the Authority as a result of the ownership or operation of the System, proceeds of certain insurance, and certain investment income; and “Current Expenses” means the Authority’s reasonable and necessary current expenses of maintaining, repairing and operating the System. The Authority has covenanted to deposit in the 1974 Sinking Fund a sufficient amount of such Revenues (after such payment of Current Expenses) 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 described 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 therefor occurring on or after the first day of the twelfth month succeeding the date of calculation.

As of July 31, 2003, approximately \$240.2 million was on deposit to the credit of the 1974 Reserve Account. The amount required to be accumulated in the 1974 Reserve Account will be approximately \$264.2 million after giving effect to the issuance of the Bonds. The difference between the current balance in the 1974 Reserve Account and the amount required to be accumulated therein after giving effect to the issuance of the Bonds will be covered by monthly deposits by the Authority not exceeding one-sixtieth of such difference as described above.

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 April 30, 2003 of \$664.8 million were 160% of the maximum aggregate annual Principal and Interest Requirements of \$415.9 million on all outstanding Power Revenue Bonds. Estimated average annual Net Revenues for the five fiscal years ending June 30, 2009 of \$761.7 million would be 1.72% of the maximum aggregate annual Principal and Interest Requirements of \$442.4 million on all outstanding Power Revenue Bonds (including the Bonds).

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

The MBIA 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 U.S. Bank Trust National Association, in New York, New York, or its successor, sufficient for the payment of any such insured amounts which are then due. Upon presentment and surrender of such MBIA Insured Bonds or presentment of such other proof of ownership of the MBIA Insured Bonds, together with any appropriate instruments of assignment to evidence the assignment of the insured amounts due on the MBIA Insured Bonds as are paid by MBIA, and appropriate instruments to effect the appointment of MBIA as agent for such owners of the MBIA Insured Bonds in any legal proceeding related to payment of insured amounts on the MBIA Insured Bonds, such instruments being in a form satisfactory to U.S. Bank Trust National Association, U.S. Bank Trust National Association shall disburse to such owners or the 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 *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 following documents filed by the Company with the Securities and Exchange Commission (the “SEC”) are incorporated herein by reference:

- (1) The Company’s Annual Report on Form 10-K for the year ended December 31, 2002; and
- (2) The Company’s Quarterly Report on Form 10-Q for the quarter ended March 31, 2003.

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

The Company files annual, quarterly and special reports, information statements and other information with the 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, 2002, and (2) the Company’s Quarterly Report on Form 10-Q for the quarter ended March 31, 2003), are available (i) over the Internet at the SEC’s web site at <http://www.sec.gov>; (ii) at the SEC’s public reference room in Washington D.C.; (iii) over the Internet at the Company’s web site at <http://www.mbia.com>; and (iv) at no cost, upon request to MBIA Insurance Corporation, 113 King Street, Armonk, New York 10504. The telephone number of MBIA is (914) 273-4545.

As of December 31, 2002, MBIA had admitted assets of \$9.2 billion (audited), total liabilities of \$6.0 billion (audited), and total capital and surplus of \$3.2 billion (audited) determined in accordance with statutory accounting practices prescribed or permitted by insurance regulatory authorities. As of March 31, 2003, MBIA had admitted assets of \$9.3 billion (unaudited), total liabilities of \$6.1 billion (unaudited), and total capital and surplus of \$3.2 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, Inc. rates the financial strength of MBIA "Aaa."

Standard & Poor's Ratings Services, a division of The McGraw-Hill Companies, Inc., rates the financial strength of MBIA "AAA."

Fitch Ratings 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.

Certain Rights of MBIA

As provided in the insurance agreement to be entered into by the Authority concurrently with the delivery of the MBIA Bond Insurance Policy, as long as MBIA shall not be in default on its obligations under the MBIA Bond Insurance Policy, MBIA shall be deemed to be the owner of the MBIA Insured Bonds 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, the owners of approximately 99% 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, 2004. 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.

Book-Entry Only System

The 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, or 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 name as may be requested by an authorized representative of DTC. One fully registered Bond will be issued for each maturity of the Bonds, each in the aggregate principal amount of such maturity 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 *Bond Insurance* 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 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 two million issues of U.S. and non-U.S. equity issues, corporate and municipal debt issues, and money market instruments from over 85 countries that DTC’s participants (“Direct Participants”) deposit with DTC. DTC also facilitates the post-trade settlement among Direct Participants of sales and other securities transactions in deposited securities through electronic computerized book-entry transfers and pledges between Direct Participants’ accounts. This eliminates the need for physical movement of securities. Direct Participants include both U.S. and non-U.S. securities brokers and dealers, banks, trust companies, clearing corporations, and certain other organizations. DTC is a wholly-owned subsidiary of The Depository Trust & Clearing Corporation (“DTCC”). DTCC in turn is owned by a number of Direct Participants of DTC and Members of the National 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 U.S. and non-U.S. securities brokers and dealers, banks, trust companies, and clearing corporations that clear through or maintain a custodial relationship with a Direct Participant, either directly or indirectly (“Indirect Participants”). DTC has Standard & Poor’s highest rating: AAA. The DTC rules applicable to its Participants are on file with the Securities and Exchange Commission (the “SEC”). More information about DTC can be found at www.dtcc.com.

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 name as may be requested by an authorized representative of DTC. The deposit of Bonds with DTC and their registration in the name of Cede & Co. or such other 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 the Beneficial Owners. The Direct and Indirect Participants will remain responsible for keeping account of their holdings on behalf of their customers.

Conveyance of notices and other communications by DTC to Direct Participants, by Direct Participants to Indirect Participants, and by Direct Participants and Indirect Participants to Beneficial Owners will be governed by arrangements among them, subject to any statutory or regulatory requirements as may be in effect from time to time. Beneficial Owners of Bonds may wish to take certain steps to augment 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 of Bonds 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 DTC. If less than all of the Bonds within a maturity are being redeemed, DTC’s practice is to determine by lot the amount of the interest of each Direct Participant in such maturity to be redeemed.

Neither DTC nor Cede & Co. (nor any other DTC nominee) will consent or vote with respect to the Bonds unless authorized by a Direct Participant in accordance with DTC’s procedures. Under its usual procedures, DTC mails an Omnibus Proxy to the 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 will be the responsibility of DTC, and disbursement of such payments to the Beneficial Owners will be the responsibility of Direct and Indirect Participants.

DTC may discontinue providing its services as securities depository with respect to the Bonds at any time by giving reasonable notice to the 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 Beneficial 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 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

Mandatory Redemption

The Bonds maturing on July 1, 2029 and July 1, 2032 will be redeemed in part on July 1, 2025, and July 1, 2030, respectively, and on each July 1 thereafter for which there is an Amortization Requirement in respect of such Bonds, in the principal amounts equal to the Amortization Requirements for such Bonds (less the principal amount of any Bonds retired by purchase and otherwise subject to adjustment as provided in the 1974 Agreement), from moneys in the 1974 Sinking Fund, at par plus accrued interest to the redemption date, without premium, in the years and amounts set forth below:

Amortization Requirements for the Bonds Due

<u>Year</u>	<u>July 1, 2029</u>	<u>Amortization Requirement</u>	<u>Year</u>	<u>July 1, 2032</u>	<u>Amortization Requirement</u>
2025		\$30,780,000	2030		\$39,515,000
2026		\$32,355,000	2031		\$41,490,000
2027		\$34,015,000	2032*		\$43,565,000*
2028		\$35,755,000			
2029*		\$37,590,000*			

* Maturity

Optional Redemption

The Bonds that mature on July 1, 2018 and the Bonds that mature on or after July 1, 2024 may be redeemed at the option of the Authority prior to maturity, from any available moneys (except moneys deposited in the 1974 Sinking Fund in respect of an Amortization Requirement), upon not less than 30 days' prior notice by mail, either in whole or in part, in such order of maturity as directed by the Authority, on any date not earlier than July 1, 2013, at a redemption price equal to the principal amount of the Bonds to be redeemed plus accrued interest to the redemption date, without premium. The Bonds that mature between July 1, 2019, and July 1, 2023 (both dates inclusive) are not redeemable at the option of the Authority.

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 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 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
Fernando E. Fagundo	Secretary of Transportation and Public Works	<i>Ex Officio</i>
José A. Bechara-Bravo	Lawyer and Businessman	Holding Over**
José A. Fernández-Polo, P.E.	Civil Engineer and General Contractor	February 2007
José Luis Rodríguez-Homs, P.E.	Engineer	February 2007
Eliezel Rodríguez-Seda, P.E.	Engineer	February 2006
Miguel Nazario-Franco	Consultant	February 2007
Zoilo López-Nieves*	Doctor of Medicine	September 2003

* Consumer representative

** This individual will serve as a member of the Governing Board until his successor is appointed.

The Board appoints an Executive Director who is the principal operating officer of the Authority and is responsible for the general operation of the Authority. The Board also appoints a Vice Executive Director who has the administrative power delegated unto him by the Executive Director and has the administrative supervision over all functions of the Authority, unless expressly reserved for himself by the Executive Director. At present, this position is vacant.

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 32 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.

Other principal officers of the Authority include the following:

Edwin Rivera, Director of Electric System, is a licensed Professional Electrical Engineer with 28 years of service at the Authority. During that time, he has occupied various positions, including Director of Engineering, Superintendent-Electric System; Assistant Head-Electric Conservation Division; and Administrator at the Project Administration Office in the Engineering Directorate.

Valeriano Otero, Director of Transmission and Distribution, is a licensed Professional Electrical Engineer with 24 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 33 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 14 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 31 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 18 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.

Milagros Calixto, Director of Engineering, holds a Bachelor of Science in Electrical Engineering and has 20 years of service with the Authority. Among the positions she has held are: Supervisor of Specification and Procurement Electrical Distribution Division; Special Assistant to the Electrical Distribution Division Head; Norms and Procedure Engineer; Supervising Engineer II; Superintendent of Norms and Procedures Office.

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 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 15 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 ("Washington Group"), operating through its affiliate 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 year 2003.

THE SYSTEM

The Authority is the supplier of virtually all of the electric power consumed in the Commonwealth. As of April 30, 2003, the Authority served approximately 1.4 million clients.

Generating Facilities

As of April 30, 2003, 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 purchases power under long-term power purchase agreements from two cogeneration facilities. Under its agreement with EcoEléctrica, it has the right to purchase 507 MW of net dependable generating capacity. Under its agreement with AES-PR, it has the right to purchase 454 MW of net dependable generating capacity. The Authority has dispatch control over both facilities, and their output is fully integrated into the System.

Existing Generating Facilities (in MW)

<u>Generating Plants</u>	<u>Nameplate Rating (77 Units)</u>	<u>Dependable Generating Capacity</u>					
		<u>Total (82 Units)</u>	<u>Steam (18 Units)</u>	<u>Three Combined Cycle Power Blocks (13 Units)</u>	<u>Combustion Turbine (25 Units)</u>	<u>Hydro (21 Units)</u>	<u>Other⁽¹⁾ (5 Units)</u>
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⁾	—	—	—
Guayama – AES-PR.....	—	454 ⁽¹⁰⁾	454 ⁽¹⁰⁾	—	—	—	—
Total.....	<u>4,421</u>	<u>5,359</u>	<u>3,446</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, made up of two 165 MW combustion turbine units and a 177 MW steam turbine unit.
- (10) Consists of two 227 MW units.

The EcoEléctrica plant is a cogeneration facility located in the Municipality of Peñuelas. The facility includes a combined cycle power block, consisting of one steam and two combustion turbine units, 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. 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 10, 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. After paying this minimum requirement, 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.

EcoEléctrica is a joint venture between subsidiaries of Edison International and Enron Corp. 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.

According to a motion filed by Enron Corp. on June 30, 2003, with the bankruptcy court, Enron Corp. entered into a stock and asset purchase agreement with Gas Natural Extremadura, a Spanish company, to sell its equity interest in EcoEléctrica. The transaction was recently approved by the bankruptcy court, and is scheduled to close in September 2003. The Authority believes that this transaction should not materially affect EcoEléctrica’s operations, generation capacity and fuel supply.

The AES-PR plant is a cogeneration facility located in the Municipality of Guayama. The plant commenced commercial operation in November 2002. This clean burning coal technology facility consists 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 produced by this facility for a term of 25 years from the date of commencement of commercial operation. The contract with AES-PR is substantially similar to the EcoEléctrica contract described above. Above a certain minimum amount, the Authority is only obligated to purchase energy actually produced by the facility. AES-PR is an affiliate of The AES Corporation.

The AES-PR and EcoEléctrica projects contribute to the Authority’s efforts towards fuel diversification and improved reliability of service. In the past, approximately 99% of the Authority’s energy was produced by oil-fired units. After incorporating the EcoEléctrica and AES-PR facilities as part of its System, the Authority estimates that up to 33% of its annual energy requirements can now be provided by non-oil-fired generating facilities.

Among other benefits, the integration of the EcoEléctrica and AES-PR cogeneration facilities into the Authority's System reduces 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 EcoEléctrica and AES-PR 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 price changes in the other components of the Authority's fuel mix.

All of the Authority's purchased power costs under the EcoEléctrica and AES-PR power purchase agreements 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.

Transmission and Distribution Facilities

The Authority's transmission and distribution system interconnects its power plants with major switching and load centers throughout Puerto Rico in order to allow the flow of power to and between these locations. The System is integrated and each generating unit is able to provide electric power to the transmission and distribution system. During the period from fiscal year 1998 to fiscal year 2002, the Authority invested \$937.9 million (or 46.4% of its capital improvement program) in its transmission and distribution system. The capital improvement program for the five fiscal years ending June 30, 2007 includes \$1.0 billion (or 48.2% of such program) for transmission and distribution facilities.

Transmission plant in service as of April 30, 2003 totaled \$992.6 million based on original installed cost. As of that date, there were 2,335 circuit miles of transmission lines and 67 transmission switchyards. Transmission lines include 331 circuit miles of 230 kV lines, 676 circuit miles of 115 kV lines and 1,327 circuit miles of 38 kV lines. There are also 30 miles of underground 38 kV cable and 55 miles of 38 kV submarine cable. Seventy-one transmission substations located at generating sites and at other sites throughout the island have a total transformer capacity of 16,325,000 kilovolt amperes ("kVA").

The Authority recently expanded its transmission system to improve the reliability of service to the northwestern part of the island, which is experiencing significant load growth. In fiscal year 2002, the Authority finished construction of 230 kV transmission lines that completed the transmission loop on the western part of the island. This western loop connects the 249 MW combustion turbine plant in the Municipality of Arecibo with the Authority's Mayagüez transmission center.

The Authority is currently constructing new 230 kV transmission lines to complete the transmission loop on the eastern part of the island. This 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 2004.

The Authority is also constructing a new 50-mile long 230 kV transmission line between its South Coast steam plant and the transmission center at Aguas Buenas. This new transmission line is expected to be operational in fiscal year 2006. Once in operation, this major infrastructure project will enhance the reliability

of the transmission system, and will permit the increase of power transfers from the south coast of Puerto Rico to the northern and central regions.

The Authority is 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 Puerto Rico from time to time. The estimated cost for this project, which is expected to be completed in fiscal year 2005, is \$120 million. The Federal Emergency Management Agency has committed to provide \$75 million in grants to the Authority to defray a substantial part of this cost. In cooperation with several municipalities, the Authority is currently designing and building major underground systems located in high-density metropolitan areas. These underground systems will permit the replacement of overhead sub-transmission and distribution lines, thereby improving reliability and assisting municipalities undertaking urban renewal projects by removing unsightly poles, lines and transformers.

Other relevant projects related to the load growth forecast of the San Juan metropolitan area are the new gas insulated 115/38 kV transmission centers of Martín Peña and Isla Grande. In addition, three new 115/38 kV transmission centers under construction in the municipalities of Comerío, Juana Díaz and Hatillo will increase the load flow capability and improve the voltage regulation of the 38 kV system under emergency conditions.

Investment in distribution plant in service as of April 30, 2003 totaled \$2.0 billion based on original cost. The capital improvement program for the five fiscal years ending June 30, 2007 includes \$525.3 million (or 25.2% of the total) for extensions and improvements to existing distribution lines to serve new clients and substations for accommodating new load growth areas. As of April 30, 2003, the electric distribution system included approximately 29,958 circuit miles of distribution lines and 1,029 distribution substations (717 are client-owned) with a total installed transformer capacity of 6,793,100 kVA.

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. Approximately 40% of the distribution facilities and all of the 230 kV and 115 kV 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 has developed a 710-kilometer optical telecommunications network. This network was designed and installed on the Authority's rights-of-way (mainly its transmission lines). It will allow the

Authority to modernize its internal communication systems, which provide operations, load management, system protection and security, and other controls. The Authority is also developing strategies for commercializing the surplus capacity of the installed fiber, adding flexibility and diversification to its operations.

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, forced or unscheduled outages (defined below), reductions in generating capacity due to partial outages, and other unforeseen events. Unlike most electric utilities in the United States, 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 able to do so. In addition, the absence of significant seasonal variations in demand results in a relatively high load factor (78.9% in fiscal year 2001, 78.1% in fiscal year 2002 and 79.8% for the ten months ended April 30, 2003), which affords the Authority less flexibility to schedule maintenance. Therefore, the Authority must have greater total reserve capacity than other utilities in the United States to cover instances of generating unit outages (scheduled and unscheduled, partial or total).

Improvements to the Authority's generating units since the early 1990s 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 provide a 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 in some cases at increased 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"). About one-third of the \$749.1 million in capital expenditures for the five fiscal years ended June 30, 2002 for production plant was spent for such design modification program.

The table below shows annualized equivalent availability and the equivalent forced outage rate (an indication of 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 1998 through 2002 and for the twelve months ended April 30, 2003.

Electric Generation Equivalent Availability and Reliability

	Years Ended June 30,					Twelve Months Ended April 30,
	<u>1998</u>	<u>1999</u>	<u>2000</u>	<u>2001</u>	<u>2002</u>	<u>2003</u>
	Equivalent availability	80%	79%	78%	80%	80%
Equivalent forced outage rate	11%	8%	9%	8%	7%	9%

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.

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. In addition, the Authority anticipates that by including the EcoEléctrica and AES-PR facilities in the Authority’s equivalent availability statistics, the Authority’s total system equivalent availability will improve even further over time. The additional reserve capacity represented by these two cogeneration facilities gives the Authority more flexibility in scheduling maintenance periods on its own generation facilities and favorably affect the System’s equivalent availability. As a result, total production plant availability increased from an average of 72% in fiscal year 1995, to an average of 80% in fiscal year 2002, and an average of 82% for the twelve months ended April 30, 2003. The Authority calculates that each percentage point increase of System availability is equivalent to adding approximately 60 MW of available capacity to the System.

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 information from three sources relating to economic activity: Econométrica Inc., Inter-American University, and the Commonwealth Planning Board. The Inter-American University uses a macroeconomic model developed in conjunction with Global Insight. Econométrica and the Commonwealth Planning Board use data provided by Government Development Bank in association with Global Insight. 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

The Authority is currently in the licensing phase of replacing two 44 MW steam-generating units of the San Juan Steam Plant (Units 5 and 6), removed from service in fiscal year 1997, with new generating units that are projected to provide a total of 464 MW of combined cycle dependable generating capacity. A prior Prevention of Significant Deterioration (“PSD”) permit obtained by the Authority in connection with this

project expired on May 31, 2002. After a meeting with EPA in August 2002, the Authority agreed to file a new PSD permit application and EPA agreed to expedite the evaluation process. The PSD permit is expected to be granted by the EPA during the current fiscal year. The new generating units are projected to be in service by the end of fiscal year 2006. See *Litigation* for a discussion of a lawsuit brought by the principal contractor for this project.

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 this project will provide the additional generating capacity needed to continue to provide reliable service to its clients through fiscal year 2009. Although the Authority believes that this project can be in operation by the end of fiscal year 2006, permitting or construction delays could affect the schedule. However, based on the Authority's projections of peak load, the System's capacity, the maintenance by the Authority of the System's equivalent availability at its current level, and the Authority's ability to delay the planned retirement of certain generating units, the Authority believes that a delay in the completion of this project 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 464 MW of additional capacity from the repowering of San Juan Steam Plant units 5 and 6, described above. With the Authority's current availability and the addition of these 464 MW of additional capacity, the Authority believes that it has sufficient capacity to retire one 50 MW unit in each of fiscal years 2004 and 2005, and one 85MW unit in each of fiscal years 2006 and 2007. Although these retirements are taken into consideration for purposes of the table, the Authority has flexibility in the timing of such retirements. 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 (MW)	Dependable Capacity (MW)	Reserve Margin (MW)	Dependable Reserve Margin (%)
2003	3,376	5,359	1,983	59
2004	3,504	5,309	1,805	52
2005	3,629	5,259	1,630	45
2006	3,748	5,638	1,890	50
2007	3,867	5,553	1,686	44

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, 2002 and for the ten-month period ended April 30, 2002 and 2003. For the fiscal years ended June 30, 2000 and thereafter, the information below reflects the inclusion of 507 MW of capacity provided pursuant to the EcoEléctrica contract. For the ten-month period ended April 30, 2003, the information below reflects the inclusion of 454 MW capacity provided pursuant to the AES-PR contract.

Statistical Information

	Years Ended June 30,					Ten Months Ended April 30,	
	1998	1999	2000	2001	2002	2002	2003
Nameplate rating at end of period (in MW).....	4,421	4,421	4,421	4,421	4,421	4,421	4,421
Dependable generating capacity at end of period (in MW).....	4,398	4,398	4,905 ⁽¹⁾	4,905 ⁽¹⁾	4,905 ⁽¹⁾	4,905 ⁽¹⁾	5,359 ⁽²⁾
Peak load, 60-minute (in MW).....	3,021	3,057	3,133	3,202	3,297	3,297	3,376
Reserve Margin (%).....	45.6	43.9	56.6	53.2	48.8	48.8	58.7
Average load (in MW).....	2,366	2,299	2,443	2,526	2,576	2,551	2,695
Load factor (%).....	78.3	75.2	78.0	78.9	78.1	77.4	79.8
Energy generated, purchased and sold (in millions of kWh):							
Electric energy generated and purchased	20,725	20,141	20,306	22,132	22,562	18,612	19,659
Auxiliary equipment use.....	<u>(1,167)</u>	<u>(1,122)</u>	<u>(1,064)</u>	<u>(1,124)</u>	<u>(1,076)</u>	<u>(893)</u>	<u>(902)</u>
Net electric energy generated and purchased	19,558	19,019	19,242	21,008	21,486	17,719	18,757
Losses and unaccounted for..	<u>(2,101)</u>	<u>(2,030)</u>	<u>(1,097)</u>	<u>(2,285)</u>	<u>(2,356)</u>	<u>(1,973)</u>	<u>(2,261)</u>
Electric Energy Sold.....	<u>17,457</u>	<u>16,989</u>	<u>18,145</u>	<u>18,723</u>	<u>19,130</u>	<u>15,746</u>	<u>16,496</u>
Electric Energy Sales:							
Residential.....	6,068	5,939	6,385	6,631	6,910	5,704	6,050
Commercial.....	6,822	6,721	7,206	7,583	7,865	6,466	6,745
Industrial.....	4,089	3,881	4,091	4,019	3,876	3,191	3,303
Other.....	478	448	463	490	479	385	398
	<u>17,457</u>	<u>16,989</u>	<u>18,145</u>	<u>18,723</u>	<u>19,130</u>	<u>15,746</u>	<u>16,496</u>
Electric Energy Revenues (in thousands):							
Residential.....	\$ 524,128	\$ 471,070	\$ 633,151	\$ 779,682	\$ 725,797	\$ 596,273	\$ 717,208
Commercial.....	745,228	688,526	878,697	1,026,219	969,182	795,670	920,852
Industrial.....	350,292	299,295	391,906	436,313	382,140	313,991	359,643
Other.....	<u>74,338</u>	<u>68,944</u>	<u>80,473</u>	<u>86,889</u>	<u>85,052</u>	<u>70,010</u>	<u>76,746</u>
	<u>\$1,693,986</u>	<u>\$1,527,835</u>	<u>\$1,984,227</u>	<u>\$2,329,103</u>	<u>\$2,162,171</u>	<u>\$1,775,944</u>	<u>\$2,074,449</u>
Average revenue per kWh (in cents):							
Residential.....	8.64	7.93	9.92	11.76	10.50	10.45	11.85
Commercial.....	10.92	10.24	12.19	13.53	12.32	12.31	13.65
Industrial.....	8.57	7.71	9.58	10.86	9.86	9.84	10.89
Other.....	15.55	15.38	17.39	17.74	17.77	18.19	19.28
All Classes.....	9.70	8.99	10.94	12.44	11.30	11.28	12.58
Average number of clients:							
Residential.....	1,185,246	1,200,061	1,217,584	1,237,053	1,254,043	1,252,689	1,269,087
Commercial.....	119,421	120,825	122,243	123,380	124,759	124,683	125,793
Industrial.....	2,094	2,040	1,986	1,929	1,874	1,880	1,812
Other.....	<u>3,193</u>	<u>3,129</u>	<u>3,094</u>	<u>3,306</u>	<u>3,212</u>	<u>3,212</u>	<u>3,227</u>
	<u>1,309,954</u>	<u>1,326,055</u>	<u>1,344,907</u>	<u>1,365,668</u>	<u>1,383,888</u>	<u>1,382,464</u>	<u>1,399,919</u>
Monthly average revenue per client:							
Residential.....	\$ 36.85	\$ 32.71	\$ 43.33	\$ 52.52	\$ 48.23	\$ 47.60	\$ 56.51
Commercial.....	520.03	474.88	599.01	693.13	647.37	638.15	732.04
Industrial.....	13,940.31	12,226.10	16,444.53	18,848.84	16,993.06	16,701.65	19,847.85
Other.....	1,940.13	1,836.16	2,167.45	2,190.18	2,206.62	2,179.64	2,378.25
All classes.....	\$ 107.76	\$ 96.01	\$ 122.95	\$ 142.12	\$ 130.20	\$ 128.46	\$ 148.18

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

(2) Includes power purchased from the EcoEléctrica and AES-PR cogeneration facilities.

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, 2002 and for the ten-month periods ended April 30, 2002 and 2003 is shown in the following table.

	Years Ended June 30,					Total ⁽¹⁾	Ten Months Ended April 30,	
	1998	1999	2000	2001	2002		2002	2003
(in thousands)								
Capital Improvements								
Production plant.....	\$ 175,158	\$ 154,407	\$ 179,119	\$ 116,775	\$ 123,646	\$ 749,105	\$ 98,250	\$ 74,178
Transmission facilities	65,252	53,816	48,826	80,741	82,015	330,650	66,471	80,574
Distribution facilities	107,952	133,847	86,848	129,139	149,479	607,265	119,748	105,233
Other ⁽²⁾	51,019	67,694	85,591	67,393	60,874	332,571	44,027	41,069
	<u>\$ 399,381</u>	<u>\$ 409,764</u>	<u>\$ 400,384</u>	<u>\$ 394,048</u>	<u>\$ 416,014</u>	<u>\$ 2,019,591</u>	<u>\$ 328,496</u>	<u>\$ 301,054</u>
Financing								
Internally generated funds.....	\$ 106,157	\$ 62,958	\$ 74,265	\$ 100,500	\$ 77,307	\$ 421,187	\$ 65,092	\$ 109,562
Borrowed funds ⁽³⁾	293,224	346,806	326,119	293,548	338,707	1,598,404	263,404	191,492
	<u>\$ 399,381</u>	<u>\$ 409,764</u>	<u>\$ 400,384</u>	<u>\$ 394,048</u>	<u>\$ 416,014</u>	<u>\$ 2,019,591</u>	<u>\$ 328,496</u>	<u>\$ 301,054</u>
Allowance for funds used during construction	\$ 10,300	\$ 11,677	\$ 12,138	\$ 22,966	\$ 15,993	\$ 73,074	\$ 12,464	\$ 16,532

- (1) Includes allowance for funds used during construction of \$73.1 million for the five fiscal years ended June 30, 2002, and \$12.5 million and \$16.5 million for the ten-month periods ended April 30, 2002 and 2003, 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 2004 was adopted in June 2003.

The projected capital improvement program for the five fiscal years ending June 30, 2007 aggregates approximately \$2.1 billion. It is currently estimated that \$491.6 million, or approximately 23.5%, 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 \$716.4 million for production plant. Of this amount, the Authority projects that approximately \$466.7 million will be invested in the improvement of generating units to extend their useful life and continue to increase their reliability and efficiency and the generating capacity of the System. The projected capital improvement program includes the replacement of generating units 5 and 6 at the San Juan Steam Plant as described under "Adequacy of Capacity" above.

The projected capital improvement program also includes \$480.2 million for transmission facilities and \$525.3 million for distribution facilities. During the next five fiscal years, the Authority will dedicate a significant amount of its resources to the improvement and expansion of its transmission and distribution facilities.

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, 2007 and its projected financing.

**Projected Capital Improvement Program
(in thousands)**

	Years Ending June 30,					Total ⁽²⁾
	2003 ⁽¹⁾	2004	2005	2006	2007	
Capital Improvements						
Production plant.....	\$ 99,458	\$ 142,831	\$ 137,845	\$ 142,918	\$ 193,317	\$ 716,369
Transmission facilities	96,488	104,027	108,181	97,104	74,369	480,169
Distribution facilities.....	123,001	112,319	98,048	105,277	86,690	525,335
Other ⁽³⁾	59,303	87,520	78,667	77,058	63,723	366,271
	<u>\$ 378,250</u>	<u>\$ 446,697</u>	<u>\$ 422,741</u>	<u>\$ 422,357</u>	<u>\$ 418,099</u>	<u>\$ 2,088,144</u>
Financing Sources						
Internally generated funds	\$ 133,188	\$ 101,762	\$ 95,517	\$ 83,263	\$ 77,905	\$ 491,635
Borrowed funds ⁽⁴⁾	245,062	344,935	327,224	339,094	340,194	1,596,509
	<u>\$ 378,250</u>	<u>\$ 446,697</u>	<u>\$ 422,741</u>	<u>\$ 422,357</u>	<u>\$ 418,099</u>	<u>\$ 2,088,144</u>
Allowance for funds used during construction.....	<u>\$ 11,780</u>	<u>\$ 21,076</u>	<u>\$ 9,719</u>	<u>\$ 19,726</u>	<u>\$ 25,782</u>	<u>\$ 88,083</u>

- (1) Based on actual results for the ten-month period ended on April 30, 2003, and an estimate for the last two months of fiscal year 2003.
- (2) Includes allowance for funds used during construction of \$88.1 million for the five-year period ending June 30, 2007 (see footnote (1) to the table under "Historical Capital Improvement and Financing Program" above).
- (3) Includes general land and buildings, general equipment, preliminary surveys and investigations.
- (4) For the purpose of this table, it is assumed that of the total \$1.5 billion Power Revenue Bonds expected to be issued in the five-year period ending June 30, 2007, \$350.0 million is expected to be used to repay lines of credit with 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 purchased 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 cents per kilowatt-hour from 1989 until March of 2000, when they were increased. Since March 2000, basic charges have averaged 5.7 cents per kilowatt-hour. The following table presents the electric sales revenues derived from basic charges and fuel adjustment charges for the five fiscal years ended

June 30, 2002 and the ten-month periods ended April 30, 2002 and 2003 and purchased power charges for the fiscal years 2000, 2001 and 2002 and for the ten-month periods ended April 30, 2002 and 2003.

	Electric Sales Revenues (in thousands)					Ten Months Ended	
	Years Ended June 30,					April 30,	
	1998	1999	2000	2001	2002	2002	2003
Basic charges.....	\$1,054,041	\$1,035,471	\$1,086,783	\$1,070,693	\$1,101,923	\$ 909,259	\$ 942,895
Fuel adjustment charges....	639,945	492,364	825,924	1,059,108	806,806	662,046	824,634
Purchased power charges..	—	—	71,520	199,302	253,442	204,639	306,920
	<u>\$1,693,986</u>	<u>\$1,527,835</u>	<u>\$1,984,227</u>	<u>\$2,329,103</u>	<u>\$2,162,171</u>	<u>\$1,775,944</u>	<u>\$2,074,449</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 11.7% of kWh sales and 13.5% of revenues from electric energy sales for the twelve-month period ended April 30, 2003.

The ten largest industrial clients accounted for 4.9% of kWh sales and 3.7% of revenues from electric energy sales for the twelve months ended April 30, 2003. No single client accounted for more than 0.9% 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, 2003, four of the Authority’s industrial clients were using such rate.

Fuel

For the fiscal year ended June 30, 2002, fuel oil expenses amounted to \$720.3 million, or 46.0% of total Current Expenses (\$944.8 million and 54.8% for the preceding fiscal year). For the ten months ended April 30, 2003, fuel oil expenses amounted to \$735.1 million, or 47.6% of total Current Expenses. For the five fiscal years ended June 30, 2002, fuel oil expense was a fairly stable component of total Current Expenses, averaging 51.5% 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 84.9% of the net electric energy generated by the System in fiscal year 2002, 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.

The Authority maintains some generating capacity as a reserve (referred to as a “controlled reserve”) in anticipation of unscheduled outages or other unforeseen events. Historically, the Authority has maintained 200 MW of controlled reserve. Under criteria in effect until recently, the Authority would have had to maintain more than 600 MW of controlled reserve. However, based on its experience, the Authority implemented improvements that have allowed it to reduce its controlled reserve requirements. The Authority has determined that it can provide reliable service to its clients while reducing fuel cost. This reduction was first implemented during fiscal year 2002 and is expected to produce annual fuel cost savings of between \$20 million and \$30 million.

The Authority’s fuel requirements for its generation facilities are 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 and AES-PR plants, 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 April 30, 2003, the Authority had an inventory of 2.4 million barrels of fuel oil.

Average fuel oil costs and related costs of production for the five fiscal years ended June 30, 2002 and for the ten months ended April 30, 2002 and 2003 are shown in the following table.

Fuel Costs

	Years Ended June 30,					Ten Months Ended April 30,	
	1998	1999	2000	2001	2002	2002	2003
Average fuel oil cost per barrel (net of handling costs)	\$18.38	\$14.56	\$23.54	\$29.33	\$22.85	\$22.45	\$30.13
Number of barrels used (in millions).....	34.4	34.4	34.0	32.2	31.5	26.3	25.0
Fuel oil cost (in millions).....	\$632.3	\$500.9	\$801.4	\$944.8	\$720.3	\$591.0	\$749.0 ⁽¹⁾
Net kWh generated (including purchased power in 2000 and 2001) (in millions).....	19,493.4	18,876.8	19,065.1	18,159.2	18,247.4	15,196.0	14,347.0
Average net kWh per barrel	566.7	548.7	560.7	564.0	579.3	577.8	573.9
Average fuel oil cost per net kWh generated (in cents).....	3.24	2.65	4.20	5.20	3.95	3.89	5.22

(1) Includes \$13.9 million funded by the PREPA client fund. The net fuel oil cost to the Authority after taking into consideration the PREPA client fund was \$735.1 million.

With the addition of the output of the EcoEléctrica and AES-PR facilities to the Authority's System, the Authority's traditional dependence on oil-fired generation has decreased. The Authority estimates that up to 33% of its annual energy requirements can now be provided by non-oil-fired generating facilities.

Starting in fiscal year 2002, the Authority has entered into a series of contracts intended to protect it against increases in the price of fuel oil. Under the guidelines adopted by the Authority's Governing Board, these contracts could cover up to 16.5% of total fuel oil consumption (approximately 5.2 million barrels of fuel oil). Under these contracts, the Authority will receive in cash the amount by which the monthly average market price of No. 6 fuel oil exceeds a fixed price per barrel (ranging between \$22 to \$25 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 (referred to as the PREPA client fund) to provide billing credits to 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 the Authority's clients, and is currently capitalized at approximately \$37.7 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 April 30, 2003, the amount owed by the Commonwealth was approximately \$31.6 million. 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 \$12.7 million per year for the five fiscal years ended June 30, 2002. All subsidy

amounts arising since June 30, 1991 have been offset against a portion of 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, which has amounted to approximately \$2.7 million per year for the five fiscal years ended June 30, 2002. 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.

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 (as defined in the Act), 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 2002, contributions in lieu of taxes to municipalities amounted to \$110.0 million, of which \$11.6 million was reimbursed to the municipalities and \$98.3 million was used to offset or reduce outstanding accounts receivable balances. In addition, for the ten-month period ended April 30, 2003, contributions in lieu of taxes to municipalities amounted to \$108.1 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 is 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.

In accordance with the Act, if the Authority's Net Revenues in any year are not sufficient to cover the full amount payable to the municipalities on account of contributions in lieu of taxes and the electric energy sales set aside, calculated as described above, the amount payable by the Authority to the municipalities will be reduced to the amount available, and the excess will not carry forward as a liability for future years. During the five fiscal years ended June 30, 2002, the Net Revenues of the Authority were not sufficient to permit the payment to the municipalities of the full amount of contributions in lieu of taxes and provide for the full amount of the electric energy sales set aside, due to the payment by the Authority 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 (subsequently joined by all the other municipalities) against the Authority in the local courts demanding the payment by the Authority of the full amount of contributions in lieu of taxes and electric energy sales set aside for prior fiscal years, calculated as described above, but without any deductions for payments made by the Authority required under the 1974 Agreement. The complaint challenges the reduction of the amount payable to the municipalities by the amount of deposits made by the Authority to certain funds under the 1974 Agreement and a previous indenture for the purposes of paying the costs of capital improvements, and seeks a payment by the Authority in the amount of

such reduction. 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 that shortfalls do not carry forward as future liabilities of the Authority, it is legally entitled to make such deposits even if their effect is to reduce such contributions and set aside available to municipalities. The Authority recently settled this litigation with 37 out of the 78 municipalities. The Authority and the remaining municipalities have been unable to reach an agreement. See *Litigation*.

DEBT

The following table sets forth the bonds and notes of the Authority outstanding as of July 15, 2003 and as adjusted for the issuance of the Bonds.

	Outstanding as of July 15, 2003	As Adjusted for the Issuance of the Bonds
	(in thousands)	
Power Revenue Bonds		
Publicly Offered ⁽¹⁾	\$4,512,198	\$5,029,503
Rural Electrification.....	<u>30,972</u>	<u>30,972</u>
Sub-total.....	\$4,543,170	\$5,060,475
Notes.....	130,000	130,000
Government Development Bank lines of credit	<u>116,115</u> ⁽²⁾	<u>26,115</u>
Total	<u>\$4,789,285</u>	<u>\$5,216,590</u>

⁽¹⁾ Includes \$27.3 million of accretion on Capital Appreciation Bonds as of July 15, 2003.

⁽²⁾ Includes \$30 million drawn under line of credit between July 15 and the date of this Official Statement.

Rural Electrification Bonds

The Rural Utilities Service (formerly the Rural Electrification Administration) has purchased Power Revenue Bonds issued by the Authority to provide funds for the construction of distribution facilities to service qualified areas. As of July 15, 2003, \$31.0 million of such bonds were outstanding at an interest rate of 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 September 2, 2003, and an extension is being currently negotiated. 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.

Government Development Bank Lines of Credit

The Authority has two lines of credit with Government Development Bank. It has a \$200 million line of credit for the interim financing of its capital improvement program. As of July 31, 2003, the Authority had drawn \$90 million under this line of credit, which will be paid from the proceeds of the Bonds. The Authority also has a \$68 million line of credit to fund payments made under a settlement agreement relating to a certain

litigation with the municipalities of Puerto Rico (see *Litigation*). As of July 31, 2003, the Authority had drawn \$26 million under this line of credit.

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. 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 <u>June 30,</u>	Outstanding Bonds Principal and Interest <u>Requirements</u>	The Bonds		Total Debt Service <u>Requirements</u>	
		<u>Maturity and Amortization Requirements</u>	<u>Interest</u>		<u>Total</u>
2004.....	\$404,137,048.81		\$22,950,844.59	\$22,950,844.59	\$427,087,893.40
2005.....	413,673,688.81		26,481,743.76	26,481,743.76	440,155,432.57
2006.....	415,918,233.81		26,481,743.76	26,481,743.76	442,399,977.57
2007.....	406,673,593.81		26,481,743.76	26,481,743.76	433,155,337.57
2008.....	376,169,833.81		26,481,743.76	26,481,743.76	402,651,577.57
2009.....	377,278,580.06		26,481,743.76	26,481,743.76	403,760,323.82
2010.....	347,527,415.06		26,481,743.76	26,481,743.76	374,009,158.82
2011.....	343,020,477.56		26,481,743.76	26,481,743.76	369,502,221.32
2012.....	346,321,873.80		26,481,743.76	26,481,743.76	372,803,617.56
2013.....	351,746,198.80		26,481,743.76	26,481,743.76	378,227,942.56
2014.....	349,169,147.54		26,481,743.76	26,481,743.76	375,650,891.30
2015.....	333,427,573.78		26,481,743.76	26,481,743.76	359,909,317.54
2016.....	326,486,723.78		26,481,743.76	26,481,743.76	352,968,467.54
2017.....	325,258,751.26		26,481,743.76	26,481,743.76	351,740,495.02
2018.....	253,989,457.50	\$21,435,000	26,481,743.76	47,916,743.76	301,906,201.26
2019.....	253,012,813.76	22,615,000	25,302,818.76	47,917,818.76	300,930,632.52
2020.....	250,642,163.76	23,805,000	24,115,531.26	47,920,531.26	298,562,695.02
2021.....	250,235,031.26	25,110,000	22,806,256.26	47,916,256.26	298,151,287.52
2022.....	228,497,162.52	26,430,000	21,487,981.26	47,917,981.26	276,415,143.78
2023.....	228,204,356.26	27,820,000	20,100,406.26	47,920,406.26	276,124,762.52
2024.....	208,062,293.76	29,280,000	18,639,856.26	47,919,856.26	255,982,150.02
2025.....	181,664,125.02	30,780,000	17,139,256.26	47,919,256.26	229,583,381.28
2026.....	158,207,256.26	32,355,000	15,561,781.26	47,916,781.26	206,124,037.52
2027.....	158,206,162.50	34,015,000	13,903,587.50	47,918,587.50	206,124,750.00
2028.....	125,860,300.00	35,755,000	12,160,318.76	47,915,318.76	173,775,618.76
2029.....	90,780,212.50	37,590,000	10,327,875.00	47,917,875.00	138,698,087.50
2030.....	90,779,387.50	39,515,000	8,401,387.50	47,916,387.50	138,695,775.00
2031.....	48,283,437.50	41,490,000	6,425,637.50	47,915,637.50	96,199,075.00
2032.....	-	43,565,000	4,351,137.50	47,916,137.50	47,916,137.50
2033.....	-	45,745,000	2,172,887.50	47,917,887.50	47,917,887.50
Total.....	<u>\$7,643,233,300.79</u>	<u>\$517,305,000</u>	<u>\$616,591,976.07</u>	<u>\$1,133,896,976.07</u>	<u>\$8,777,130,276.86</u>

NET REVENUES AND COVERAGE

The following table presents the Net Revenues of the Authority under the provisions of the 1974 Agreement for the five fiscal years ended June 30, 1998 through 2002 and for the ten-month periods ended April 30, 2002 and 2003 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,					Ten Months Ended April 30,	
	1998	1999	2000	2001	2002	2002	2003
	Average number of clients	1,309,954	1,326,055	1,344,907	1,365,668	1,383,888	1,382,464
Electric energy sales (in millions of kWh).....	17,457	16,989	18,145	18,723	19,130	15,746	16,496
Source of Net Revenues							
(dollars in thousands)							
Revenues:							
Sales of electric energy:							
Residential ⁽¹⁾	\$ 524,128	\$ 471,070	\$ 633,151	\$ 779,682	\$ 725,797	\$ 596,273	\$ 717,208
Commercial	745,228	688,526	878,697	1,026,219	969,182	795,670	920,852
Industrial.....	350,292	299,295	391,906	436,313	382,140	313,991	359,643
Other	74,338	68,944	80,473	86,889	85,052	70,010	76,746
	<u>1,693,986</u>	<u>1,527,835</u>	<u>1,984,227</u>	<u>2,329,103</u>	<u>2,162,171</u>	<u>1,775,944</u>	<u>2,074,449</u>
Revenues from Commonwealth							
for rural electrification	1,007	941	881	705	739	620	590
Other operating revenues	11,841	8,827	10,240	8,210	8,514	7,061	7,417
Other (principally interest earned).....	26,841	26,350	29,936	35,059	22,257	23,520	14,731
	<u>1,733,675</u>	<u>1,563,953</u>	<u>2,025,284</u>	<u>2,373,077</u>	<u>2,193,681</u>	<u>1,807,145</u>	<u>2,097,187</u>
Current Expenses:							
Operations:							
Fuel.....	625,346	500,920	801,433	944,760	720,292	591,029	735,142
Purchased power.....	--	--	64,517	177,330	227,923	182,644	274,209
Other production.....	43,658	42,818	55,690	56,301	56,029	47,495	34,367
Transmission and Distribution	86,901	83,385	94,793	105,034	114,971	94,641	97,584
Customer accounting and Collection	73,647	67,517	76,598	83,453	84,689	69,241	74,818
Administrative and General	139,986	142,866	151,069	139,117	146,497	125,972	133,672
Maintenance ⁽²⁾	215,118	212,530	219,812	213,666	212,959	178,485	191,903
Other	1,501	2,725	2,911	3,028	3,235	2,707	2,850
	<u>1,186,157</u>	<u>1,052,761</u>	<u>1,466,823</u>	<u>1,722,689</u>	<u>1,566,595</u>	<u>1,292,214</u>	<u>1,544,545</u>
Net Revenues.....	<u>\$ 547,518</u>	<u>\$ 511,192</u>	<u>\$ 558,461</u>	<u>\$ 650,388</u>	<u>\$ 627,086</u>	<u>\$ 514,931</u>	<u>\$ 552,642</u>
Coverage							
Principal and Interest Requirements.....	<u>\$ 316,138</u>	<u>\$ 348,963</u>	<u>\$ 346,417</u>	<u>\$ 367,796</u>	<u>\$ 392,043</u>	-	-
Ratio of Net Revenues to Principal and Interest Requirements.....	1.73	1.46	1.61	1.77	1.60	-	-

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

(2) Includes, for maintenance of generating facilities, \$116.9 million, \$126.1 million, \$115.6 million, \$113.0 and \$112.2 million for fiscal years ended June 30, 1998, 1999, 2000, 2001 and 2002, respectively. For the ten months ended April 30, 2002 and 2003 the maintenance expense of generating facilities was \$96.0 million and \$106.2 million, respectively.

Management's Discussion and Analysis of Operating Results

The following represents the Authority's analysis of its operations for the ten-month periods ended April 30, 2002 and 2003, and for the five fiscal years ended June 30, 2002. For additional analysis of the Authority's results of operations, see *Management's Discussion and Analysis* in the Authority's audited financial statements, included as Appendix II.

For the ten months ended April 30, 2003 as compared to the ten months ended April 30, 2002, Revenues and Current Expenses increased by \$290.0 and \$252.3 million, respectively, resulting in an increase in Net Revenues of \$37.7 million. The increase in Revenues and Current Expenses was mainly due to an increase of \$7.67 per barrel (or 34.2%) in the price of fuel oil. Accounts receivable of the Authority increased \$27.0 million from \$438.6 million on June 30, 2002 to \$465.6 million on April 30, 2003. In addition, accounts receivable from the governmental sector decreased from \$108.4 million on June 30, 2002 to \$80.7 million on April 30, 2003.

For the fiscal year ended June 30, 2002 as compared to June 30, 2001, Revenues decreased by \$179.4 million and Current Expenses decreased by \$156.1 million, resulting in a decrease in Net Revenues of \$23.3 million. The decrease was mainly due to a decrease of \$6.48 per barrel (or 22.1%) in the price of fuel oil. Accounts receivable of the Authority increased from \$410.7 million on June 30, 2001 to \$438.6 million on June 30, 2002. In addition, accounts receivable from the governmental sector increased from \$93.1 million on June 30, 2001 to \$108.4 million on June 30, 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 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.

The following table presents the disposition of Net Revenues, in the order of priority of payment, for the five fiscal years ended June 30, 2002 and for the ten months ended April 30, 2002 and 2003, 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					Ten Months Ended	
	(in thousands)					April 30,	
	Years Ended June 30,					2002	
Disposition of Net Revenues	1998	1999	2000	2001	2002	2002	2003
1974 Revenue Fund:							
1974 Sinking Fund:							
Interest.....	\$ 216,384	\$ 224,935	\$ 224,758	\$ 240,459	\$ 248,469	\$ 205,018	\$ 208,161
Principal.....	116,199	139,704	145,058	146,989	158,357	131,962	114,445
1974 Reserve Account.....	(8,881)	-	-	-	-	-	(17,000)
Reserve Maintenance Fund.....	5,004	6,000	7,000	7,000	7,000	5,830	5,830
Self-insurance Fund.....	-	-	-	-	-	-	-
Capital Improvement Fund.....	106,157	62,958	74,265	100,500	77,307	65,092	109,562
General Obligation Notes:							
Interest.....	718	410	103	-	-	-	-
Contributions in lieu of taxes and other ⁽¹⁾	<u>111,937</u>	<u>77,185</u>	<u>107,277</u>	<u>155,440</u>	<u>135,953</u>	<u>107,029</u>	<u>131,644</u>
Net Revenues	<u>\$ 547,518</u>	<u>\$ 511,192</u>	<u>\$ 558,461</u>	<u>\$ 650,388</u>	<u>\$ 627,086</u>	<u>\$ 514,931</u>	<u>\$ 552,642</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: \$20.0 million, \$18.1 million, \$23.5 million, \$33.6 and \$26.0 million for fiscal years ended June 30, 1998, 1999, 2000, 2001 and 2002, respectively. For the ten months ended April 30, 2002 and 2003, those subsidies amounted to \$21.4 million and \$23.5 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 high 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 that 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.

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 3.7%, and incorporate the Authority's results for the first ten months of fiscal year 2003.

Fuel..... Projected fuel prices are based upon an analysis prepared by the Authority. The following table (which incorporates the Authority's actual experience during the first ten months of fiscal year 2003) sets forth projected average per barrel fuel prices:

Projected Fuel Prices

Years Ending June 30,	Average Price Per Barrel ⁽¹⁾
2003	\$28.20 ⁽²⁾
2004	\$29.61
2005	\$27.24
2006	\$27.36
2007	\$27.96

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

(2) Based on actual prices through April 30, 2003 and estimates for the remainder of the fiscal year.

The following table presents the Authority's estimates of Net Revenues for the five fiscal years ending June 30, 2007, 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. 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,				
	2003 ⁽¹⁾	2004	2005	2006	2007
Average number of clients	1,401,379	1,420,024	1,439,656	1,458,277	1,477,899
Electric energy sales (in millions of kWh).....	19,888.5	20,536.2	21,146.2	21,796.3	22,458.6
Authority generation (gross)(in millions of kWh)....	23,676.2	24,326.3	25,048.8	25,818.9	26,603.4
Purchased generation (gross)(in millions of kWh)....	5,303.0	6,195.0	6,622.0	6,519.0	6,351.0

<u>Sources of Net Revenues</u>	(dollars in thousands)				
Revenues:					
Sales of electric energy:					
Residential	\$ 848,704	\$ 919,870	\$ 907,407	\$ 929,614	\$ 949,605
Commercial.....	1,099,070	1,187,370	1,206,163	1,260,723	1,314,370
Industrial.....	430,351	463,224	456,183	464,602	472,026
Other	92,333	93,632	91,435	91,458	91,406
	<u>2,470,458</u>	<u>2,664,096</u>	<u>2,661,188</u>	<u>2,746,397</u>	<u>2,827,407</u>
Revenues from Commonwealth for Rural Electrification.....	704	591	161	116	76
Other (principally, interests earned).....	28,333	38,247	40,247	42,247	44,247
	<u>2,499,495</u>	<u>2,702,934</u>	<u>2,701,596</u>	<u>2,788,760</u>	<u>2,871,730</u>
Current Expenses ⁽²⁾ :					
Operations:					
Fuel.....	840,722	873,970	812,568	847,038	880,163
Purchased Power.....	345,705	447,050	473,260	480,123	483,696
Other Production	40,861	51,174	52,924	54,737	56,616
Transmission and Distribution.....	112,306	112,329	116,170	120,150	124,274
Customer Accounting and Collections	88,827	97,207	100,531	103,975	107,544
Administration and general.....	159,094	164,563	170,189	176,021	182,063
Maintenance.....	236,314	243,862	252,200	260,841	269,795
Other – Interest Charges	3,187	2,078	2,129	2,182	2,238
	<u>1,827,016</u>	<u>1,992,233</u>	<u>1,979,971</u>	<u>2,045,067</u>	<u>2,106,389</u>
Net Revenues.....	<u>\$ 672,479</u>	<u>\$ 710,701</u>	<u>\$ 721,625</u>	<u>\$ 743,693</u>	<u>\$ 765,341</u>

<u>Coverage</u>					
Principal and Interest Requirements ⁽³⁾	\$ 382,519	\$ 427,088	\$ 447,143	\$ 476,260	\$ 498,184
Ratio of Net Revenues to Principal and Interest Requirements	1.76	1.66	1.61	1.56	1.54

- (1) Based on actual results through April 30, 2003 and estimates for the remainder of the fiscal year.
- (2) The salary expenses and other Current Expenses (excluding fuel oil and purchased power) projections assume an annual growth of 4% and 2%, respectively.
- (3) Includes debt service requirements for (i) the outstanding Power Revenue Bonds (including the Bonds), and (ii) expected Power Revenue Bond issues, all at an assumed interest rate of 6% (\$517.3 million in fiscal year 2004, \$465.8 million in fiscal year 2005, and \$517.6 million in fiscal year 2007) (no repayments of principal of these issues are assumed until after fiscal year 2005).

The Authority's estimates of Net Revenues, which were made as part of the adoption of its budget of Current Expenses for fiscal year 2003, 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 on Power Revenue Bonds 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, 2007, in accordance with the provisions of the 1974 Agreement.

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

<u>Disposition of Net Revenues</u>	<u>Years Ending June 30,</u>				
	<u>2003⁽¹⁾</u>	<u>2004</u>	<u>2005</u>	<u>2006</u>	<u>2007</u>
1974 Revenue Fund:					
1974 Sinking Fund:					
Interest	\$249,809	\$264,219	\$265,567	\$276,526	\$296,220
Principal	137,422	166,004	181,576	199,724	201,965
Reserve	(30,000) ⁽²⁾	4,807	4,807	4,807	4,807
Reserve Maintenance Fund	7,000	7,000	7,000	7,000	7,000
Self-insurance Fund	-	-	-	-	-
Capital Improvement Fund	133,188	101,762	95,517	83,263	77,905
Contributions in lieu of taxes and other ⁽³⁾	<u>175,060</u>	<u>166,909</u>	<u>167,158</u>	<u>172,373</u>	<u>177,444</u>
Total Net Revenues	<u>\$672,479</u>	<u>\$710,701</u>	<u>\$721,625</u>	<u>\$743,693</u>	<u>\$765,341</u>

(1) Based on actual results for the ten-month period ended April 30, 2003 and an estimate for the last two months of fiscal year 2003.

(2) This represents the transfer of excess funds from this account to the 1974 Bond Service Account.

(3) 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: \$27.1 million, \$31.0 million, \$28.5 million, \$29.5 million and \$30.5 million for fiscal years ending June 30, 2003, 2004, 2005, 2006 and 2007, 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 and Administrative Proceedings

Consent Decree

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, which has already been paid, and to implement additional compliance projects amounting to \$4.5 million, which have already been funded to the full extent required by the Consent Decree. In addition, 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 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 interpretation explained above. Although both Notices of Dispute Resolution are pending before the United States District Court, the parties reached an agreement in principle to settle such Notices and notified the court as to the agreement in February 2003. The agreement implements EPA's interpretation of the applicable method to determine visible emissions, and addresses the notices of violation. The Authority believes that the agreement, once finalized and approved by the Court, will enable the Authority to take additional measures that will enhance its ability to comply with the Consent Decree.

Probation

In September 1995, while preparing for Hurricane Luis, approximately 270,000 gallons of acidic wastewater were discharged from the Palo Seco power plant into the Bayamón River, affecting a nearby mangrove swamp. After investigations by the EPA and the United States Department of Justice, on June 11, 1999, the Authority pleaded guilty to a misdemeanor of negligently discharging a pollutant into waters of the

United States, in violation of the criminal provisions of the Clean Water Act, and was ordered to pay a \$140,000 fine, which it has paid. The Authority was placed on probation for two years.

In response to this violation, the Authority has undertaken an extensive program to prevent and detect violations of environmental law. Pursuant to this program, the Authority's plant personnel have been trained at seminars in methods to avoid and detect environmental violations.

In June 2001, the U.S. Probation Office filed a show cause motion with the magistrate judge alleging that the Authority had not complied with all the terms of its probation. The show cause order stated that EPA contended that the Authority had violated certain conditions of the Consent Decree, which in turn violated Condition Five of the probation conditions. Through negotiations with the government, resolution of these issues was reached by Letter Agreement dated December 13, 2001, under which PREPA agreed to an extension of its probation by 18 months, to the enumeration of a series of specific environmental requirements to be put in place in lieu of Condition Five, and to pay a \$10,000 fine.

The Government of the United States and the Authority executed a Settlement Agreement on June 20, 2002. The United States District Court for the District of Puerto Rico accepted the terms of the Settlement Agreement, after a hearing held on July 18, 2002, and entered an Amendment Order of Probation on July 24, 2002. Material points of the agreement include the selection of a Visible Emissions Compliance Auditor acceptable to the Court, the funding of 14 air quality-monitoring stations in an amount not to exceed \$420,000 to be provided to the Puerto Rico Environmental Quality Board and a fine of \$10,000. This fine was paid in August of 2002.

The Settlement Agreement also provides that the Authority will burn fuel with a sulfur content not to exceed 0.5% by weight at the Authority's Palo Seco and San Juan power plants for a period of not less than two years. Both power plants began burning 0.5% sulfur fuel in early 2003. The use of 0.5% sulfur fuel is expected to increase the Authority's fuel costs by approximately \$15 to 27 million per year for these two years. PREPA is mitigating this cost increase by using money from the Clients Fund and through a hedging program for fuel purchases.

Comprehensive Environmental Response, Compensation and Liability Act (CERCLA)

In June 2002, the Authority received a "Special Notice Concerning Remedial Investigation / Feasibility Study for Soil at the Vega Baja Solid Waste Disposal Superfund Site." EPA has identified the Authority and six other entities as potentially responsible parties (PRP), as defined in CERCLA. The Authority requested additional information from EPA regarding the extent of its activities at the site. In April 2003, the Authority agreed to join the other PRPs in an Administrative Order on Consent for Remedial Investigation and Feasibility Study, with the understanding that such agreement did not constitute an acceptance of responsibility. The Authority believes that participation in this study will enable the Authority to demonstrate that it has no responsibility regarding the site or that its responsibility, if any, is *de minimis*. Under the Administrative Order on Consent, the Authority committed up to \$250,000 as its contribution to partially fund the Remedial Investigation and Feasibility Study. It is expected that this amount will be disbursed over a two-year period, which is the approximate time it will take to complete the study.

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.

Air Quality Compliance

The Authority continues in its effort to reduce visible emissions at the Aguirre and Costa Sur power plants. While current operating permits allow the use 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. Also, as part of the probation extension agreement discussed above, the Authority is burning No. 6 fuel oil with sulfur contents equal or less than 0.5% at its Palo Seco and San Juan power plants.

The Authority continues the use of fuel additives under a test program. Since each power unit has its own characteristics, the program will allow the identification of the most suitable additive to improve maintenance and enhance environmental compliance. Up to date, water and oil-based fuel additives have been tested at the Aguirre, South Coast and Palo Seco power plants. Since the beginning of burning of No. 6 fuel oil with 0.5% or less sulfur content, additives have been discontinued at Palo Seco Power Plant.

EPA issued an administrative order that allowed 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 had the effect of eliminating ammonia injection for Nitrogen Oxide emission control, resulting in expected savings of approximately \$5 million annually.

After implementing the Air Quality Compliance Programs pursuant to the Consent Decree and certain additional measures, like using No. 6 fuel oil with a sulfur content of 0.5% at the San Juan and Palo Seco power plants, the Authority expects to be in full compliance with all visible emission requirements.

Water Quality Compliance

As of April 2003, the Authority had achieved a 99% level of compliance with the Clean Water Act regulations.

The Authority has completed compliance plans for abating water pollution at its four major power plants - Aguirre, San Juan, South Coast, and Palo Seco, as required by the Consent Decree. The Authority has incurred \$5.9 million regarding water pollution abatement during current fiscal year. Projects scheduled for fiscal year 2004 total approximately \$11.0 million.

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 that 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 this waiver request and field studies are under evaluation with EPA.

The Authority submitted to EPA the reports and waiver requests, pursuant to the Clean Water Act-Section 316 Thermal Waiver, for the San Juan and Palo Seco power plants on July 11, 1997 and November 18, 1997, respectively. The field study work plan for the Aguirre Power Plant was approved by EPA in August

2000. The contract to perform the study was signed in February 2003. The study is currently ongoing. It will take approximately a year to be completed at an estimated cost of \$1.0 million.

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. These projects for all four major power plants are 75% completed. For fiscal year 2004 the Authority allocated \$1.4 million for these projects.

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. This program also includes scheduled major overhaul to dikes and fuel tanks. As of April 30, 2003, approximately, \$19.9 million has been spent in projects under this program. The measures for this program are estimated to cost approximately \$34.5 million for the next five years. The Authority expects to spend \$15 million, approximately, during fiscal year 2004.

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. The Authority continues to implement a program for the removal and disposal of all distribution transformers with a PCB concentration of 50 ppm or greater. The Authority estimates that approximately 3,000 PCB or PCB contaminated distribution transformers remain to be disposed of as of April 30, 2003. During fiscal year 2002, a total of 2,222 transformers were disposed of under this program, plus an additional 703 as of April 30, 2003. This program is subject to a three-year extension petition to the EPA, and it is scheduled for completion by the last quarter of fiscal year 2004. The budget assignment for this program for fiscal year 2004 is \$1.9 million, approximately.

Asbestos Abatement

The Authority is engaged in encapsulating or gradually removing asbestos-containing insulation from its power plants. As of April 30, 2003, the Authority has spent \$1.4 million in asbestos abatement projects. For fiscal year 2004, the Authority allocated \$4.0 million for this program.

Capital Improvement Program

The Authority's capital improvement program for the five fiscal years ending June 30, 2008 includes \$116.5 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.

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 purchased all-risk property and boiler and machinery policies with a combined coverage of \$650 million per occurrence. The policies' self-retention in case of earthquake and windstorm losses is \$25 million, and \$2 million for all other covered risks.

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. While the Authority and the 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 April 30, 2003, approximately \$79.6 million was 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, 2003, the Authority had 9,607 employees (including Irrigation System Employees), of which 509 were temporary unionized employees. Of such employees, 6,783 were represented by four local unions. The Electrical Industry and Irrigation Workers Union ("UTIER") represents 5,402 employees engaged in operations and maintenance. The three other unions represent construction workers (Insular Union of Industrial and Electrical Construction Workers 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, the agreement with UEPI expires on December 18, 2004 and the agreement with UPAEE expires on July 2, 2006.

Of the 9,607 employees, 3,199 are employed in the transmission and distribution facilities directorate, 2,249 are employed in the generating facilities directorate, 1,669 are employed in the customer service directorate, and the remaining employees are 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 defined benefit 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, 2002 and April 30, 2003 were \$42.9 million and \$42.8 million, respectively. This represents 7.01% and 7.82% for the fiscal year 2002, and 6.03% and 10.90% for the ten months ended April 30, 2003, 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 ten months ended April 30, 2003, total pension expense of the Authority was approximately \$42.8 million, including approximately \$27.5 million for past service costs. Unfunded past service liability to be borne entirely by the Authority approximated \$571.7 million as of June 30, 2002. As of June 30, 2002, the date of the last actuarial valuation of the Retirement System, the pension plan was 72% 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 and Administrative Proceedings" under *Environmental Matters*.

In May 1998, as described above in "Subsidies, Contributions in Lieu of Taxes and Set Aside" under *The Authority*, the Municipality of Ponce filed a complaint against the Authority in the Puerto Rico local courts demanding the payment by the Authority of the full amount of contributions in lieu of taxes and electric energy sales set aside for prior fiscal years, calculated without any deductions for payments made by the Authority

required under the 1974 Agreement. All 78 municipalities of the Commonwealth subsequently joined this lawsuit against the Authority. The complaint seeks a payment by the Authority in an amount of approximately \$358 million. The Authority filed a motion to dismiss the complaint and the municipalities filed a motion for summary judgment. The court has designated two special commissioners to study the allegations of the complaint related to accounting issues and legal issues. 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 a previous indenture and shortfalls do not carry forward as future liabilities of the Authority, it is legally entitled to make such deposits even if the effect is to reduce such contributions and set aside available to municipalities.

On April 14, 2003, the Authority made a settlement offer consisting of a payment in cash of \$68 million and \$57 million for electric infrastructure projects in the municipalities, for a total of \$125 million. As of July 15, 2003, 37 out of the 78 municipalities had accepted the Authority's offer and will receive their proportional share of the settlement offer, including approximately \$25.5 million in cash and \$21.5 million in electric infrastructure projects previously approved by the Authority. The Authority does not expect this settlement to materially affect its financial condition. After giving effect to the settlement, the amount claimed by the remaining municipalities is approximately \$215 million. The Authority and the remaining municipalities have been unable to reach an agreement. As part of the settlement agreement, the municipalities agreed to support an amendment to the Act that was proposed by the Authority that would make clear that the amount payable to the municipalities is calculated based on a percentage of the Net Revenues of the Authority and payable after complying with the Authority's deposit obligations under the 1974 Agreement. The Authority expects that the amendment will be considered in the legislative session that will begin in August 2003.

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 is evaluating the completion of the project by another major contractor.

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 with the requirements of the Code, to the extent permitted by the Constitution and the laws of the Commonwealth, 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. 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 is 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 Bond for federal income tax purposes.

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

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

Premium Bonds

The excess, if any, of the tax basis of a Bond to a purchaser (other than a purchaser who holds such Bond as inventory, stock in trade or for sale to customers in the ordinary course of business) who purchases such Bond as part of the initial offering and at the initial offering price as set forth on the inside cover page of this Official Statement over the amount payable at maturity of such Bond is "Bond Premium." Bond Premium is amortized over the term of such Bond for federal income tax purposes (or in the case of a Bond with Bond Premium callable prior to its stated maturity, the amortization period and yield may be required to be determined on a basis of a call date that results in the lowest yield on such Bond). No deduction is allowed for such amortization of Bond Premium; however, United States Treasury regulations provide that Bond Premium is treated as an offset to qualified stated interest received on the Bond. An owner of such Bond is required to decrease his adjusted basis in such Bond by the amount of amortizable Bond Premium attributable to each taxable year such Bond is held. An owner of such Bond should consult his tax advisor with respect to the precise determination for federal income tax purposes of the treatment of Bond Premium upon sale, redemption or other disposition of such Bond and with respect to the state, Commonwealth and local tax consequences of owning and disposing of such Bond.

UNDERWRITING

The Underwriters have jointly and severally agreed, subject to certain conditions, to purchase the Bonds from the Authority at an aggregate discount of \$3,619,219.58 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 to purchase the Bonds are subject to certain conditions precedent. The Underwriters will be obligated to purchase all of the Bonds if any Bonds are purchased. The Underwriters may offer to sell the Bonds to certain dealers (including dealers depositing the Bonds into unit investment trusts, certain of which may be sponsored or managed by the Underwriters) and others at prices lower than the initial public offering prices. The offering prices may be changed from time to time by the Underwriters. The Authority has agreed to indemnify, to the extent permitted by law, the Underwriters against certain liabilities, including liabilities under federal securities laws, or to contribute to payments that the Underwriters may be required to make in respect thereof.

Goldman, Sachs & Co., a managing underwriter, has entered into an agreement with FirstBank Puerto Rico, a bank organized under the laws of the Commonwealth, pursuant to which FirstBank has agreed to act as a consultant to Goldman Sachs 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 Goldman Sachs'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: J.P. Morgan Securities Inc. and R - G Investments Corporation; Merrill Lynch & Co. and BBVA Capital Markets; Banc of America Securities LLC and Oriental Financial Services Corp.; Lehman Brothers Inc. and Santander Securities

Corporation; Morgan Stanley & Co. Incorporated and Popular Securities, Inc.; and Wachovia Bank, National Association and Doral Securities Inc.

MATERIAL RELATIONSHIPS

Washington Group, 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 opinion 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 O'Neill & Borges, 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 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 of the Authority as of and for the years ended June 30, 2002 and 2001 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 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 years 2002 and 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 “A3” by Moody’s Investors Service and “A-” by Standard & Poor’s Ratings Services. These ratings do not reflect the expected issuance by MBIA of the MBIA Bond Insurance Policy covering the MBIA Insured Bonds. Moody’s Investors Service and Standard & Poor’s Ratings Services have given the MBIA Insured Bonds ratings of “Aaa” and “AAA,” respectively, based on the expected issuance of the MBIA Bond Insurance Policy. 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 (but excluding the Commonwealth of Puerto Rico Financial Information and Operating Data Report incorporated by reference herein); 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 the date of this Official Statement, 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 and request to cure such breach, and the Authority shall have refused to comply within a reasonable time. All Proceedings shall be instituted only in the Federal district court for the District of Puerto Rico or 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 interpretations of the Rule, or any 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 the Covenants, 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, 2002 and June 30, 2001, together with the independent accountants' report of Ernst & Young LLP, San Juan, Puerto Rico, (iii) a letter from the Authority's Consulting Engineers, Washington Group, regarding its opinion as to certain engineering matters in this Official Statement, (iv) the proposed form of opinion of Sidley Austin Brown & Wood LLP, Bond Counsel, and (v) a specimen of the MBIA Bond Insurance Policy.

The information set forth in this Official Statement, except for certain information on the page following the inside cover page and the information appearing in *Underwriting, Material Relationships*, Appendices III, IV and V and the information pertaining to DTC and MBIA, 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 and MBIA was supplied by DTC and MBIA, 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 least 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 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 thereof 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, within 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.

APPENDIX II

Financial Statements

Puerto Rico Electric Power Authority

June 30, 2002

Puerto Rico Electric Power Authority
Financial Statements and Supplemental Schedules
June 30, 2002

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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 sheets of the Puerto Rico Electric Power Authority (the Authority), a component unit of the Commonwealth of Puerto Rico, as of June 30, 2002 and 2001, and the related statements of revenues, expenses and changes in net assets, and cash flows for the years 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 audits.

We conducted our audits 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 audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Authority as of June 30, 2002 and 2001, and its changes in net assets and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States.

As discussed in Note 1 to the financial statements, effective July 1, 2001, the Authority changed its accounting policy related to financial statements presentation to comply with the provisions of Governmental Accounting Standards Board Statement No. 34, *Basic Financial Statements – and Management's Discussion and Analysis – for State and Local Governments*.

Our audits have been made primarily for the purpose of expressing an opinion on the financial statements of the Authority taken as a whole. The Management's Discussion and Analysis on pages 3 through 8 and supplemental information included in Schedule II-VII is not a required part of the basic financial statements, but is supplementary information required by the Governmental Accounting Standards Board and the 1974 Agreement, respectively. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the required supplementary information. However, we did not audit the information and express no opinion on it. Supplemental information included as Schedule II-VII 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).

In accordance with *Government Auditing Standards*, we have also issued our report dated September 27, 2002, on our consideration of the Authority's internal control over financial reporting and our tests of its compliance with certain provisions of laws, regulations, contracts and grants. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be read in conjunction with this report in considering the results of our audits.

Ernst + Young LLP

September 27, 2002, except to the second and third paragraphs of Note 18, as to which the dates are October 3, 2002 and October 10, 2002, respectively

Stamp No. 1842052
affixed to
original of
this report.

Puerto Rico Electric Power Authority

MANAGEMENT'S DISCUSSION AND ANALYSIS

This section of the Puerto Rico Power Authority's (the Authority) financial report presents the analysis of the Authority's financial performance during the fiscal year ended June 30, 2002. As management of the Authority, we offer readers of the financial statements this narrative overview and analysis of the financial activities. We encourage readers to consider the information presented here in conjunction with the financial statements that follow this section.

FINANCIAL HIGHLIGHTS

- The Authority's net assets increased by \$27.8 million or over 6 percent as a result of this year's operations.
- Operating income for the fiscal year was \$367.8 million, representing a 1.5 percent decrease compared to the fiscal year 2000-2001.
- Ratios of fuel adjustment revenues to total operating revenues were 37 percent for 2001-2002 and 45 percent for 2000-2001.
- Operating expenses decreased \$159.6 million, representing an 8.1 percent decrease, when compared to fiscal year 2000-2001.
- Ratios of fuel oil expenses to total operating expenses excluding depreciation expenses were 46 percent for 2001-2002 and 55 percent for 2000-2001.
- The decrease in the fuel adjustment revenues and fuel expense of \$252.3 and \$224.5 million, respectively, was mainly due to a decline in fuel oil price per barrel of \$6.48 (or 22.1%).
- The Authority's Net Utility Plant increased by \$187.7 million or 4.5 percent and Net Assets increased by \$459.4 million or 8.0 percent.
- Accounts receivable of the Authority increased from \$469.1 million on June 30, 2001 to \$481.8 million on June 30, 2002, representing a 2.7 percent.
- Accounts receivable from the governmental sector increased from \$93.1 on June 30, 2001 to \$108.4 on June 30, 2002, representing a 16.4 percent.

OVERVIEW OF FINANCIAL REPORT

Management's Discussion and Analysis (MD&A) of operating results serves as an introduction to the basic financial statements and supplementary information. Summary financial statement data, key financial and operational indicators used in the Authority's strategic plan, projected capital improvement program, operational budget and other management tools were used for this analysis.

Puerto Rico Electric Power Authority

MANAGEMENT'S DISCUSSION AND ANALYSIS (continued)

During the 2002 fiscal year, the Authority adopted Government Accounting Standards Board (GASB) Statement No. 34 and related pronouncements. The implementation of these pronouncements had an effect on the Authority's basic financial statements such as the classification of net assets, modifications to certain note disclosures, and the inclusion of a Management's Discussion and Analysis (MD&A) section as required supplementary information. In addition, the statements of cash flows are now presented using the direct method.

REQUIRED FINANCIAL STATEMENTS

The financial statements of the Authority consolidate the financial position and operations of the Puerto Rico Electric Power Authority and the Puerto Rico Irrigation Systems, which include a Balance Sheet, Statement of Revenues, Expenses and Changes in Net Assets, Statement of Cash Flow and the notes to financial statements.

The Balance Sheet presents the financial position of the Authority and provides information about the nature and amount of resources and obligations at year-end.

The Statement of Revenues, Expenses and Changes in Net Assets presents the results of the business activities over the course of the fiscal year and information as to how the net assets changed during the fiscal year.

The Statement of Cash Flows shows changes in cash and cash equivalents, resulting from operational, financing and investing activities, which include cash receipts and cash disbursement information, without consideration of the depreciation of capital assets.

The notes to the financial statements provide information required and necessary to the understanding of material information of the Authority's financial statements. The notes present information about the Authority's significant accounting policies, significant account balances and activities, risk management, obligations, commitments and contingencies, and subsequent events.

The financial statements were prepared by the Authority's management from the detail accounting books and records.

Puerto Rico Electric Power Authority

MANAGEMENT'S DISCUSSION AND ANALYSIS (continued)

FINANCIAL ANALYSIS

The Authority's net assets increased from last year by \$27.8 million. Our analysis below focuses on the Authority's net assets and changes in net assets during the year.

Authority's Net Assets *(In Thousands)*

	2002	2001
Current, noncurrent and other assets	\$1,836,558	\$1,564,808
Capital assets	4,359,399	4,171,743
Total assets	6,195,957	5,736,551
Long-term debt outstanding	4,632,928	4,242,155
Other liabilities	1,070,684	1,029,841
Total liabilities	5,703,612	5,271,996
Net assets:		
Invested in capital assets, net of related debt	113,475	151,647
Restricted	367,351	329,430
Unrestricted	11,519	(16,522)
Total net assets	\$ 492,345	\$ 464,555

The largest portion of the Authority's net assets (75 percent) is restricted and represents resources that are subject to external restrictions on how they may be used. An additional portion of the Authority's net assets (23 percent) reflects its investments in capital assets, less any related debt used to acquire those assets that is still outstanding.

Changes in the Authority's net assets can be determined by reviewing the following condensed Statement of Revenue, Expenses and Changes in net Assets.

Puerto Rico Electric Power Authority

MANAGEMENT'S DISCUSSION AND ANALYSIS (continued)

Authority's Changes in Net Assets *(In Thousands)*

	2002	2001
Operating revenues	\$2,166,632	\$2,331,989
Other income	42,323	54,548
Total revenues	2,208,955	2,386,537
Operating expenses	1,798,788	1,958,354
Interest expense, net	253,590	238,018
Total expenses	2,052,378	2,196,372
Income before contribution in lieu of taxes and other	156,577	190,165
Contribution in lieu of taxes and other	(128,787)	(148,271)
Change in net assets	27,790	41,894
Net assets, beginning of year	464,555	422,661
Net assets, end of year	\$ 492,345	\$ 464,555

For the fiscal year ended June 30, 2002, as compared to June 30, 2001, operating revenues and expenses decreased by \$165.4 million (or 7.0%) and \$159.6 million (or 8.1%), resulting in an increase of net assets of \$27.8 million. The decrease in operating revenues and expenses was mainly due to a decline in fuel oil price per barrel of \$6.48.

CAPITAL ASSET AND DEBT ADMINISTRATION

Capital Assets

The Authority's investment in capital assets as of June 30, 2002, amounts to approximately \$4,359.4 million (net of accumulated depreciation). This investment in capital assets includes land, generation, transmission and distribution systems, buildings, fixed equipment, furniture, fixtures and equipment. The total increase in the Authority's investment in capital assets (net of accumulated depreciation) for the current fiscal year was 4.5 percent.

A substantial portion of the capital expenditures for production plant in fiscal year ended June 30, 2002, was spent on the rehabilitation and life extension of generating plant in order to achieve and maintain higher levels of availability, reliability and efficiency.

Major capital asset events during fiscal year 2001-2002 included the following:

- 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 Mayaguez switchyard, thereby improving the reliability of service to the northwestern part of the island, which is experiencing significant load growth.

Puerto Rico Electric Power Authority

MANAGEMENT'S DISCUSSION AND ANALYSIS (continued)

- 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.
- In addition, 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.

These projects are funded from cash reserves, excess-operating revenues, and debt issued for such purpose.

Additional information on the Authority's capital assets can be found in Note 6 of this report.

Long-Term Debt

At the end of the fiscal year 2002, the Authority had total long-term debt outstanding of \$4,633 million, comprised of revenue bonds and other borrowings.

Authority Outstanding Debt

	<u>2002</u>	<u>2001</u>
	<i>(In Thousands)</i>	
Power revenue bonds, net	\$4,627,928	\$4,237,155
Note payable	5,000	5,000
	4,632,928	4,242,155
Current portion	(280,070)	(285,939)
Long-term debt excluding current portion	\$4,352,858	\$3,956,216

The Authority maintains ratings of "Baa1" by Moody's and "A-" by S&P for its bonds.

Additional information on the Authority's long-term debt can be found in Notes 7-9.

ECONOMIC FACTORS AND NEW YEAR'S BUDGETS AND RATES

The Puerto Rican economy must be analyzed as a region within the U.S. economy, being an integral part of the U.S. monetary and banking system, as well as within its territorial and custom boundaries. The main drive of the Puerto Rican economy is a huge external sector closely tied to the flow of merchandise, tourists, and capital between Puerto Rico and the U.S. Thus, historically, the real growth rates of the Puerto Rican economy have closely followed the

Puerto Rico Electric Power Authority

MANAGEMENT'S DISCUSSION AND ANALYSIS (continued)

behavior of the U.S. economy. In fiscal year 2002 Puerto Rico experienced the consequences of the slowdown in the U.S. economy, since the U.S. Real GDP increased by only 0.8%.

The Puerto Rican economy is expected to regain its growing path in fiscal year 2003, advancing at rates between 2% and 3% in real terms, according to the latest forecast of the Interamerican University Econometric Model. This turnaround in the performance of the Puerto Rican economy will contribute to achieve the conservative income projections of the Authority for fiscal year 2003.

The Authority adopted the 2003 fiscal year budget on June 18, 2002. The revenues for fiscal year 2003 are projected to approximately \$2,736 million. This budget includes a total of approximately \$430 million for the Capital Improvement Program (CIP), representing an increase of about 3% from fiscal year 2002.

REQUEST FOR INFORMATION

This financial report is designed to provide a general overview of the Authority's finances. Questions concerning any of the information provided in this report or requests for additional financial information should be addressed to the Chief Financial Officer. The executive offices of the Authority are located at 1110 Ponce de León Avenue, San Juan, Puerto Rico 00907.

Puerto Rico Electric Power Authority
Balance Sheets

	June 30	
	2002	2001
	<i>(In Thousands)</i>	
Assets		
Current assets:		
Cash and cash equivalents	\$ 165,255	\$ 92,364
Receivables, net	438,678	404,900
Fuel oil, at average cost	59,971	76,400
Materials and supplies, at average cost	135,808	146,435
Prepayments and other assets	20,420	26,134
Total current assets	820,132	746,233
Other non-current receivables	43,080	64,224
Restricted assets:		
Cash and cash equivalents held by trustee for payment of principal and interest on bonds	273,743	261,568
Investments held by trustee	350,678	319,021
Construction fund and other special funds	282,364	123,041
Total restricted assets	906,785	703,630
Utility plant:		
Plant in service	6,169,225	5,596,586
Accumulated depreciation	(3,015,056)	(2,788,112)
	3,154,169	2,808,474
Construction in progress	1,205,230	1,363,269
Total utility plant, net	4,359,399	4,171,743
Deferred expenses:		
Unamortized debt issue cost	33,849	28,128
Other	32,712	22,593
Total deferred expenses	66,561	50,721
Total assets	\$ 6,195,957	\$ 5,736,551

	June 30	
	2002	2001
	<i>(In Thousands)</i>	
Liabilities and net assets		
Current liabilities:		
Notes payable to banks	\$ 125,000	\$ 125,000
Accounts payable and accrued liabilities	497,974	442,341
Customers' deposits	133,510	125,540
Total current liabilities	<u>756,484</u>	<u>692,881</u>
Current liabilities payable from restricted assets:		
Current portion of long-term debt and notes payable	280,070	285,939
Accrued interest	123,183	112,562
Total liabilities payable from restricted assets	<u>403,253</u>	<u>398,501</u>
Noncurrent liabilities:		
Long-term debt, excluding current portion payable from restricted assets	4,352,858	3,956,216
Deferred credit for purchase of power payable from restricted assets	41,422	46,894
Sick leave benefits to be liquidated after one year	120,412	130,212
Supplemental spouse survivor benefits	21,300	41,900
Pension benefits exchanged for forfeited sick leave	7,883	5,392
Total noncurrent liabilities	<u>4,543,875</u>	<u>4,180,614</u>
Total liabilities	<u>5,703,612</u>	<u>5,271,996</u>
Net assets:		
Invested in utility plant, net of related debt	113,475	151,647
Restricted for capital activity and debt service	367,351	329,430
Unrestricted	11,519	(16,522)
Total net assets	<u>492,345</u>	<u>464,555</u>
Total net assets and liabilities	<u><u>\$6,195,957</u></u>	<u><u>\$5,736,551</u></u>

See accompanying notes.

Puerto Rico Electric Power Authority
Statements of Revenues, Expenses and Changes in Net Assets

	Year ended June 30	
	2002	2001
	<i>(In Thousands)</i>	
Operating revenues	\$2,166,632	\$2,331,989
Operating expenses:		
Operations:		
Fuel	720,292	944,760
Purchased power	227,923	177,330
Other production	56,299	56,566
Transmission and distribution	115,834	107,258
Customer accounting and collection	85,183	83,908
Administrative and general	152,142	140,183
Maintenance	215,994	215,180
Depreciation	225,121	233,169
Total operating expenses	1,798,788	1,958,354
Operating income	367,844	373,635
Interest income	25,766	45,239
Other income	16,557	9,309
Income before interest charges and contribution in lieu of taxes	410,167	428,183
Interest charges:		
Interest on bonds	247,982	238,043
Interest on other long-term debt	487	2,415
Other interest	3,235	3,028
Amortization of debt discount, issuance costs and refunding loss	17,880	17,498
Allowance for funds used during construction	(15,994)	(22,966)
Total interest charges, net	253,590	238,018
Income before contribution in lieu of taxes and other	156,577	190,165
Contribution in lieu of taxes and other	(128,787)	(148,271)
Changes in net assets	27,790	41,894
Net assets, beginning balance	464,555	422,661
Net assets, ending balance	\$ 492,345	\$ 464,555

See accompanying notes.

Puerto Rico Electric Power Authority
Statements of Cash Flows

	Year ended June 30	
	2002	2001
	<i>(In Thousands)</i>	
Cash flows from operating activities		
Cash received from customers	\$ 2,887,245	\$ 3,203,984
Cash paid to suppliers and employees	(2,385,448)	(2,760,591)
Net cash flows provided by operating activities	501,797	443,393
Cash flows from noncapital financing activities		
Proceeds from penalties to AES Puerto Rico, L.P.	1,652	-
Other special funds, net	(1,768)	-
Principal paid on fuel line of credit	(1,015,000)	(1,040,000)
Proceeds from fuel line of credit	1,015,000	1,040,000
Interest paid on fuel line of credit	(3,505)	(8,068)
Net cash flows used in noncapital financing activities	(3,621)	(8,068)
Cash flows from capital and related financing activities		
Construction expenditures	(412,777)	(405,860)
Allowance for funds used during construction	15,994	22,966
Net (decrease) increase in construction funds	(18,801)	23,585
Power revenue bonds:		
Proceeds from issuance of bonds, net of original issue discount	500,007	600,002
Principal paid on revenue bonds	(147,116)	(144,863)
Interest paid on revenue bonds	(223,065)	(210,993)
Proceeds from issuance of refunding bonds, net of original issue discount	206,896	-
Defeased bonds, net of original issue discount or premium	(199,376)	-
Payment of bond anticipation notes	(80,000)	(299,000)
Proceeds from bond anticipation notes	80,000	36,000
Interest paid on bond anticipation notes	(487)	(6,044)
Net cash flows used in capital and related financing activities	(278,725)	(384,207)
Cash flows from investing activities		
Purchases of investment securities	(1,057,086)	(1,480,156)
Proceeds from sale and maturities of investment securities	860,437	1,456,331
Interest on investments	43,463	38,223
Net cash flows (used in) provided by investing activities	(153,186)	14,398
Net increase in cash and cash equivalents	66,265	65,516
Cash and cash equivalents at beginning of year	402,044	336,528
Cash and cash equivalents at end of year	\$ 468,309	\$ 402,044

	Year ended June 30	
	2002	2001
	<i>(In Thousands)</i>	
Cash and cash equivalents		
Unrestricted	\$ 165,255	\$ 92,364
Restricted:		
Cash and cash equivalents held by trustee for payment of principal and interest on outstanding bonds	273,743	261,568
Cash and cash equivalents held in construction and other special funds	29,311	48,112
	<u>\$ 468,309</u>	<u>\$ 402,044</u>
 Reconciliation of net operating revenues to net cash provided by operating activities		
Operating income	\$ 367,844	\$ 373,635
Adjustments to reconcile operating income to net cash provided by operating activities:		
Depreciation	225,121	233,169
Amortization of other assets	17,880	17,498
Contribution in lieu of taxes	(128,787)	(148,271)
Changes in assets and liabilities that increase (decrease) cash:		
Receivables	(16,571)	(28,105)
Fuel oil	19,934	(9,941)
Materials and supplies	10,525	16,360
Prepayments and other assets	5,714	381
Deferred debits	(21,439)	(22,129)
Noncurrent liabilities, excluding note payable to GDB	(33,380)	(4,345)
Accounts payable and accrued liabilities	46,985	6,627
Customers' deposits	7,971	8,514
Total adjustments	<u>133,953</u>	<u>69,758</u>
 Net cash flows provided by operating activities	 <u>\$ 501,797</u>	 <u>\$ 443,393</u>

See accompanying notes.

Puerto Rico Electric Power Authority

Notes to Financial Statements

June 30, 2002

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 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.

Basis of Presentation – Blended Component Unit

The financial statements of the Authority include the financial position and operations of the Puerto Rico Irrigation Systems (Irrigation Systems). The Irrigation Systems operate 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 Irrigations Systems conforms to the requirements of Governmental Accounting Standards Board (GASB) No. 14, *The Financial Reporting Entity* on its standalone financial statements. (GASB No. 14 establishes standards for defining and reporting on the financial reporting entity. It also establishes standards for reporting participation in joint ventures. It applies to financial reporting by primary governments, governmental joint ventures, jointly governed organizations, and other standalone governments; and it applies to the separately issued financial statements of governmental component units. In addition, this Statement should be applied to governmental and nongovernmental component units when they are included in a governmental financial reporting entity.

Puerto Rico Electric Power Authority
Notes to Financial Statements (continued)

1. Reporting Entity (continued)

Basis of Presentation – Blended Component Unit (continued)

Condensed financial information as of June 30, 2002 and 2001, and for the year then ended for the Irrigation systems is as follows:

	2002	2001
	(in thousands)	
Balance sheets:		
Assets:		
Receivables, net	\$ 7,943	\$ 2,834
Prepayments and other assets	2,139	2,075
Utility Plant, net of depreciation	18,745	18,618
Total assets	28,827	23,527
Liabilities:		
Accounts payable, net	24,557	18,511
Statement of revenues, expenditures and changes in net assets		
Operating revenues	4,461	2,886
Operating expenses	5,207	2,561
	(746)	325
Net assets, beginning balance	5,016	4,691
Net assets, ending balance	\$ 4,270	\$ 5,016

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 accounting principles generally accepted in the United States. Although the Authority is not under Federal Energy Regulatory Commission (FERC) regulations, the Authority has adopted the uniform system of accounts prescribed by FERC.

Puerto Rico Electric Power Authority
Notes to Financial Statements (continued)

2. Summary of Significant Accounting Policies (continued)

Basis of Accounting (continued)

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," as amended by GASB Statement No. 34, which requires proprietary activities to apply all applicable GASB pronouncements as well as all Financial Accounting Standards Board (FASB) Statements and Interpretations, and 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 accounting principles generally accepted in the United States 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.

GASB Statement Nos. 34, 37 and 38

During the 2002 fiscal year the Authority adopted the provisions of Governmental Accounting Standards Board (GASB) Statement No. 34, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments* (Statement 34); GASB Statement No. 37, *Basic Financial Statements – and Management's Discussion and Analysis – for State and Local Governments: Omnibus* (Statement 37); and GASB Statement No. 38, *Certain Financial Statement Disclosures* (Statement 38). Statements 34, 37 and 38 established standards for external financial reporting and disclosure for all state and local government entities, which for the Authority includes a statement of net assets, a statement of revenues, expenses and changes in net assets and a statement of cash flows. The most significant change related to the implementation of Statement 34 for Authority is the requirement that net assets be classified into three components – invested in capital assets, net of related debt; restricted; and unrestricted, on a retroactive basis. Previously, Authority net assets were reported as fund equity, as either retained earnings or contributions in aid of construction. These classifications are defined as follows:

Puerto Rico Electric Power Authority
Notes to Financial Statements (continued)

2. Summary of Significant Accounting Policies (continued)

GASB Statement Nos. 34, 37 and 38 (continued)

- Invested in capital assets, net of related debt – This component of net assets consists of capital assets, net of accumulated depreciation and reduced by the outstanding balances of any bonds, or other long-term borrowings that are attributable to the acquisition, construction, or improvement of those assets. If there are significant unspent related debt proceeds at year-end, the portion of the debt attributable to the unspent proceeds is not included in the calculation of invested in capital assets, net of related debt. Rather, that portion of the debt is included in the same net assets component as the unspent proceeds.
- Restricted – This component of net assets consists of net assets subject to external constraints on their use imposed by creditors (such as through debt covenants), contributors, or laws or regulations of other governments or constraints imposed by law through constitutional provisions or enabling legislation.
- Unrestricted net assets – This component of net assets consists of net assets that do not meet the definition of “restricted” or “invested in capital assets, net of related debt.”

The adoption of Statements No. 34, No. 37, and No. 38 had no effect on the financial statements except for the classification of net assets, changes in financial statement presentation and modification of certain financial statement note disclosures.

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.

Materials and Supplies

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

Puerto Rico Electric Power Authority
Notes to Financial Statements (continued)

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 require 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 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 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.

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, 2002 and 2001 amounted to \$16 million and \$23 million, respectively. These amounts are net of interest income earned on investments amounting to \$3.9 million and \$8.7 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.

Puerto Rico Electric Power Authority
Notes to Financial Statements (continued)

2. Summary of Significant Accounting Policies (continued)

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% for 2002 and 2001.

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.

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 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 and purchased power are consumed.

Puerto Rico Electric Power Authority
Notes to Financial Statements (continued)

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% to the Municipalities 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 obligations 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 the 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 revenues, expenses and changes in net assets and reduce the related accounts receivable in the balance sheets.

Contributed Capital

The Authority records contributed capital as income.

Reclassifications

Certain reclassifications have been made to the 2001 financial statements to conform with the 2002 financial statements presentation.

Puerto Rico Electric Power Authority
Notes to Financial Statements (continued)

3. 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 balance sheets.

At June 30, 2002, 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):

	2002		2001	
	Carrying Amount	Bank Balance	Carrying Amount	Bank Balance
Unrestricted	\$165,255	\$171,831	\$ 92,364	\$103,413
Restricted:				
Held by the Trustee	273,743	273,743	261,568	261,568
Held by the Authority	29,311	29,311	48,112	24,723
	\$468,309	\$474,885	\$402,044	\$389,704

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.

4. Accounts Receivable

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

	2002	2001
Electric and related services:		
Government agencies and municipalities	\$108,428	\$ 93,127
Residential, industrial, and commercial	248,114	238,640
Recoveries under fuel adjustment clause under (over) billed	(8,055)	(6,098)
Unbilled services	124,641	120,368
Commonwealth subsidy (fuel adjustment clause) for certain residential clients	31,598	37,924
Miscellaneous accounts and others	8,101	15,895
	512,827	499,856
Allowance for uncollectible accounts	(34,551)	(35,355)
	478,276	464,501
Accrued interest on investments	3,482	4,623
Less - Other non-current receivables, mostly related to Commonwealth	(43,080)	(64,224)
	\$438,678	\$404,900

Puerto Rico Electric Power Authority
Notes to Financial Statements (continued)

4. Accounts Receivable (continued)

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 is paying that amount over a fifteen-year period in installments of approximately \$6.3 million per year, without interest. As of June 30, 2002 and 2001, the outstanding fuel adjustment subsidy receivable amounted to approximately \$31.6 and \$37.9 million, respectively.

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.

5. Restricted Assets

At June 30, 2002 and 2001, 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:

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.

Bond Service Account and Redemption Account (1974 Sinking Fund) - Current year requirements for principal of and interest on Power Revenue Bonds. As of June 30, 2002, cash and cash equivalents in this account amounted to \$273 million (2001 - \$262 million).

Puerto Rico Electric Power Authority
Notes to Financial Statements (continued)

5. Restricted Assets (continued)

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

	2002	2001
1974 Reserve Account	\$260,193	\$245,633
1974 Self - insurance Fund	77,353	73,388
1974 Sinking Fund	13,132	-
	\$350,678	\$319,021

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 Financial Statements (continued)

5. Restricted Assets (continued)

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

	2002		2001	
	Cash and Cash Equivalents	Investments	Cash and Cash Equivalents	Investments
1974 Construction Fund	\$25,405	\$166,710	\$40,619	\$ 921
Reserve Maintenance Fund	1,022	40,454	2,397	30,214
Cogeneration Fund	-	-	5,096	-
Other Fund	2,884	45,889	-	43,794
	\$29,311	\$253,053	\$48,112	\$74,929

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

	2002	2001
U.S. Government obligations	\$225,459	\$45,503
Corporate bonds	4,527	9,058
Equity securities	23,067	20,368
	\$253,053	\$74,929

6. Utility Plant

As of June 30, utility plant consist of:

	2002	2001
	<i>(In Thousands)</i>	
Distribution	\$ 1,984,478	\$ 1,854,205
Transmission	985,724	912,515
Production	1,574,173	1,400,143
Other production	536,089	533,782
Hydroelectric	85,637	85,679
General	972,577	779,714
Irrigation systems	30,547	30,548
	6,169,225	5,596,586
Less - Accumulated depreciation	(3,015,056)	(2,788,112)
	3,154,169	2,808,474
Construction in progress	1,205,230	1,363,269
	\$ 4,359,399	\$ 4,171,743

Puerto Rico Electric Power Authority
Notes to Financial Statements (continued)

6. Utility Plant (continued)

Utility plant activity for the year ended June 30, 2002, was as follows:

	Beginning Balance	Increases	Decreases	Transfers	Ending Balance
Utility Plant	\$ 5,596,586	\$ 378,094	\$ (1,414)	\$ 195,959	\$ 6,169,225
Construction work in progress	1,363,269	416,014	(378,094)	(195,959)	1,205,230
Total utility plant	6,959,855	794,108	(379,508)	-	7,374,455
Less:					
Accumulated depreciation	(2,788,112)	(226,944)	-	-	(3,015,056)
Total utility plant, net	<u>\$ 4,171,743</u>	<u>\$ 567,164</u>	<u>\$(379,508)</u>	<u>\$ -</u>	<u>\$ 4,359,399</u>

Construction work-in-progress at June 30, 2002, consists principally of expansions and upgrades to the electric generation, distribution and transmission systems.

7. Defeasance of Debt

During 2002 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, 2002 and 2001, \$723.0 and \$447.6 million, respectively, of Power Revenue Bonds series P, Q, R, T, V, X, and HH, which remain outstanding are considered defeased.

8. Notes Payable to Banks

On July 3, 1999, 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 1.92% and 1.91%, respectively, for 2002; and 6.76% and 4.12%, respectively, for 2001.

Puerto Rico Electric Power Authority
Notes to Financial Statements (continued)

9. Accounts Payable and Accrued Liabilities

	2002	2001
	<i>(In Thousands)</i>	
Accounts payable, accruals, and withholdings in process of payment	\$281,528	\$239,382
Additional accruals and withholdings:		
Injuries and damages and other	20,523	24,877
Accrued vacation and payroll benefits	52,403	48,708
Accrued sick leave and payroll benefits - exclusive of benefits to be liquidated after one year of approximately \$120.4 million and \$130.2 million in 2002 and 2001, respectively	21,584	15,385
Accrued accident leave	3,973	3,973
Accrued compensation	24,043	24,186
Accrued pension plan contribution and withholding from employees:		
Employees' Retirement System	3,398	3,188
Supplemental unfunded benefit obligation spouse-survivor benefit - exclusive of benefit to be liquidated after one year of approximately \$21.3 million in 2002 and \$41 million in 2001	15,579	10,344
Supplemental unfunded pension obligation exchanged for forfeited sick leave benefits - exclusive of benefits to be liquidated after one year of approximately \$7.8 and \$5.4 million in 2002 and 2001, respectively	3,902	10,242
Employees health plan	14,273	17,972
Contract retainage	21,674	20,789
Contribution in lieu of taxes	11,645	6,381
Other accrued liabilities	23,449	16,914
	\$497,974	\$442,341

Puerto Rico Electric Power Authority
Notes to Financial Statements (continued)

10. Long-Term Debt

At June 30, long-term debt consists of:

	2002	2001
	<i>(In Thousands)</i>	
Power Revenue Bonds payable:		
Publicly offered at various dates from 1988 to 2002, interest rates ranging from 3.8% to 7.0%, maturing to 2031	\$4,687,535	\$4,295,860
RUS issues - interest rate of 5%, maturing to 2028	150,831	158,690
	4,838,366	4,454,550
Less unamortized discount and debt reacquisition costs	(210,438)	(217,395)
Revenue bonds payable, net	4,627,928	4,237,155
Note payable	5,000	5,000
	4,632,928	4,242,155
Less current portion of long-term debt	(280,070)	(285,939)
	\$4,352,858	\$3,956,216

Long-term debt activity for the years ended June 30, 2002 and 2001, was as follows:

	2002	2001
	<i>(In Thousands)</i>	
Long-term debt excluding current portion	\$4,242,155	\$3,748,268
New issues:		
Power revenue bonds	515,305	612,240
Power revenue refunding bonds	205,065	-
Debt discount on new bond issues – net	23	(6,438)
Defeasance of bonds	(203,735)	-
Debt discount and excess reacquisition costs on cancelled bonds – net	(9,131)	-
Accretion of capital appreciation bonds	14,296	17,236
	4,763,978	4,371,306
Payment to bondholders:		
Power revenue – July 1	(143,214)	(141,088)
Power revenue – January 1	(3,902)	(3,775)
Total payments	(147,116)	(144,863)
Amortization of debt discount and excess reacquisition costs	16,066	15,712
Balance at end of year	\$4,632,928	\$4,242,155
Current portion of long-term debt	\$ 280,070	\$ 285,939

Puerto Rico Electric Power Authority
Notes to Financial Statements (continued)

10. Long-Term Debt (continued)

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.

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).

Power Revenue Bonds Payable (continued)

During fiscal year 2002, the Authority issued the Power Revenue Bonds, Series II and JJ. The Authority is issuing the Series JJ Bonds pursuant to Section 210 of the 1974 Agreement to refund blocks of the following previous issuance: Series HH, Q, T, V, and X. Blocks refunded are summarized as follow:

Series HH	\$108,300,000
Series Q	20,870,000
Series T	10,835,000
Series V	7,910,000
Series X	55,820,000
Total refunded	<u><u>\$203,735,000</u></u>

The refunding will permit the Authority to realize savings on its debt service requirements on bonds outstanding under the 1974 agreement. Reduction of the total debt service payments over the next 16 years is approximately \$11,000,000. This will generate an economic gain (difference between present value of the old and new debt service payments) of approximately \$9,600,000. The authority will deposit the net proceeds of the Series JJ Power Revenue Bonds Refunding Bonds with the 1974 trustee, as escrow agent, under the term of an escrow deposit agreement. The net proceeds were invested in Government Obligations, the principal of and interest on which when due, provided moneys sufficient to pay the redemption price of the Refunded Power Revenue Bonds on and the interest coming due on the Refunded Power Revenue Bonds through their respective dates of redemption.

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

Puerto Rico Electric Power Authority
Notes to Financial Statements (continued)

10. Long-Term Debt (continued)

Power Revenue Bonds Payable (continued)

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

Principal amount of Series II Bonds	\$515,305,000
Principal amount of Series JJ Refunding Bonds	205,065,000
Plus:	
Net original issue premium	4,918,094
 Proceeds	 \$725,288,094
 Application of net proceeds:	
Deposit to Escrow Fund for Refunded Power Revenue Bonds	\$211,325,000
Repayment to Government Development Bank	80,000,000
Deposit to 1974 Construction Fund	420,000,000
Cost of Issuance	13,963,094
 Total	 \$725,288,094

Maturities of the Power Revenue Bonds Series II issued during fiscal year 2002 ranges from July 1, 2016 to July 1, 2031. The Term Bonds bear interest rates ranging from 5.13% to 5.25%. Interest on the Term Bonds and Serial Bonds is payable on each July 1.

Maturities of the Power Revenue Bonds Series JJ issued during fiscal year 2002 ranges from July 1, 2006 to July 1, 2018. The Serial Bonds bear interest rates ranging from 4.00% to 5.38%. Interest on the Term Bonds and Serial Bonds is payable on each July 1.

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.

Puerto Rico Electric Power Authority
Notes to Financial Statements (continued)

10. Long-Term Debt (continued)

Power Revenue Bonds Payable (continued)

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 5.63% and mature from 2003 to 2020. Interest on the Term Bonds and Serial Bonds will be payable on each January 1 and July 1.

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.

Puerto Rico Electric Power Authority
Notes to Financial Statements (continued)

10. Long-Term Debt (continued)

Power Revenue Bonds Payable (continued)

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, 2002, the interest rate was 2.25% (2001 - 3.77%).

Puerto Rico Electric Power Authority
Notes to Financial Statements (continued)

10. Long-Term Debt (continued)

Scheduled Maturities of Long-Term Debt

The scheduled maturities of long-term debt with interest thereon at June 30, 2002, including sinking fund debt service requirements, are as follows:

Year ending June 30	Power Revenue Bonds	RUS Power Revenue Bonds	EcoEléctrica Note	Total
<i>(In Thousands)</i>				
2003	\$ 656,353	\$ 23,405	\$ -	\$ 679,758
2004	400,493	15,104	5,000	420,597
2005	391,814	13,525	-	405,339
2006	402,140	13,080	-	415,220
2007-2010	1,464,285	52,347	-	1,516,632
2011-2015	1,669,395	54,319	-	1,723,714
2016-2020	1,373,542	35,863	-	1,409,405
2021-2025	1,080,803	15,869	-	1,096,672
2026-2031	665,652	6,464	-	672,116
	<u>8,104,477</u>	<u>229,976</u>	<u>5,000</u>	<u>8,339,453</u>
Less:				
Unamortized discount	(56,228)	-	-	(56,228)
Excess reacquisition costs	(154,210)	-	-	(154,210)
Interest	(3,416,942)	(79,145)	-	(3,496,087)
	<u>4,477,097</u>	<u>150,831</u>	<u>5,000</u>	<u>4,632,928</u>
Current portion, net of discount and excess reacquisition costs	<u>(271,153)</u>	<u>(8,917)</u>		<u>(280,070)</u>
Long-term debt, excluding current portion	<u>\$ 4,205,944</u>	<u>\$141,914</u>	<u>\$5,000</u>	<u>\$ 4,352,858</u>

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.

Puerto Rico Electric Power Authority
Notes to Financial Statements (continued)

11. Employees' Retirement Benefits (continued)

Pension Plan (continued)

Plan Description (continued)

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, 2001 and projected to June 30, 2002 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.

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.

An accrued liability of \$11.8 million and \$15.6 million exists as of June 30, 2002 and 2001, respectively, including the current and non-current portions.

Puerto Rico Electric Power Authority
Notes to Financial Statements (continued)

11. Employees' Retirement Benefits (continued)

Supplemental Benefits not Funded Through the System (continued)

Supplemental Pension Obligations Exchanged for Forfeited Sick Leave Benefits (continued)

The authority's annual pension cost for the year ended June 30, 2002 and related information for the Plan and supplemental benefits follows:

	Pension Plan
Contribution rates:	
Authority	14.83%
Plan members	10.63%
Annual pension cost (thousands)	\$42,958
Contributions made and accruals (thousands)	\$42,958
Actuarial valuation date	6/30/2001
Actuarial cost method	Entry age
Amortization method	Level percentage of pay, closed (4.5% payroll increases per year)
Remaining amortization period	35 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 Financial Statements (continued)

11. Employees' Retirement Benefits (continued)

Supplemental Benefits not Funded Through the System (continued)

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%	\$ -
06/30/02	43.00	100%	\$ -

The annual required contribution amounted to \$43.0 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. 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 \$41.1 million in 2002 and \$37.8 million in 2001. Currently, 9,320 retirees meet eligibility requirements.

12. Revenues from Major Clients and Related Parties

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

	2002	2001
	<i>(In Thousands)</i>	
Governmental sector, principally instrumentalities, agencies and corporations of the Commonwealth of Puerto Rico	\$244,095	\$269,355
Municipalities	102,740	103,124
	\$346,835	\$372,479

Puerto Rico Electric Power Authority
Notes to Financial Statements (continued)

13. Net Assets

Restricted assets at June 30, 2002 and 2001 include \$77.4 million and \$73.4 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).

14. Contribution in Lieu of Taxes

	2002	2001
	<i>(In Thousands)</i>	
Municipalities	\$109,961	\$121,890
Commonwealth:		
Hotels	3,052	3,297
Fuel adjustment subsidy	15,035	22,379
Other subsidies (offset against outstanding accounts receivable and reimbursable costs)	739	705
	\$128,787	\$148,271
	\$128,787	\$148,271

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.

On June 20, 2002, the Government of the United States (the "Federal Government") and the Authority executed a Settlement Agreement to resolve litigation over the proposed extension of the Authority's term of probation arising from certain alleged environmental violations.

The United States District Court for the District of Puerto Rico accepted the terms of the Settlement Agreement, after a hearing held on July 18, 2002, and entered an Amended Order of Probation on July 24, 2002. The material points of the Settlement Agreement and the Probation Order are the following:

Puerto Rico Electric Power Authority
Notes to Financial Statements (continued)

15. Commitments and Contingencies (continued)

Environmental Matters (continued)

The Authority's term of probation will extend for 18 months, commencing on the date the Federal Government and the Authority select a Visible Emissions Compliance Auditor acceptable to the Court;

The Authority will burn fuel with sulfur content not to exceed 0.50% by weight at the Authority's Palo Seco and San Juan power plants for a period not less than two years, starting not later than one year from July 24, 2002. This shall be a test period and the Authority is not obligated to continue burning such fuel after the test period expires. Based on current market prices, this would increase the Authority's fuel costs by approximately \$15 to \$27 million per year for these two years. The Authority plans to mitigate this cost increase by using money in its Clients Fund;

The Authority will pay for the purchase of up to fourteen air quality monitoring stations in an amount not exceeding \$420,000; and

The Authority is required to pay a nominal fine of \$10,000 to the Federal Government. In addition, the Authority has voluntarily decided to burn fuel with sulfur content not to exceed 1.0% by weight at Palo Seco and San Juan power plants, starting in late 2002 until use of 0.50% sulfur content fuel begins at both plants.

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 the final testing 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 for fiscal year ended June 30, 2001.

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 Financial Statements (continued)

15. Commitments and Contingencies (continued)

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 insurance policies covering all-risk property (excluding transmission and distribution lines), boiler and machinery and public liability. The all-risk property and boiler and machinery policies have 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 \$2 million retention. 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 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 \$3.0 billion and \$2.8 billion at June 30, 2002 and 2001, respectively.

The net assets and restricted assets set aside in the Self-insurance Fund for self insurance amounted to approximately \$77.4 million in 2002 and \$73.4 million in 2001.

Changes in the balances of the health insurance program and other self-insurance risks during fiscal years 2002 and 2001 were as follows:

	Liability Beginning Balance	Expenses	Payments	Liability Ending Balance
	<i>(In Thousands)</i>			
2002	\$46,822	\$90,269	\$98,323	\$38,768
2001	\$40,921	\$95,344	\$89,443	\$46,822

Puerto Rico Electric Power Authority
Notes to Financial Statements (continued)

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, fifty-one 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.

Construction and Other Commitments

As of June 30, 2002, the Authority has commitments of approximately \$252.8 million on active construction, maintenance, and engineering services contracts.

Puerto Rico Electric Power Authority
Notes to Financial Statements (continued)

16. Optical Fiber Network Transaction (OFN)

On September 2000, the Authority entered into two agreements with Puerto Rico Information Network, Inc. (PRIN). The first agreement (Development and Management Agreement) establishes that PRIN would design and develop an OFN that will form part of the Authority's internal communications system. The second agreement (Initial Installment Purchase Agreement) establishes that upon the completion of the OFN, PRIN would transfer to the authority the title of the network.

17. 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, 2002 and 2001, the accrued interest on capital appreciation bonds amounted to \$14.3 million and \$17.2 million, respectively.

18. Subsequent Events

Bond Issuance

On July 2, 2002, the Authority issued \$401,785,000 Power Revenue Refunding Bonds, Series KK, and \$98,125,000 Power Revenue Bond, Series LL, to refund Refunded Power Revenue Bonds and to finance a portion of the cost of various projects under its capital improvement program, respectively. The refunding will permit the Authority to realize savings on its debt service requirements on bonds outstanding under the 1974 Agreement.

In addition, on October 3, 2002, the Authority issued \$105,055,000 Power Revenue Refunding Bonds, Series MM to refund Refunded Power Revenue Bonds.

Optical Fiber Network Acquisition

On October 10, 2002, the Authority paid \$36.8 million to acquire the fiber optic telecommunications network mentioned in Note 16.

Report on Compliance and on
Internal Control Over Financial Reporting
Based on an Audit of the Financial Statements in
Accordance with Government Auditing Standards

To the Board of Directors
Puerto Rico Electric Power Authority

We have audited the financial statements of Puerto Rico Electric Power Authority (the Authority), a component unit of the Commonwealth of Puerto Rico, as of and for the year ended June 30, 2002 and 2001, and have issued our report thereon dated September 27, 2002. 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.


Compliance

As part of obtaining reasonable assurance about whether the Authority's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grants, noncompliance with which could have a direct and material effect on the determination of financial statements amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit and accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance that are required to be reported under *Government Auditing Standards*.

Internal Control Over Financial Reporting

In planning and performing our audit, we considered the Authority's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide assurance on the internal control over financial reporting. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control over financial reporting that might be material weaknesses. A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. We noted no matters involving the internal control over financial reporting and its operation that we consider to be material weaknesses.

This report is intended solely for the information and use of the Board of Directors, management, federal awarding agencies and pass-through entities, and is not intended to be an should not be used by anyone other than these specified parties.



September 27, 2002

Stamp No. 1842053
affixed to
original of
this report.

Supplemental Information

Puerto Rico Electric Power Authority

Supplementary Information
Schedule of Funding Progress

(In Millions)

June 30, 2002

<u>Actuarial Valuation Date</u>	<u>Actuarial Value of Assets (a) Note 1</u>	<u>Actuarial Accrued Liability (AAL) (b)</u>	<u>Unfunded AAL (UAAL) (b) - (a)</u>	<u>Funded Ratio (a)/(b)</u>	<u>Covered Payroll (c)</u>	<u>UAAL Percentage Of Covered Payroll [(b) - (a)]/(c)</u>
<u>Pension Plan</u>						
6/30/95	\$ 891.4	\$1,193.6	\$302.2	75%	\$247.2	122%
6/30/96	999.9	1,255.6	255.7	80%	261.0	98%
6/30/97	1,083.8	1,332.7	248.9	81%	270.5	92%
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%
6/30/01	1,546.7	1,964.1	417.4	79%	289.7	144%

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, 2002 and 2001 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, 2002 and 2001
Statements of Income (GAAP) and Reconciliation of Net Income
(In Thousands)

	2002		2001	
	1974 Agreement	Statement of Income (GAAP)	1974 Agreement	Statement of Income (GAAP)
Reconciliation of components of net income:				
Revenues:				
Operating revenues	\$2,162,171	\$2,166,632	\$2,329,103	\$2,331,989
Revenues from Commonwealth for rural electrification	739	739	705	705
Other operating revenues	8,514	8,514	8,210	8,210
Other	22,257	22,257	35,059	35,059
1974 Agreement construction fund investment income and gain sale of other properties	-	10,813	-	10,575
	<u>2,193,681</u>	<u>2,208,955</u>	<u>2,373,077</u>	<u>2,386,538</u>
Current expenses:				
As shown	1,566,595	1,573,667	1,722,689	1,725,185
Other interest	-	3,235	-	3,028
Total as defined	<u>1,566,595</u>	<u>1,576,902</u>	<u>1,722,689</u>	<u>1,728,213</u>
Net revenues, as defined	<u>627,086</u>		<u>650,388</u>	
Depreciation		<u>225,121</u>		<u>233,169</u>
Disposition of Revenues: (not classified in order of payment)				
Interest on debt	248,469	248,469	240,459	240,459
Amortization debt discount and financing expenses	-	3,197	-	3,316
Amortization of bond defeasance	-	14,683	-	14,182
Allowance for funds used during construction	-	(15,994)	-	(22,966)
Net interest on long-term debt	<u>248,469</u>	<u>250,355</u>	<u>240,459</u>	<u>234,991</u>
Power revenue bonds:				
Principal	158,357	-	146,989	146,989
Internal Funds	77,307	-	100,500	100,500
Reserve Maintenance Fund	7,000	-	7,000	7,000
Contribution in lieu of taxes	135,953	128,787	155,440	148,271
Total expenses (GAAP)		<u>2,181,165</u>		<u>2,344,644</u>
Net revenues, as defined	<u>\$ 627,086</u>		<u>\$ 650,388</u>	
Net income		<u>\$ 27,790</u>		<u>\$ 41,894</u>
				<u>\$ 41,894</u>

See accompanying Notes.

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, 2002 and 2001
(In Thousands)*

	2002	2001
Sources of Net Revenues:		
Revenues:		
Electric revenues	\$2,162,171	\$2,329,103
Revenues from the Commonwealth for rural electrification	739	705
Other operating revenues	8,514	8,210
Other (principally interest)	22,257	35,059
	2,193,681	2,373,077
Current Expenses:		
Operations:		
Fuel	720,292	944,760
Purchased Power – Eco-Eléctrica	226,896	177,330
Purchased Power – AES	1,027	-
Other production	56,028	56,301
Transmission and distribution	114,971	105,034
Customer accounting and collection	84,689	83,453
Administrative and general	146,498	139,117
Maintenance	212,959	213,666
Interest (Other than long term debt)	3,235	3,028
	1,566,595	1,722,689
Net revenues, as defined	\$ 627,086	\$ 650,388
Disposition of Net Revenues:		
Revenue fund:		
Power revenue bonds - sinking fund requirements:		
Interest	\$ 247,982	\$ 238,044
Principal	158,357	146,989
Reserve	-	-
Reserve maintenance fund	7,000	7,000
Balance available for capital improvements and other needs	77,307	100,500
	490,646	492,533
General obligation notes:		
Interest	487	2,415
Principal	-	-
	487	2,415
Contribution in lieu of taxes and other:	135,953	155,440
Net revenues, as defined	\$ 627,086	\$ 650,388

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					
	2002			2001		
	Total	Held by Authority Other Assets	Restricted Deposits with Trustee Other Assets	Total	Held by Authority Other Assets	Restricted Deposits with Trustee Other Assets
By Account						
1974 Agreement (restricted):						
Sinking Fund – principal and interest	\$ 286,875	\$ -	\$286,875	\$261,568	\$ -	\$261,568
Reserve account	260,193	-		245,633	-	\$245,633
Self Insurance Fund	77,353	-	77,353	73,388	-	73,388
Reserve Maintenance Fund	41,476	41,476		32,612		
Construction Fund						
Rural Utilities Service (RUS)			921			921
Other	1,426	505		1,388	467	
Cogeneration Fund	190,689	190,689		40,152	40,152	
PREPA Client Fund	-	-		5,096	5,096	
General purpose (unrestricted):	48,773	48,773		43,793	43,793	
General	162,719	162,719		89,947	89,947	
Working funds	2,536	2,536		2,417	2,417	
Total	\$1,072,040	\$446,698	\$287,796	\$795,994	\$214,484	\$262,489
By type of assets held						
Working funds	\$ 2,536	\$ 2,536		\$2,417	\$ 2,417	
Cogeneration Fund	-	-		5,096	5,096	
Cash in bank and time deposits (by depository institutions):						
Government Development Bank for Puerto Rico						
Banco Popular de Puerto Rico	8,598	8,598		7,621	7,621	
Citibank, N. A.	6,285	6,285		54,447	54,447	
State Street Bank and Trust Co., N.A.	273,743	-	273,743	261,568	-	261,568
Banco Bilbao Vizcaya	30,053	30,053		15	15	
Banco Bilbao Vizcaya, Mayaguez, PR	217	217		2,073	2,073	
First Bank, San Juan, Puerto Rico	334	334		782	782	
Banco Santander, Santurce, Puerto Rico	86,539	86,539		24,051	24,051	
Roig Commercial Bank, Humacao, P.R.	56	56		173	173	
Western Bank, Mayaguez, Puerto Rico	637	637		785	785	
Economic Development Bank	30,000	30,000				
Other institutions						
Total	438,998	165,255	273,743	359,028	97,460	261,568
Investment Securities	633,042	281,443	14,053	436,966	117,024	319,021
Total	\$1,072,040	\$446,698	\$287,796	\$795,994	\$214,484	\$262,489

See accompanying notes.

Puerto Rico Electric Power Authority
 Supplement Schedule of Changes in Cash and Investments by Funds
 Year ended June 30, 2002
 (In Thousands)

	General Purposes Funds				
	Total	General Fund	Revenue Fund	Working Fund	General Obligations Notes Fund
Balances at June 30, 2001	\$ 795,994	\$ 89,916	\$ 31	\$2,417	\$ -
Operations:					
Net revenues	-	(627,086)	136,440	-	-
Funds provided from internal operations	492,074	492,074	-	-	-
1974 Agreement investment income	-	(10,813)	-	-	-
Offset of current year's contribution in lieu of taxes against certain government accounts receivable	-	108,161	(108,161)	-	-
Offset of current year's 5% contribution in lieu of taxes against Commonwealth of Puerto Rico debt and transfers to General Obligations Notes Fund	-	25,991	(25,991)	-	-
Funds used for construction	(412,015)	-	-	-	-
Funds used for restoration of plant	-	-	-	-	-
Financing:					
Proceeds from new bond issues-net of original issue discounts	720,370	-	-	-	-
Defeased bonds-net of original issue discounts	(199,376)	-	-	-	-
Accretion of capital appreciation bonds	14,296	14,296	-	-	-
Amortization of debt discount and excess reacquisition costs	16,066	16,066	-	-	-
Sinking Funds and account transfers	-	-	-	-	-
Notes issued for construction	80,000	-	-	-	-
Notes issued for fuel purchases	1,015,000	1,015,000	-	-	-
Payment of notes	(1,095,000)	(1,015,000)	-	-	-
Payment of interest	(227,057)	(3,505)	-	-	-
Payment of current maturities of long-term debt	(147,116)	-	-	-	-
Changes in assets and liabilities:					
Working funds	-	(119)	-	119	-
Accounts receivable (includes non-current)	(23,945)	(23,945)	-	-	-
Fuel oil	19,934	19,934	-	-	-
Materials and supplies	10,525	10,525	-	-	-
Prepayments and other	5,788	5,788	-	-	-
Deferred debits	(15,041)	(15,041)	-	-	-
Accounts payable and accrued liabilities (includes non-current)	13,572	13,572	-	-	-
Customer deposits	7,971	7,971	-	-	-
Interfund transfers, etc.	-	2,959	(2,201)	-	-
Total before interfund accounts	1,072,040	126,744	118	2,536	-
Add (deduct) interfund accounts	-	35,857	-	-	-
Balances at June 30, 2002	\$1,072,040	\$ 162,601	\$ 118	\$2,536	\$ -

See accompanying notes.

Sinking Fund

Interest 1974 Agreement	Principal 1974 Agreement	Reserve 1974 Agreement	Self Insurance Fund
\$ 114,177	\$ 147,391	\$245,633	\$73,388
247,982	158,357	-	-
-	-	-	-
-	-	-	-
-	-	-	-
-	-	-	-
-	-	-	-
-	-	-	-
-	-	-	-
-	-	-	-
-	-	-	-
-	-	-	-
-	-	-	-
-	-	-	-
(223,065)	-	-	-
-	(147,116)	-	-
-	-	-	-
-	-	-	-
-	-	-	-
-	-	-	-
-	-	-	-
-	-	-	-
-	-	-	-
-	-	-	-
-	-	-	-
(8,259)	(2,592)	14,560	3,965
130,835	156,040	260,193	77,353
\$ 130,835	\$ 156,040	\$260,193	\$77,353

Other Funds

Construction 1974 Agreement	Reserve Maintenance Fund	Cogeneration Fund	Clients Fund
\$ 41,540	\$32,612	\$ 5,096	\$43,793
77,307	7,000	-	-
-	-	-	-
10,813	-	-	-
-	-	-	-
-	-	-	-
-	-	-	-
(412,015)	-	-	-
-	-	-	-
720,370	-	-	-
(199,376)	-	-	-
-	-	-	-
-	-	-	-
80,000	-	-	-
-	-	-	-
(80,000)	-	-	-
(487)	-	-	-
-	-	-	-
-	-	-	-
-	-	-	-
-	-	-	-
-	-	-	-
-	-	-	-
-	-	-	-
-	-	-	-
-	-	-	-
-	-	-	-
(10,180)	1,864	(5,096)	4,980
227,972	41,476	-	48,773
(35,857)			
\$ 192,115	\$41,476	\$ -	\$48,773

Puerto Rico Electric Power Authority
 Supplement Schedule of Changes in Cash and Investments by Funds
 Year ended June 30, 2002
 (In Thousands)

	General Purposes Funds				
	Total	General Fund	Revenue Fund	Working Fund	General Obligations Notes 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			
Interest 1974 Agreement	Principal 1974 Agreement	Reserve 1974 Agreement	Self Insurance Fund
\$102,659	\$141,732	\$228,553	\$68,936
241,359	146,989	-	-
-	-	-	-
-	-	-	-
-	-	-	-
-	-	-	-
-	-	-	-
-	-	-	-
-	-	-	-
-	-	-	-
-	-	-	-
-	-	-	-
-	-	-	-
-	-	-	-
-	-	-	-
-	-	-	-
-	-	-	-
-	-	-	-
-	-	-	-
(210,993)	-	-	-
-	(144,863)	-	-
-	-	-	-
-	-	-	-
-	-	-	-
-	-	-	-
-	-	-	-
-	-	-	-
-	-	-	-
-	-	-	-
-	-	-	-
-	-	-	-
-	-	-	-
(18,848)	3,533	17,080	4,452
114,177	147,391	245,633	73,388
<hr/>			
\$ 114,177	\$147,391	\$245,633	\$73,388

Other Funds			
Construction 1974 Agreement	Reserve Maintenance Fund	Cogeneration Fund	Clients Fund
\$17,696	\$23,791	\$4,749	\$45,378
99,600	7,000	-	-
9,685	-	-	-
-	-	-	-
-	-	-	-
-	-	-	-
(405,638)	-	-	-
-	-	-	-
-	-	-	-
600,002	-	-	-
-	-	-	-
-	-	-	-
-	-	-	-
36,000	-	-	-
(299,000)	-	-	-
(6,044)	-	-	-
-	-	-	-
-	-	-	-
-	-	-	-
-	-	-	-
-	-	-	-
-	-	-	-
-	-	-	-
-	-	-	-
-	-	-	-
-	-	-	-
-	-	-	-
-	-	-	-
-	-	-	-
-	-	-	-
(2,219)	1,821	347	(1,585)
50,082	32,612	5,096	43,793
<hr/>			
(8,542)			
<hr/>			
\$ 41,540	\$32,612	\$5,096	\$43,793

Puerto Rico Electric Power Authority
 Supplemental Schedule of Changes in Long-Term
 Debt and Current Portion of Long-Term Debt
 Years ended June 30, 2002 and 2001
(In Thousands)

	<u>2002</u>	<u>2001</u>
Long-term debt excluding current portion:		
Balance at the beginning of year	\$3,956,216	\$3,485,426
Transfers to current liabilities:		
Power revenue bonds	<u>(125,181)</u>	<u>(152,248)</u>
Total transfers	<u>(125,181)</u>	<u>(152,248)</u>
Remainder	3,831,035	3,333,178
New issues:		
Power revenue bonds	515,305	612,240
Power revenue refunding bonds	205,065	-
Note payable to EcoElectrica	-	-
Debt discount on new bond issues - net	23	(6,438)
Defeasance of bonds	<u>(203,735)</u>	<u>-</u>
Debt discount and excess reacquisition costs on cancelled bonds - net	<u>(9,131)</u>	<u>-</u>
Accretion of capital appreciation bonds	<u>14,296</u>	<u>17,236</u>
Balance at the end of year	<u>\$4,352,858</u>	<u>\$3,956,216</u>
Current portion of long-term debt:		
Balance at beginning of year	<u>\$ 285,939</u>	<u>\$ 262,842</u>
Transfer from long-term debt	<u>125,181</u>	<u>152,248</u>
Payments to bondholders:		
Power revenue - July 1	<u>(143,214)</u>	<u>(141,088)</u>
Power revenue - January 1	<u>(3,902)</u>	<u>(3,775)</u>
Total payments	<u>(147,116)</u>	<u>(144,863)</u>
Amortization of debt discount and excess reacquisition costs	<u>16,066</u>	<u>15,712</u>
Balance at end of year	<u>\$ 280,070</u>	<u>\$ 285,939</u>

See accompanying notes.



August 8, 2003

Puerto Rico Electric Power Authority
San Juan, Puerto Rico

Dear Sirs:

Washington Group International (“Washington Group”), 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 U.S. Bank Trust National Association 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 2002.

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 Group 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 Group 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 Group without it having conducted an independent investigation thereof. In addition, Washington Group 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 Group 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 961 MW of capacity presently being provided by cogenerators as described in the Official Statement to which this letter is appended, and its 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

A handwritten signature in cursive script, reading "George W. Romano, Jr.", written in black ink.

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

SIDLEY AUSTIN BROWN & WOOD LLP

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August __, 2003

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

\$517,305,000
PUERTO RICO ELECTRIC POWER AUTHORITY
POWER REVENUE BONDS, SERIES NN
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, and subject to redemption prior to maturity, all as set forth in the resolution of the Authority authorizing the issuance of said Series NN Bonds (the “Bonds”).

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 U.S. Bank Trust National Association, 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 rendered on 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 for in the documents pertaining to the Bonds) or in reliance upon advice of counsel other than ourselves on the exclusion from gross income of the interest on 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 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 GUARANTY INSURANCE POLICY

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

Policy No. [NUMBER]

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

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

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

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

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

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

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

COUNTERSIGNED:

Registered Licensed Agent

City, State

STD-RCS-6
4/95

MBIA Insurance Corporation

President

Attest:

Assistant Secretary